Highlights—ADO 2007

Developing Asia's performance in 2006 was exceptional. Strong growth of 7.6% looks set for 2007, and inflationary pressures should ebb. Managing macroeconomic stresses, moving ahead with micro reforms, and rebalancing economic growth are important challenges. Asia also needs to do better at creating jobs.

Synopsis

Growth in 2006 is the fastest since 1995

- Developing Asia's expansion gathered speed in 2006. Regional GDP grew at 8.3%, faster than any year since 1995. Growth was aided by a highly favorable external environment, benign domestic circumstances, good economic management, and the fruits of reform efforts.

Stresses and imbalances become more visible

- But evidence of imbalances and overheating continued to gather: surging property and equity markets, fast credit expansion, and rising goods prices, particularly of foodstuffs. Authorities answered by raising interest rates, mopping up excess liquidity, and restraining credit growth and public spending. But structural responses have been slower. Widening current account surpluses as well as capital inflows contributed to a further buildup of international reserves. In trade-weighted terms, and adjusted for inflation, many regional currencies appreciated in 2006, though some remained broadly unchanged. Inequality, job creation, and environmental pressures are growing concerns.

Brisk expansion is expected in 2007 and 2008

- Although the pace of expansion is expected to ease in 2007 and 2008, growth is still set to remain brisk. Net exports' contribution to growth will soften, but strengthening domestic demand will fill part of the gap. Another year of strong performance should see GDP growth of 7.6% in 2007, with little change in tempo in 2008. In response to tightening measures and lower oil prices, inflationary pressures should start to recede. Current account surpluses will begin to narrow as a share of GDP, but slowly.

Performance in 2006

The PRC and India's weight in regional output is getting larger

- Prodigious growth in the People's Republic of China (PRC) and India underpinned aggregate regional expansion in 2006. The share of both in regional output continued to increase.

The PRC grows at a blistering 10.7%

- In the PRC, rapid expansion of exports and strong fixed asset investment spurred growth to 10.7% in 2006. To cool the economy, the authorities raised interest rates, increased bank reserve requirements, mopped up excess liquidity in the financial sector, and applied a raft of administrative controls intended to curtail or delay new projects. Fixed asset investment slowed in the second half, but export growth continued unabated, and the current account surplus swelled to 8.6% of GDP. Reserves in the PRC broke through the $1 trillion mark. Inflation rose toward the end of the year, largely as a result of rising grains prices. Elsewhere, favorable commodity prices helped lift growth in Mongolia. Korea expanded by a robust 5%. East Asia's growth accelerated to 8.7% in 2006.

India consolidates fast growth

- In India, vibrant industrial growth as well as buoyant services helped growth accelerate to an estimated 9.2%. Manufacturing exports expanded at a fast clip. Employment in manufacturing also picked up. But steadily rising wholesale price inflation, booming property prices, and ballooning credit growth has prompted the Reserve Bank of India to crank up policy rates and to impose restraints on lending to the property sector. Sluggish agricultural productivity growth remains a concern as the majority of India's population still depends on agriculture for their livelihoods. Sharp rises in food prices have underlined the need for structural reforms.

Trend growth in Bangladesh and Pakistan accelerates

- Trend growth in Bangladesh and Pakistan again accelerated in 2006, but the countries' performance on inflation was less impressive. In Bangladesh, annual inflation picked up in response to fast credit growth, pass-through to consumers and producers of oil-price rises, and higher commodity prices. In Pakistan, inflation came down from its earlier peak in 2005, but remained well above target. In the Maldives, growth in 2006 bounced back as it recovered from the devastation of the tragic tsunami. Despite hostilities, fueled by expansionary spending policies, growth accelerated in Sri Lanka. Political developments continued to dominate in Nepal, and growth remained anemic. A drought dragged down growth in Afghanistan, while Bhutan benefited from increased hydropower exports to India. For South Asia as a whole, growth of 8.7% was the fastest since 1988.

