Developing Asia and the world

Developing Asia and the Pacific: Performance and prospects

Performance in 2006

Developing Asia grew at its fastest pace in 11 years in 2006 (Figure 1.1.1). Steady global expansion of output and trade, moderate inflation with low real interest rates, as well as the impact of earlier reforms on productivity, were all conducive to growth. In many countries, circumstances proved unusually benign, and risks failed to materialize.

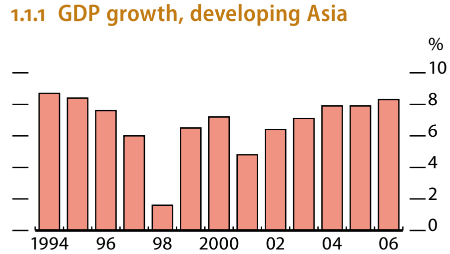
Asia's giants—the People's Republic of China (PRC) and India—alone accounted for just under 70% of the region's expansion. In 2005, the PRC accounted for 41% of regional output compared to just 35% in 2000. India's share in regional output increased by half a percentage point (Figure 1.1.2).

In both countries, fast growth coexists with stresses and imbalances. In the PRC, booming exports and fixed asset investment again propelled growth. The authorities—concerned about the pace and quality of fixed asset investment, fast credit growth in the banking sector, and rising asset prices—raised interest rates, increased reserve requirements for banks, and introduced a raft of administrative controls intended to discourage or defer new capital projects. As a consequence, the growth of fixed asset investment slowed in 2006, though it still advanced at double digits. Export growth showed no letup, and the current account surplus widened again. By December 2006, the PRC had amassed international reserves of close to $1.1 trillion. To stem the leeching of reserves into domestic liquidity, the People's Bank of China sold additional sterilization bonds.

In India, agricultural productivity continued to languish, largely reflecting neglected infrastructure and poor rural extension services. Rising food prices contributed significantly to inflation. Tensions also surfaced as rapidly expanding industry and services activities encroached on agricultural land. Gaps continued to widen between the more prosperous coastal states and those in the interior of India—where population growth is fastest and the record on job creation weakest.

Many other countries also enjoyed vigorous growth. Azerbaijan and Kazakhstan again saw benefits from high oil prices. Favorable commodity prices helped expansion in Mongolia. Armenia's construction boom continued, and the services sector grew by 20% as rising wages and remittances bolstered private consumption. Cambodia saw double-

1.1.1 GDP growth, developing Asia



Source: Asian Development Outlook database.

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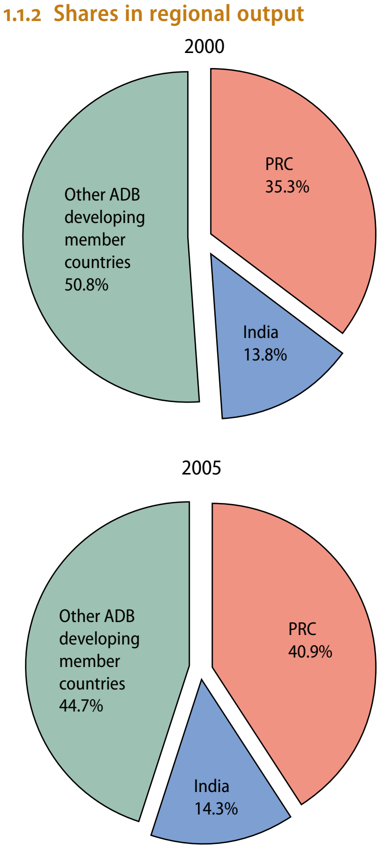
1.1.2 Shares in regional output



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digit rates of expansion for the third straight year: textiles, tourism, and agriculture all performed well. Robust growth has become almost routine in Viet Nam, and 2006 was no different, with both exports and domestic demand making strong contributions. Growth in the Lao People's Democratic Republic (Lao PDR) accelerated, as large hydropower and mining projects progressed. The Maldives bounced back from the destruction of the tragic 2004 tsunami, growing at 18.2%. Although Pakistan could not repeat its record-breaking performance of 2005, growth in 2006 was above its recent pattern. Bangladesh, too, continued to see its trend up. Despite civil conflict, Sri Lanka grew at its quickest pace since 1979, buoyed by strong private sector activity and expansionary public spending. (Figure 1.1.3 gives a profile of growth in developing Asia.)

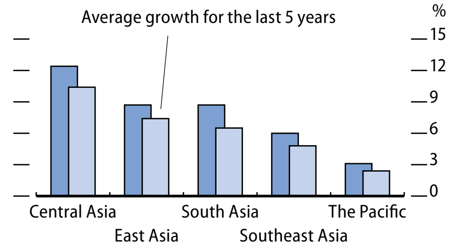
However, performance was patchy in the larger economies of Southeast Asia. High interest rates—aimed at bringing down the inflationary surge caused by the reduction of gasoline and diesel subsidies late in 2005—curtailed growth in Indonesia. Consumption and investment demand growth was insipid. In the Philippines, growth edged up from 2005, underpinned by a strong recovery in agriculture. But investment spending stayed weak. In Thailand, net exports lifted growth, but gathering political uncertainty dented domestic demand, and business and consumer confidence ebbed. Growth accelerated in Malaysia, largely primed by another year of robust consumption demand and greater public investment spending.

Growth in the Pacific countries followed a familiar sawtooth pattern, with growth accelerating in some countries but slowing in others. Growth accelerated in Fiji Islands and Papua New Guinea and, as these are the largest economies, lifted overall performance. The former benefited from a pickup in sugar production and in construction, and latter from favorable export prices.