Central Asia booms on oil price gains

- Azerbaijan and Kazakhstan's performance benefited from high oil prices. Although oil prices drifted down in the fourth quarter, average prices in 2006 were still 20% higher than in 2005. A housing boom and heavy investments in mineral development sustained Armenia's rapid growth. In the Kyrgyz Republic, growth was slow, due to weak gold production and lingering political difficulties. Strong remittances, as well as healthy aluminum output and exports, sustained growth in Tajikistan. Uzbekistan kept up its solid growth record, helped by continued farm privatization. Central Asia's GDP grew at 12.4%.

Southeast Asia shows checkered growth

- Southeast Asia's performance was patchy. Growth in Indonesia was lame due to weak consumption and fixed investment spending. But as monthly inflation rates eased, Bank Indonesia lowered policy rates. In the Philippines, growth edged up on a strong recovery in agriculture, but investment

stayed weak. Net exports lifted Thailand's growth, but domestic demand was crimped by earlier increases in interest rates and by gathering political uncertainty. In Malaysia, strong growth of domestic consumption helped lift growth; public investment spending accelerated. Viet Nam's impressive run of rapid growth continued: strong domestic demand growth was supported by gains in oil prices and by vibrant exports. Cambodia and the Lao People's Democratic Republic both showed healthy expansion. Aggregate growth in Southeast Asia was 6.0% in 2006.

- The Pacific islands grew at 3.1%. The two largest economies, Papua New Guinea and Fiji Islands, both enjoyed faster expansion, lifting the average. In Timor-Leste, civil disorder and security problems stymied growth of the non-oil economy. Elsewhere, performance was uneven. Overall in the Pacific, outcomes remain largely unimpressive and are constrained as much by economic mismanagement and ineffective institutions as by the disadvantages of small size and remoteness.

Growth lags in Pacific islands

International outlook

- Prospects for the international economy remain broadly favorable. Despite production cuts by the Organization of the Petroleum Exporting Countries, crude oil prices are well off their highs of August 2006. Some metals prices, such as copper, have also come down. Lower commodity prices will generally ease inflationary pressures and bring terms-of-trade gains, as developing Asia is a net importer.

Commodity prices are set to soften

- Growth in the major industrial economies is set to slow, but growth in the euro zone and Japan is close to potential. Inflationary pressures seem to be slowly dissipating in the United States (US). Corrections in the housing market there have been sharp, but not disorderly. There is now less dissonance about the outlook, and the chances of a recession are receding (though not completely), and so far markets have absorbed risks. As investment spending pulls back, US growth is expected to slow in 2007. In Europe, the outcome in 2006 was the best in 6 years and momentum has picked up. Germany leads the way, but business and consumer confidence is more broadly strong. Growth may moderate a little in 2007. In Japan, domestic demand has come back to life after temporarily sagging in the middle of 2006. Employment growth and positive business sentiment should help support demand, and growth should nearly match 2006's performance. Although the Bank of Japan raised interest rates in February, tightening is expected to be gradual.

Growth is seen moderating in G3

- With easing of industrial output growth, global trade volumes will expand less quickly than last year, but at a still-robust pace. However, there are indications that the global electronics cycle could slip a gear, and if capital spending slows more quickly than anticipated in the US, the downdraft would be felt by Asian producers.

Growth of trade volumes will stay robust

Prospects for developing Asia

- As output growth gently slows in industrial countries, there will be modest knock-on effects in developing Asia. Lower oil prices should help soothe inflationary pressures, as might any appreciation of regional currencies. Domestic tightening measures already taken in 2006 and followed up in 2007 will help guide down both output growth and inflation. For developing Asia, robust growth of 7.6% is projected in 2007 with inflation easing to 3.0%. With expenditure switching to domestic demand, the region's current account surplus is seen narrowing. Growth is expected to nudge up to 7.7% in 2008.

Developing Asia is picked to grow at 7.6% in 2007

- In the PRC, efforts to restrain galloping fixed asset demands are expected to gain more traction in 2007. Recent monthly data are yet to show clear trends for industrial production and fixed asset investment. It may prove difficult for the central Government to make lasting inroads into investment spending, as this will depend on it changing the strong incentives for expansion at provincial and local levels. Concerns linger about excess liquidity in financial markets; reserve-ratio requirements for commercial banks, as well as interest rates, were raised early in 2007. Further reserves accumulation in 2007 is expected, and this will continue to exert pressures on domestic liquidity. Aggregate growth of 10.0% is forecast for 2007. Pressures for spending will ease, allowing growth to moderate to 9.8% in 2008.

Gentle deceleration seen in the PRC

- In India, the key wholesale price index of inflation hovered just below 6.5% in early 2007, well above the central bank's comfort level. The Reserve Bank of India has, in fact, lifted policy rates on four occasions since April 2006, has increased reserve-ratio requirements on commercial banks, and has imposed limits on bank lending to the property sector. Growth is expected to trim to about 8% (and inflationary pressures abate) in 2007, but accelerate a little in 2008, provided that restraints do not inadvertently choke off industrial expansion. The pace of reform momentum in India is weakening as elections approach.

India's growth, too, will ease in 2007

- Although growth in most other countries will come off the pace set in 2006, the region's economic pulse remains strong. In some countries though, growth should accelerate. With inflationary pressures receding, and with the prospect of further interest rate reductions, growth in 2007 is expected to pick up in Indonesia, which is also showing hopeful signs of a recovery in consumption and investment spending. In the Kyrgyz Republic, growth should accelerate as the political situation settles and gold-mining operations expand. There is also some upside potential in other countries, such as Papua New Guinea, which is expected to benefit from favorable export prices and a recovery in mining.

Some countries, like Indonesia, are expected to accelerate

- In a few countries, prospects are now much more uncertain. Even before the coup of December 2006, Fiji Islands faced many challenges and 2007 looked as if it would be a difficult year. But now the attrition of confidence and loss of new aid flows triggered by the coup may push the country into recession. In Thailand, consumer and business confidence is slipping and growth is expected to slow in 2007. The introduction of capital controls in December 2006 unsettled markets and fine-tuning is still going on. Clarity about future direction is yet to emerge. Bangladesh's caretaker Government will remain in power until elections are held. Early

Some countries face downside political risks—others upside risks

indications there suggest that conditions for business could improve as reform momentum is maintained and the anticorruption drive intensifies. Nepal is looking forward to elections, which, if they go well, could yield a peace dividend.

Challenges

- Macroeconomic stabilization, structural rebalancing, and building markets and institutions to support future growth are the biggest challenges facing developing Asia. In some ways they are linked, but stabilization has to move fastest.

Stabilization is a key challenge

- Rising inflation (or pressures for credit expansion) and rapidly accumulating foreign exchange reserves suggest that adjustments would be helped both by an increase in interest rates and by an appreciation of domestic currencies. Smaller exchange rate adjustments would require larger interest rate rises to douse inflationary threats. But any capital inflows attracted by higher interest rates would add to forces for the expansion of domestic liquidity.

Exchange and interest rates need to adjust

- In part, macro pressures reflect underlying structural impediments. Retarded agricultural development in India has contributed to rapidly rising food prices and distributional tensions over land use. Constraints on consumption spending in the PRC fan the investment boom and the ballooning external surplus.

Structural imbalances aggravate macro stabilization problems

- Closer regional integration and tighter links to the G3 are connected facets of globalization. They stress the need for strong macroeconomic policy coherence and sound prudential management, as well as for initiatives that support these aims at a global, regional, and domestic level. Evidence about the evolving nature of macroeconomic and trade relationships is examined in Part 1 (*Uncoupling Asia: Myth and reality* and *Trade and structural change in East and Southeast Asia: Implications for growth and industrialization*).

Asia is integrating more deeply with itself and the world

- Developing Asia can make better use of its huge international reserves, exceeding $2 trillion at end-2006. By most measures, countries are holding reserves far in excess of those they need to cover short-term maturing foreign exchange liabilities, plus any demands that may come from internal sources. Even on conservative assumptions, redeployment of reserves could yield a substantial fiscal dividend. For example, if only 50% of developing Asia's reserves were invested in a globally diversified portfolio, attracting a yield of 500 basis points above the current return, this would generate a $60 billion fiscal dividend, equivalent to about 0.9% of regional GDP. These additional resources could plug infrastructure gaps and increase the supply of essential public goods. Or they could be used to retire public debt, creating larger fiscal space in the years ahead.