Weak performance was seen in isolated cases. In Nepal, politics continued to dominate and growth was slow. Growth in the Kyrgyz Republic moved into positive territory, but recovery was hampered by weak gold production and by lingering political difficulties. Civil disorder in Timor-Leste caused its non-oil economy to shrink, but oil extraction activity (which is accounted for separately) was unaffected. Economic activity also contracted in the Federated States of Micronesia. Growth in the Cook Islands, Kiribati, and Tonga trailed in at less than 2%.

Despite exceptionally fast growth and rising oil prices, consumer price inflation did not, in general, accelerate in 2006. The outcome of 3.4% was less than the 4.0% projection made in *Asian Development Outlook 2006*. But this aggregate pattern disguises wide variations at the country and subregional level (Figure 1.1.4). In some countries, inflationary pressures rose as the year progressed. In India, wholesale price inflation accelerated, despite tightening measures by the Reserve Bank of India, which raised interest rates on four occasions in 2006, lifting the key policy rate from 6.25% to 7.25%. The central bank also imposed tighter reserve requirements on commercial banks and stricter conditions for lending to the property sector. In Bangladesh too, annual inflation accelerated. Fast credit growth, pass-through of earlier oil price rises, and rising prices of other commodities all contributed to inflation. Although inflation fell in Pakistan, it remained high and above the State Bank of Pakistan's target.

1.1.3 Profile of regional growth, 2006



Source: Asian Development Outlook database.

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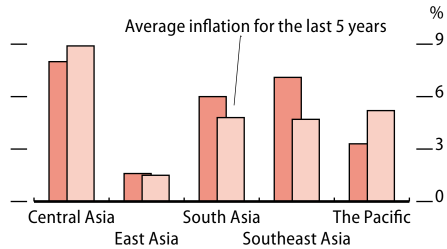
1.1.4 Regional inflation trend, 2006



Source: Asian Development Outlook database.

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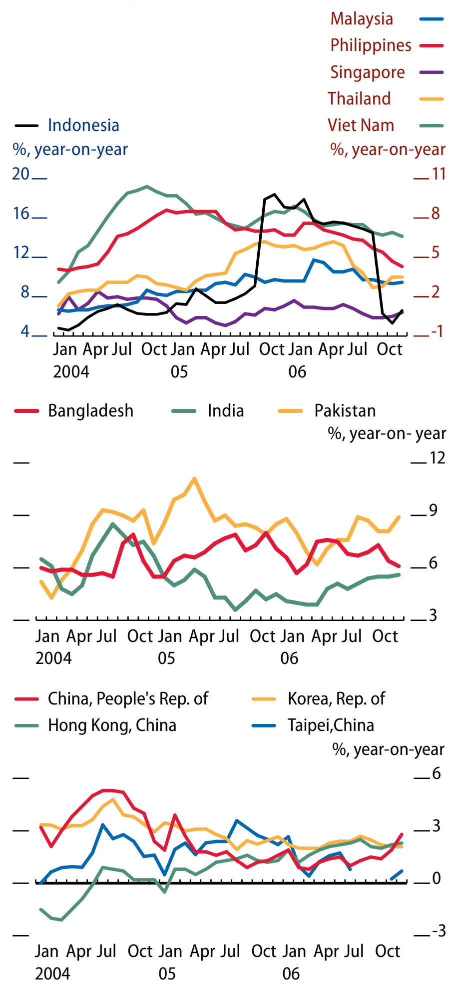
1.1.5 Monthly inflation rates



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

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In Sri Lanka, inflation accelerated over the course of the year to average 9.6%. Strong domestic demand in Central Asia, fed by high oil prices, lifted inflation to 8.0%.

In the PRC, food prices climbed toward the end of the year, and although monthly inflation picked up, the annual average remained low. Highly competitive supply conditions in industry helped restrain consumer price inflation, as did falling oil prices in the later months of the year. But overheating manifested itself in other ways. In particular, bank credit remained a concern, and equity and property prices soared. In response, the central bank lifted the key policy interest rate by 54 basis points in 2006, and increased reserve requirements on commercial banks on three occasions. It subsequently raised interest rates by another 27 basis points in March 2007.

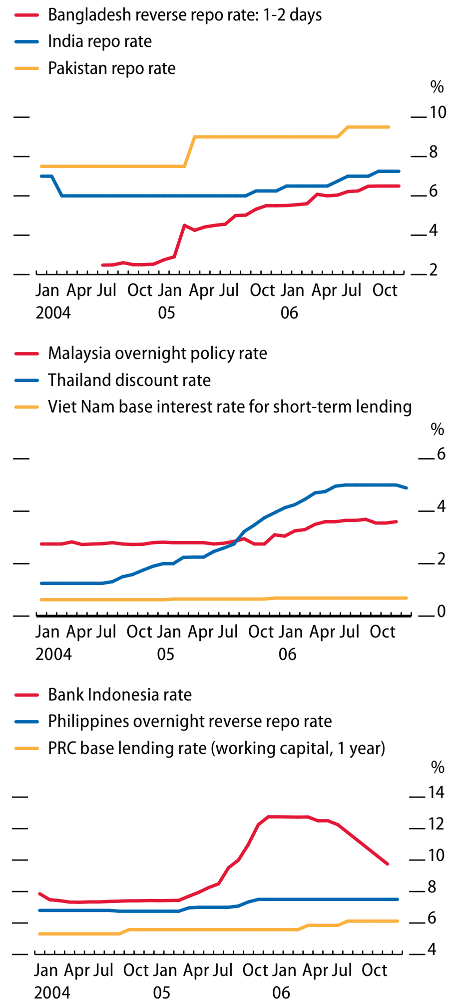
In Indonesia, Malaysia, and Thailand, annual average inflation rates rose. In large part, this reflected the effects of increases in oil prices and of reduced retail subsidies on gasoline and diesel. However, in the second half of the year monthly inflation rates began to slow, responding to tighter monetary conditions (Figure 1.1.5). Modest exchange rate appreciation also played a part. In the Philippines, where the pass-through of high oil prices was quick, annual headline inflation fell in 2006. In view of falling monthly inflation rates, a number of countries lowered policy interest rates—most notably Indonesia, where the central bank lowered its main policy rate by 300 basis points in seven steps during the year (Figure 1.1.6).

Fiscal risks were to the fore in some countries of Central Asia, as well as in Sri Lanka. Tajikistan's external debt position leaves little room for maneuver and the Kyrgyz Republic's debt indicators make it eligible for relief under the Heavily Indebted Poor Countries initiative. In Sri Lanka, rising public spending widened the deficit and was partly financed through domestic credit expansion. Pakistan also ran a sizable fiscal deficit in 2006, to support development programs and earthquake rehabilitation and reconstruction activities.

Elsewhere, deficits were generally modest, and were financed with comparative ease. Strong growth buoyed fiscal revenues. Various countries continued their efforts to bring down levels of public debt. In the Philippines, a legislative impasse in the approval for the 2006 budget led to nominal expenditures being frozen at 2005 levels. As a consequence, expenditures as a proportion of GDP fell. At the same time, revenues accrued from the newly expanded value-added tax. Reduced outlays and rising revenues cut the central Government's deficit to just 1% of GDP. In Indonesia and Malaysia too, deficits were modest in 2006 as governments sought to consolidate or reduce debt. Thailand's planned disbursements for infrastructure projects were delayed by political uncertainties.

In India, the Fiscal Responsibility Act is a centerpiece of the Government's economic stabilization and reform program. It calls for a reduction in the federal budget deficit by at least 0.3% of GDP a year, taking it to 3.0% of GDP by FY2008 (ending March 2009). In 2006, the federal budget deficit as a proportion of GDP again fell, despite rising expenditures on social programs and on rural infrastructure. Fast growth has done much to buoy revenues. Improved collection at the state level has also helped the overall fiscal position.

1.1.6 Policy interest rates



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

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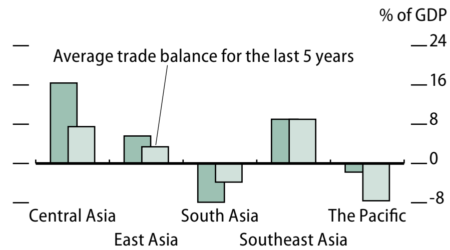
Developing Asia's trade surplus widened in 2006. Both the value of exports and imports grew quickly in United States (US) dollar terms, but as exports grew from a larger base, the trade surplus expanded. In some countries, export growth was extraordinary. In Azerbaijan, for example, it ballooned by 61% as new sources of oil and gas came on stream. Torrid growth of exports from Mongolia and Papua New Guinea reflected both higher volumes and better prices for their primary resources.

The PRC's merchandise exports again grew rapidly in 2006, barely down on 2005's expansion. Imports also grew briskly, but continued to trail export growth such that the PRC's trade surplus jumped to nearly $200 billion dollars, or 7.4% of GDP. This pattern of strong import growth but even stronger export growth was repeated in a number of other countries. Thailand moved from a trade deficit to a trade surplus and surpluses widened in Indonesia and Singapore. In the Republic of Korea (hereafter Korea) and Malaysia, trade surpluses narrowed. In South Asia, trade deficits were again the norm, and in all countries but Bangladesh and Bhutan they widened (Figure 1.1.7). Nevertheless, they remain manageable.

1.1.7 Regional trade balance trend, 2006



Source: Asian Development Outlook database.

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Broadly, current account payments positions moved in step with trade balances. For the region as a whole, the current account surplus in 2006 was 5.3% of GDP in 2006, the largest on record. Central Asia, East Asia, and Southeast Asia all posted hefty surpluses, but South Asia's deficit stepped up to over 2% of its GDP. Pakistan's deficit is large and was partly financed through privatization receipts. Buoyant remittances provided a valuable source of foreign exchange for a range of countries in 2006. In Central Asia, remittance income climbed in the Kyrgyz Republic and Tajikistan. It is also important to many small Pacific islands. In Bangladesh, Nepal, and Philippines, inward remittances reversed trade deficits and generated current account surpluses. Remittances significantly helped the payments positions of Pakistan and Sri Lanka.

Large current account surpluses made a significant contribution to reserve accumulation (Box 1.1.1). Developing Asia's stock of foreign exchange reserves at end-2006 reached about $2.3 trillion, up $418 billion in a year. Although the region attracted gross capital inflows in 2006, it also invested significantly overseas, which helped stem the buildup of reserves. Of the increase in total reserves, just less than 80% was attributable to current account transactions.

Outlook for 2007 and 2008

As usual, the outlook for developing Asia in 2007 and 2008 will hinge on prospects for the global economy. The idea that, because of its growing importance in global demand and strengthened intraregional trade linkages, developing Asia is now less susceptible to the vicissitudes of the international economy is at odds with the facts (see the chapter, *Uncoupling Asia: Myth and reality*, in Part 1).