Countries are looking for better ways to use their reserves

- Some countries are already taking a more active posture. The Korean Investment Corporation (formed in 2005) has a mandate "to achieve sustainable returns on foreign currency assets." In March 2007, the PRC authorities announced their intention to more actively manage their foreign exchange reserves. But while the potential rewards are certainly

Korea is already moving in this direction

tempting, central banks and governments are rightfully wary of risks. If investments go bad, it could undermine confidence in government or the central bank (or both). Having an appropriately regulated "fund," acting at arm's length, to manage some portion of reserves may have advantages. But setting up such structures and attracting people with the right expertise to run them will take time.

- A more direct approach, recently proposed in India's budget, is to use reserves to pay for foreign-currency costs of projects or to guarantee borrowing by special-purpose investment vehicles. The latter approach could exert pressure toward currency appreciation. Interest rates could also rise, as a consequence of sterilization operations. With no sterilization, investment guarantees that attract foreign debt inflows would imply domestic credit expansion.

Some approaches may put upward pressure on exchange rates

- Exchange rate management issues remain to the fore. Although the yuan appreciated against the US dollar by 3.3% in 2006, its trade-weighted value barely budged. But other regional currencies, such as the baht and the peso, moved up in trade-weighted terms.

Exchange rates are appreciating at different speeds

- Thailand's controls on capital inflows introduced in December triggered a market rout. The initial rules were widely regarded as too stringent. In response, exemptions have been widened. As offshore investors do not bear the costs of any destabilizing effects of their behavior, a tax on inflows could be beneficial.

Taxing capital inflows can make sense

- But theory and practice can be different. First, identifying conditions that warrant a tax on capital inflows is not straightforward. Even if the Thai baht appreciated sharply in 2006 against the US dollar and reserves accumulated, it is uncertain that this threatened the economy or export businesses. In trade-weighted terms, the appreciation was unexceptional. Also, the appreciation did not deter healthy export performance, and the trade balance moved from deficit to surplus in 2006.

The devil is in the detail

- Even if there is compelling evidence that the pressures directed toward speculative capital inflows need easing, there are questions of how to do this. Precisely because capital is fungible, designing regulations that are not porous is extremely difficult. If short-term capital flows threaten destabilization or longer-term structural damage, simpler approaches, perhaps based on flat withholding taxes on inflows with rebates for approved transactions, may have attractions.

Simple taxes are best

- Fast economic growth can both breed complacency and slow reform efforts. But as the Asian crisis painfully illustrated, the failure of institutions and structural policies to keep pace can derail growth. It is much easier to adjust and make difficult changes in good weather.

Fast growth can breed complacency

- The challenge in the PRC is to diversify growth and spread its benefits more widely. But there are constraints. In some sense, the availability of resources has run ahead of the capacity to administer and deliver high-quality services. A crucial blockage is the banking and financial system, which is geared to lending for enterprise investment but not yet for

In the PRC, bank-dominated finance is a bottleneck

household needs, including spending on durables, education, and health care. Easing constraints will require a variety of institutional and policy adjustments in the financial and fiscal arenas.

India needs to sustain industrialization

- Industrialization in India is gathering pace, having had several false starts in earlier decades. The country needs a vibrant industry sector to sustain growth and create jobs. Maintaining momentum will require attention to glaring infrastructure inadequacies, as well as to labor and other regulations that can deter investors.

Investment is struggling in some countries

- Investment appears to be struggling in some countries. The fixed investment ratio is falling in the Philippines and industry's share in output is declining. In Pakistan, fixed investment is a constraint in pushing growth to the next level and modernizing the economy. In Indonesia, the Asian crisis and a comparatively slow recovery appear to have badly dented investor confidence. In Malaysia and Thailand too, postcrisis investment rates have remained in the doldrums. Investment rates may have been too high before the crisis, but they are now too low (see Part 1, *Ten years after the crisis: The facts about investment and growth*).