As explained in the following section, *Prospects for the world economy in 2007 and 2008*, the outlook is broadly favorable. Although global growth is anticipated to slow, it will also become more balanced within the G3 (US, euro zone, and Japan). Growth is expected to come down in the US in 2007 before picking up in 2008, but output growth will

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

Developing Asia's foreign exchange reserves rose by $417.6 billion during 2006 to $2.28 trillion, according to preliminary data (box table). The advance was much larger than the $250.7 billion seen in 2005 and represented a return to the pattern of steadily increasing large annual gains made by the region since 2001 (Box figure 1).

The rebound in accumulation in 2006 was mainly due to recovery from anemic increases in 2005 by some large reserve holders such as Hong Kong, China; India; Korea; and Singapore, as well as solid gains made by Kazakhstan, Malaysia, and Thailand. All countries but one appear to have increased their foreign exchange holdings in 2006.

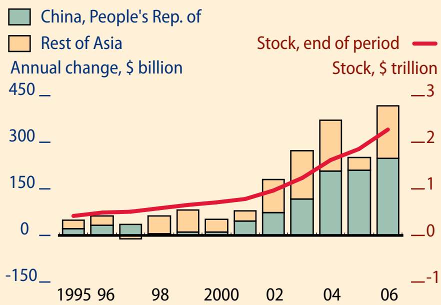
The larger increase in reserves of the People's Republic of China (PRC) in 2006 reflected a strengthening in its current account surplus during the year. At $1.066 trillion, the PRC accounted for about 47% of developing Asia's stock of foreign exchange reserves at end-2006, up from 27% at end-2001, accumulating about 57% of the region's increase in reserves over this period (versus 59% in 2006).

Box figure 2 indicates that the region's share in the United States (US) merchandise trade deficit, which has been relatively stable since 2000, increased at a faster pace in 2006. The trade deficit with developing Asia amounted to $323.9 billion, or 39.6% of the total trade deficit ($818.1 billion), up by 1.8 percentage points from 2005.

In East Asia, the PRC accounted for $232.5 billion, or 28.4% of the US deficit, up by 2.1percentage points, while the share of other countries fell by 0.5 percentage points, to produce a net 1.6 percentage point increase for East Asia. A deeper US trade deficit with Southeast Asia accounted for the balance of 2006's increase.

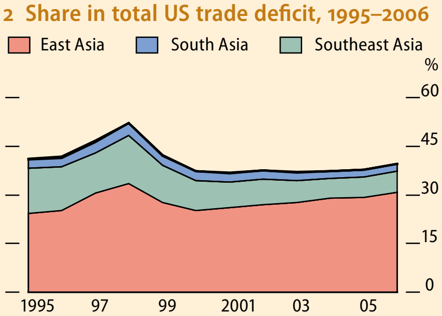
The PRC's gain in share of the US deficits since 2000 reflects both the country's development as the lowest-cost producer of many goods, and the growth of specialization and intraregional trade, which features exports of components and supplies to the PRC for assembly into goods for export.

1 Developing Asia's foreign exchange reserves



Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of China, available: http://www.cbc.gov.tw; Bank of Korea, available: http://www.bok.or.kr; all downloaded 8 March 2007.

2 Share in total US trade deficit, 1995–2006



Source: US Census Bureau, available: www.census.gov, downloaded 16 February 2007.

Developing Asia's foreign exchange reserves ($ billion)

	Stock end-2006	Change over the year 2006	2005
Central Asia	22.2	13.5	-2.0
Armenia	1.1	0.3	0.2
Azerbaijan	2.5	1.3	0.1
Kazakhstan	17.7	11.7	-2.4
Kyrgyz Republic	0.7	0.2	0.1
Tajikistan	0.2	0.0	0.0
East Asia	1,705.0	298.2	233.2
China, People's Rep. of	1,066.3	247.5	208.9
Hong Kong, China	133.2	8.9	0.7
Korea, Rep. of	238.4	28.4	11.8
Mongolia	0.9	0.5	0.2
Taipei,China	266.1	12.9	11.6
South Asia	190.3	42.0	6.3
Bangladesh	3.8	1.0	-0.4
Bhutan	0.5	0.0	0.1
India	170.2	39.2	5.9
Maldives	0.2	0.0	0.0
Nepal	1.6	0.1	0.0
Pakistan	11.3	1.5	0.3
Sri Lanka	2.6	0.0	0.5
Southeast Asia	358.1	63.3	13.3
Cambodia	1.2	0.2	0.0
Indonesia	40.7	7.9	-1.9
Lao People's Dem. Rep.	0.2	0.0	0.0
Malaysia	81.7	12.3	4.5
Myanmar	1.1	0.3	0.1
Philippines	19.9	4.1	2.8
Singapore	136.3	20.9	3.8
Thailand	65.1	14.6	2.0
Viet Nam	11.9	2.9	2.0
The Pacific	2.0	0.7	-0.1
Fiji Islands	0.2	-0.1	-0.2
Micronesia, Fed. States of	0.0	0.0	0.0
Papua New Guinea	1.4	0.7	0.1
Samoa	0.1	0.0	0.0
Solomon Islands	0.1	0.0	0.0
Tonga	0.0	0.0	0.0
Vanuatu	0.1	0.0	0.0
Developing Asia	2,277.6	417.6	250.7

Note: Foreign exchange reserves exclude gold, special drawing rights, and the reserve position in the International Monetary Fund.

Sources: International Monetary Fund, *International Financial Statistics* online database; Hong Kong Monetary Authority, available: http://www.info.gov.hk/hkma/; both downloaded 8 March 2007; staff estimates.

stay close to potential in both the euro zone and Japan. Global trade is expected to expand at about 7.5%, which is close to longer-term averages. Oil and other commodity prices are expected to come down in 2007, and again in 2008. But it is also possible that the global electronics cycle could turn in 2007, which would negatively affect export prospects particularly for East and Southeast Asia.

The baseline assumptions for individual economies are set out in each country chapter in Part 2. Monetary conditions are generally set to tighten in 2007 as a number of countries attempt to tame inflationary pressures. This is particularly true in South Asia but further tightening may also occur in the PRC if liquidity continues to wash through the economy. In Southeast Asia, as the pass-through effects of high oil prices come to an end, there may be scope for interest rates to come down. They have already been reduced in Indonesia and in Thailand.

Fiscal stances are tipped toward mild expansion but most countries are mindful of the costs that rising and high public debt brings. In the Philippines, a stronger fiscal position may allow some additional spending on priority programs, including infrastructure. Larger spending on infrastructure is also planned in Indonesia, Malaysia, and Thailand. In India, spending at the state level could threaten the commitments of the Fiscal Responsibility Act. Fiscal positions are more problematic in Pakistan and Sri Lanka, but it is expected that deficits will narrow in 2007. Fiscal consolidation is also needed in several Central Asian countries. In the PRC, the central Government's deficit is expected to stay below 1%, but spending for rural development and the environment may pick up.

Set against this background, robust growth is again expected in 2007 and 2008. Growth of 7.6% is projected in 2007, nudging up to 7.7% in 2008. These projections imply that growth will move onto a more sustainable footing and that overheating pressures that surfaced in 2006 will gradually abate. Table 1.1.1 summarizes projections by subregion for growth, consumer price inflation, and the current account balance (as a percentage of GDP).

Growth in all subregions, except the Pacific, is expected to slow in 2007. The biggest deceleration is likely in Central Asia, as lower oil prices work their way through to demand. The slowdown there partly reflects the removal of the one-time impact of large investment projects. Now that they are on stream, their effects register in a higher level of income, but not in a fillip to growth. In 2007, the pace of expansion is expected to moderate in Armenia, Azerbaijan, and Kazakhstan. A more stable political situation in the Kyrgyz Republic and new mining projects should help lift growth. There is also room for faster growth in Tajikistan.

In 2007, South Asia is expected to grow by 7.7%. Steps taken by the Reserve Bank of India to cool inflation are seen slowing India's pace of investment and consumption spending in 2007, and growth of 8% is forecast for 2007. But if inflation proves to be stubborn, further tightening by the central bank is likely to follow. In Pakistan growth

1.1.1 Selected economic indicators, developing Asia, 2005–2008

	2005	2006	2007	2008
Gross domestic product (annual % change)				
Developing Asia	7.9	8.3	7.6	7.7
Central Asia	11.2	12.4	10.3	9.4
East Asia	8.3	8.7	8.0	8.0
South Asia	8.7	8.7	7.7	8.0
Southeast Asia	5.6	6.0	5.6	5.9
The Pacific	2.5	3.1	4.5	2.8
Consumer price index (annual % change)				
Developing Asia	3.4	3.4	3.0	3.2
Central Asia	7.7	8.0	8.6	7.9
East Asia	2.0	1.6	1.9	2.2
South Asia [a]	5.3	6.0	5.5	5.3
Southeast Asia	6.3	7.1	4.2	4.0
The Pacific	2.4	3.3	3.5	3.3
Current account balance (% of GDP)				
Developing Asia	4.5	5.3	5.0	5.0
Central Asia	1.2	4.3	3.2	3.3
East Asia	6.0	7.0	6.8	6.9
South Asia	-1.2	-2.1	-2.2	-2.2
Southeast Asia	4.9	7.0	6.1	5.6
The Pacific	6.2	-2.0	-1.2	2.0

[a] India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

is expected to pick up on 2006: as stronger performance by agriculture is expected. There is also scope for expansion of the garment sector, but challenges are just over the horizon with the end of voluntary restraints on the PRC's textile and clothing exports to the US and European Union in 2008. In Bangladesh much will depend on how the interim Government performs economically, as well as on political developments. Growth in Sri Lanka will come off the record pace of 2006, but it is still expected to consolidate trend performance. If political conditions become more settled, Nepal may reap a modest dividend in 2007. Continuing recovery from the tsunami should see double-digit growth in the Maldives.

In 2007 and 2008, softer external demand and policy curbs are expected to pull growth down gradually in the PRC. But incentives for spending at the local and provincial level will remain strong in the lead-up to the Communist Party Congress later in 2007. Industrial expansion is also set to continue apace, as the PRC makes inroads into new markets and improves productivity. Growth of 10.0% is now forecast in 2007, with a further slowing to 9.8% in 2008. Outcomes have previously consistently beaten forecasts for the PRC, but if growth does not begin to slow, the authorities will most likely press harder on the brakes. Failure to moderate growth in the near and medium term would raise risks of painful adjustments later on.