Policy, regulatory, and institutional failures hinder investment

- Investment shortfalls mask deeper challenges. Business investment climate surveys point to a wide array of problems that vary in nature and degree across countries. Some countries in developing Asia, such as Korea and Malaysia, do well by international standards, but many do not. Heavy and sometimes predatory regulation, corruption, onerous administrative requirements, and difficulties with contract enforcement can quickly turn profits to losses, and assets into liabilities. Central to all this is improving the policy, regulatory, and institutional environment in which businesses operate.

Infrastructure gaps hobble private investment

- Across developing Asia, complaints about poor infrastructure are heard time and again. Good infrastructure is needed to connect villages and towns to each other and to the global economy. In India, poor rural infrastructure is taking its toll on agricultural productivity growth. In the Philippines, stark infrastructure gaps have played a role in retarding industrialization and job creation. High levels of congestion, squalor, and grime in Asia's megacities are a result of years of sorely neglected infrastructure investment (and maintenance). By adding to costs, poor infrastructure services deter private investment.

Prospects ultimately depend on capacity to change

- *Asian Development Outlook 2007* throws the spotlight on a variety of structural issues. Developing Asia's prospects over the next few decades will depend critically on its ability to adapt in a constantly changing environment.

What you make, and how you make it, matters

- In *Growth amid change,* it is shown that those countries that have sustained fast growth have *both* successfully industrialized *and* expanded services. Successful industrialization is intimately linked to the kinds of products made and how they are made. Korea, Malaysia, and Singapore, for example, have all been successful at moving up the technological ladder. For some countries, market size and location restrict opportunities for industrialization. These countries will have to incubate approaches tailored to their own circumstances and potential. For some, outmigration and inward remittances may offer opportunities that would otherwise not be available.

- "Walking on two legs"—fostering both industry and services—is the only viable development model for most countries. Services, as well as industry, offer significant potential for productivity gains. And a vibrant industry sector needs efficient services infrastructure. High-productivity tradable services can make an important contribution, but on their own they are unlikely to create sufficient jobs. Education constraints may also limit rapid expansion of high-productivity services.

Services alone cannot sustain growth

- Approaches need to be country specific, but some orthodox elements are crucial: high investment rates that over time build, expand, and upgrade the range of economic activities; funds for infrastructure services vital for economies of scale and other benefits; relevant and purposeful education (discussed in *Education and structural change in four Asian countries*); markets that support labor mobility and flexibility, alongside affordable social protection; arrangements that lower risks and uncertainty for businesses, allowing them to create wealth; and integration that exposes countries to diversity as well as to new technological and institutional designs.

How to shift gear smoothly

- Yet markets cannot accomplish everything on their own. New economic activities and the diversity that appears vital for growth may need a helping hand. But good design principles are key. Winners need to select themselves through performance, not be picked by governments.

Design principles are key

Risks

- As always, events could evolve in surprising and unexpected ways, and derail projections. Given underlying economic momentum, risks remain tilted down.

Risks remain tilted down

- Markets have moved to reprice risks in a calm manner so far this year. Yet this could still give way to less settled conditions—a turn of events triggered by policy mistakes, or geopolitical or other shocks. If asset prices are badly punctured, and markets decisively reverse, the chill will soon be felt.

Asset market reversals are a threat

- While any slowdown in global growth would adversely affect the volume of world trade, the failure of the Doha Round would make things worse. In this growing vacuum, preferential trade agreements would thrive further and already-audible protectionist calls would be amplified.

Protectionist calls are growing

- The overall geopolitical and security situation remains a source of uncertainty. The price of strategic commodities, such as oil, could be hit by negative developments. In the event of a human flu pandemic, developing Asia would bear a disproportionately high cost.

Geopolitical and security risks could harm prospects

- Recent developments have brought country risks to the fore. Security issues across Asia are unresolved. In some countries, important elections are scheduled, and their outcomes will be crucial for confidence.

Country risks need to be watched