Elsewhere in East Asia, growth is expected to soften in Hong Kong, China and in Taipei,China, partly because of their close economic ties to the PRC, though local factors will also play a part. Korea, too, is expected to slow as exports cool with the moderate slowdown in the US economy. Mongolia should continue to enjoy fast growth over the next 2 years as agriculture, mining output, and construction continue expanding. For East Asia as a whole, growth of 8.0% is projected in 2007 and 2008.

Overall, Southeast Asia will show little change in 2007 relative to 2006. Growth is put at 5.6%, edging up to 5.9% in 2008. But Indonesia, Southeast Asia's largest economy, is seen accelerating as lower interest rates and weaker inflation give a boost to domestic spending. Efforts to improve the investment climate may also begin to pay off. In Malaysia, growth is likely to ease a little in 2007. Electronics activity will remain susceptible to global developments and any slowing of durable goods demand in the US. The Philippines is expected to maintain steady growth of around 5.4%. The investment rate may stabilize and then pick up, and although expansion of infrastructure spending would be helpful, the benefits would unlikely be felt before 2008.

Cambodia, Lao PDR, and Viet Nam will again grow quickly in 2007 and 2008. But Cambodia will need to diversify its export base and improve productivity if it is to stand up to stiffening garments competition. In Thailand, prospects are dominated by political factors. Since the coup of September 2006, business and consumer confidence have declined. Shifts in policy and uncertainty about future direction have kept consumers and investors on the sidelines. Growth of 4.0% is penciled in for 2007, but has a larger than usual degree of uncertainty.

Growth is expected to accelerate briefly in the Pacific in 2007 before reverting to a more lackadaisical pace. The anticipated leap in growth in 2007 largely reflects the stimulus to demand provided by the deployment

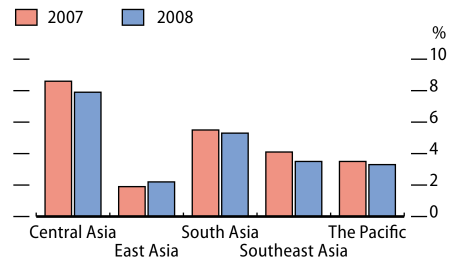
of a large international force in Timor-Leste for peacekeeping and to assist in the conduct of elections. However, stronger growth in Papua New Guinea will also help lift the average. With the planned departure of peacekeepers in 2008 and slower growth in Papua New Guinea, the subregional average will drop back. A coup and the withdrawal of new aid have added to already difficult circumstances in Fiji Islands. Its economy may well contract in 2007, with growth remaining anemic in 2008.

Inflation is expected to ease in 2007 (Figure 1.1.8). Falling prices of commodities in international markets will help, as will vigilance from monetary authorities across the region. The largest reduction in inflation is expected to be in Southeast Asia: inflation will slow in nearly all subregional countries, but the largest contributor to the deceleration is likely to be Indonesia. Running at double digits in 2005 and 2006, inflation is expected to drop to 6.2% in 2007, stabilizing at about that level in 2008. Only in Singapore is inflation expected to pick up, and even then not by much.

In South Asia, falling inflation in India—prompted by slower credit growth and higher interest rates—will lead the headline figure down. Inflation in Pakistan is forecast to move closer to the State Bank of Pakistan's target, and is seen coming down to about 7% in 2007 and further to 6.5% in 2008. Despite rapid growth, inflation is expected to remain tame in the PRC. Any further currency appreciation would tend to restrain it. The main downside risk to inflation across developing Asia remains the possibility of a rebound in oil prices.

Developing Asia's current account is expected to remain firmly in surplus in 2007 and 2008 (Figure 1.1.9). In nominal US dollar terms, the surplus will widen but should steady as a share of GDP. Although some further appreciation of regional currencies is expected, both exports and imports are again likely to grow strongly. On the export side of the trade balance, productivity gains and lower unit costs will help offset impacts of any currency appreciation on prices. Remittances will stay an important source of foreign exchange for some countries. Import demand will be supported by stronger domestic spending, but lower prices for oil and other commodities will reduce import bills for some economies. The profile of the surplus is unlikely to change much, with South Asia continuing to run a deficit, and all other subregions in surplus. Southeast Asia's surplus is expected to close somewhat as expenditure switches more to domestic demand.

1.1.8 Regional inflation trends



Source: Staff estimates.

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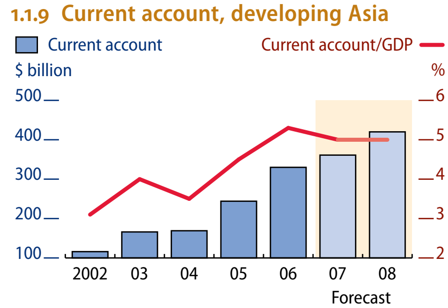
1.1.9 Current account, developing Asia



Sources: Asian Development Outlook database; staff estimates.

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Challenges

Economic management

Macroeconomic stability

In many countries of developing Asia, "first generation reforms," which focus on macroeconomic stability and opening markets, have progressed a lot. Achievements have contributed to favorable outcomes on inflation without damaging growth. For example, in Southeast Asia, the authorities have been quick to tame the inflationary pressures that occurred on the heels of large oil price increases. The enhanced credibility of monetary policy doused inflationary expectations and allowed many countries

to absorb high oil prices more easily than would have been possible in the past. Equally, fiscal authorities, realizing the fiscal risks and high opportunity costs posed by rising gasoline, diesel, and kerosene subsidies, were quick to pare them back.

In South Asia, inflationary pressures have surfaced as a consequence of the pass-through of high oil prices but also because of accelerating growth. Growth has trended steadily upward in Bangladesh, India, and Pakistan. As sizable subsidies have been retained on oil products, and domestic prices remain well below international prices (*ADO 2006 Update*, Box 1.1.1), fiscal strains have been accentuated. Nevertheless, in all countries, policy frameworks governing interest rates, exchange rates, and fiscal regimes are acquiring greater clarity. The monetary authorities have set clear goals and have taken concerted measures to ease inflationary pressures. Fiscal problems and difficulties still lurk, but the overall direction is one of improvement. In Central Asia, International Monetary Fund programs have helped stabilize macroeconomic balances

But there are some countries where macroeconomic balances are more fragile. In Sri Lanka, for example, credit financing of expansionary government spending is directly stoking inflation. In Myanmar, the dual exchange rate system and monetization of government deficits keep inflation a perennial problem. In some of the small Pacific countries, an oversized government sector crowds out the space for private sector initiative and activity.

Foreign exchange reserves

Since 2002, a particularly sharp buildup of foreign exchange reserves has been seen in developing Asia, largely in East and Southeast Asia, but also in India. Initially, reserve accumulation was motivated by a strong self-insurance motive and was intended to provide a buffer against speculative attacks. If the costs of a financial crisis in terms of lost GDP are large (as they appear to be), and the probability of a crisis occurring is significantly reduced by sizable reserves, then it may be worth paying a hefty insurance premium to do this (Rodrik 2006).

The need for reserves is influenced by a variety of factors, including exposure to short-term external liabilities, the nature of the exchange rate regime, country risk characteristics, and import financing requirements. A comparison of actual reserves with estimates of a broad measure of needs shows that actual reserves exceed "adequacy levels" by 50% or more (*Asia Economic Monitor*, December 2006). Although these ratios are by no means exceptional for emerging market economies, it is hardly surprising that there is now growing interest in how to make better use of international reserves. Asia's reserves tend to be invested in short-term, secure assets that earn low yields that may be insufficient to compensate for even modest exchange rate appreciation.

The rewards from investing more actively are potentially large. For example, if just 50% of reserves were invested in a globally diversified portfolio, attracting a yield of 500 basis points above the current return, this would generate a fiscal dividend of about $60 billion, equivalent to 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.

Some countries have already moved in the direction of more active reserves management. Capitalized by funds from the exchange equalization account, the mandate of the Korean Investment Corporation (formed in 2005) is "to achieve sustainable returns on foreign currency assets." In March 2007, the PRC announced that it would take a more active approach to reserves management (Box 1.1.2). But while the rewards are certainly tempting, central banks and governments are rightfully wary of risks. If investments go bad, this could undermine confidence in government and/or the central bank. Having an appropriately regulated "fund," operating at arm's length, to manage some portion of reserves may have advantages. But setting up such an organization and attracting people with the right expertise is likely to take time.

1.1.2 New investment agency for reserves management in the People's Republic of China

On the back of a surging trade surplus and rising foreign direct investment, the PRC's foreign exchange reserves, already the world's largest foreign reserves holding, hit $1.07 trillion at the end of 2006, up $247 billion from the end of 2005. All the (official) foreign reserves are now managed by the State Administration of Foreign Exchange (SAFE), an arm of the central bank.

They are conservatively invested in US treasury bonds and other government securities, and generally earn small yields. Standard Chartered Bank in Shanghai has estimated the investment return on the PRC's reserves to be 3%, compared with, for example, an average 18% annual return for Singapore's Temasek Holdings since it was established. In addition, the central bank may even lose from holding currency reserves in US dollars, including valuation losses as the yuan appreciates and opportunity costs due to the dollar depreciating against investment in alternative currencies.

In 2003, Central Huijin Investment Company Limited was established to be another investment arm of the central bank. It has used part of the foreign reserves to recapitalize major state banks and other state-owned financial institutions. It now holds a large proportion of state-owned financial assets. However, Central Huijin seems to be managed much like SAFE, which conservatively invests in low risk and return securities.

On 9 March 2007, the Government unveiled a plan to establish a state investment agency, to make better use of its reserves. The intention is to model operational aspects of the agency along the lines of Temasek Holdings and the Government Investment Corporation (GIC) of Singapore. Even though the proposal has not yet been finalized, it is likely that the foreign reserves will be divided into two parts—normal reserves that will continue to be managed by SAFE and others directed by the new investment agency. The new agency is expected to manage at least $200 billion of foreign reserves, and to adopt an asset management model in which reserves will be invested in higher-yielding products, such as stocks, corporate bonds, commodities, and technology companies abroad, in order to spread portfolio risks. It is still unclear if Central Huijin will be merged with the new agency. If it is, the new agency will be able to manage not only the currency reserves but also state-owned assets—reflecting the GIC–Temasek approach.

Temasek, one of the operational models for the new agency, was set up by the Singapore Government in 1974 to manage state-owned assets. Temasek owns stakes in many of Singapore's largest companies, including Singapore Airlines, DBS Bank, and Singapore Power. It also holds investments in iconic Singaporean institutions like Raffles Hotel and Singapore Zoo. About half of its managed assets are held externally. As of 31 March 2006, Temasek had $84 billion of assets under management, yielding around 24% for the year.

The Singapore Government established GIC in 1981 as another investment arm to directly manage its foreign reserves. GIC is run as a private investment company, although it is wholly owned by the Singapore Government. This arrangement allows GIC to operate as a global fund manager, while allowing the Government oversight over the management of the country's reserves. GIC invests internationally in equities, fixed income instruments, money market paper, and real estate. It is also involved in some of Asia's largest funds, such as the AIG Asian Infrastructure Fund, the largest private infrastructure fund in Asia.

Sources: Bloomberg 9, 10, 11 March 2007; *Financial Times*, 9 March 2007; www.temasek.com.sg; www.gic.com.sg.

An alternative, more direct approach, recently proposed in India's FY2007 budget, would be to use foreign exchange to pay for the foreign currency costs of projects, or to back guarantees that would lower the costs of borrowing by special purpose investment vehicles.

Both proposals have their attractions. But in either case contingent fiscal liabilities would be likely to rise. If guarantees are used, the resulting debt inflows could exert pressure for an appreciation of the exchange rate. If inflows are sterilized, this will push interest rates up; with no sterilization, the inflows would add to credit expansion. Decisions on whether and how to put reserves to better use should be taken in the broader context of fiscal and monetary policy frameworks.

Exchange rates

Figure 1.1.10 shows the movement of nominal exchange rates against the US dollar. Most currencies appreciated, Viet Nam's dong being an exception. The Malaysian ringgit and the PRC yuan, whose dollar pegs ended in July 2005, appreciated modestly in 2006. The appreciation of other currencies, including the Korean won, Philippine peso, and Thai baht, was more pronounced.

Changes in nominal effective (trade-weighted) exchange rates are compared with unweighted US dollar changes in Figure 1.1.11. Generally, movements of nominal effective exchange rates were smaller than their appreciation against the US dollar in 2006. This is because the currencies of most countries' major trading partners also appreciated against the US dollar. In nominal effective terms, the appreciation of the ringgit has been small. By December 2006, the Thai baht had appreciated in nominal effective terms by over 10%, and the Philippine peso by 4.5%.

Following the announcement of a near-record trade surplus in February 2007, the PRC authorities stated in March that they may now consider greater flexibility of the yuan. The sensitivity of other countries' nominal effective exchange rates to an appreciation of the yuan would be quite small (Figure 1.1.12). The main impact of its appreciation would most probably be seen in adjustments to market shares outside the region, not in terms of bilateral trade flows within. About 51% of the PRC's exports are to the US, EU, and Japan. Comparable shares for other countries range from 35% up. But these numbers may exaggerate the true extent of competition, concentrated in consumer goods industries that constitute a smaller share of total exports (Box 1.1.3). Also, firms in the PRC have already shown themselves adroit in improving productivity levels, which would help to offset any price and cost disadvantages created by a more expensive currency. There would be benefits at home. Consumers would gain from cheaper consumer goods imports, and the People's Bank of China would be better able to stem pressures on liquidity coming from rapidly accumulating foreign reserves. Pressures on the financial sector would be eased if the share of lowly remunerated reserves and sterilization bonds on their balance sheets were reduced.

Capital controls

In December 2006, Thailand imposed controls on capital inflows with the intention of stemming the baht's appreciation. The initial rules were widely regarded as too stringent and triggered a rout in the equity

1.1.3 Trade and structural change in East and Southeast Asia

The chapter, *Trade and structural change in East and Southeast Asia: Implications for growth and industrialization*, in Part 1, provides an in-depth analysis of recent developments in international trade in manufactures in the region.

It shows that the rising share of the region, and especially of the PRC, in world exports and imports has been fueled by the explosive growth of intra-industry trade in parts and components in machinery sectors. Multinational enterprises are active in established production networks with a vertical division of labor leading to trade in goods in different stages of processing. The region's economies trade most intensively in the manufacturing industries that have the highest growth in world trade: electrical machinery, transportation equipment, chemicals and allied products, and precision instruments.

The region is also shown to be highly competitive in traditional labor-intensive manufactured products. Although intraregional trade is of increasing significance—with the PRC the point of assembly for final products—consumption of these final products is overwhelmingly in destinations outside the region. Final demand in the United States, Europe, and Japan and other extraregional markets is the driving force behind the rise of intraregional trade in East and Southeast Asia.

Hence, globalization is driving the process of regional integration and the processes are mutually reinforcing. So, although the region is partaking in the trend toward bilateral preferential trade agreements, it is market forces rather than tariff preferences that are more influential in determining what is produced and where it is produced.

The impact of the emergence of the PRC on industrialization and trade performance in other parts of the region, such as ASEAN, are also examined.

market (Figure 1.1.13). In response, exemptions have been widened. It has also been clarified that the aim is to eventually abandon the controls. Further relaxation of controls took place in mid-March 2007: the 30% nonremunerated reserve requirement for investors in debt securities and unit trusts, who fully hedge their investments through forward swaps of at least 3 months, was abrogated.

In principle, the case for a tax on *destabilizing* capital inflows is clear. As offshore investors do not consider or internalize the costs of any destabilizing effects of their behavior on the domestic economy, a tax on inflows could be beneficial.

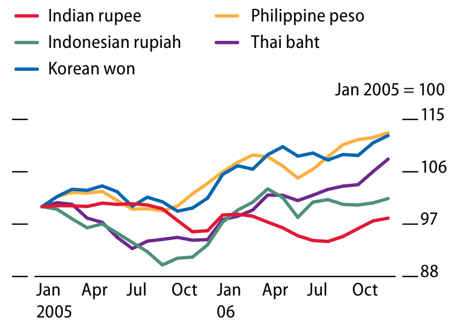
But theory and practice can differ. First, identifying conditions that warrant the imposition of a tax on capital inflows is not straightforward. Even if the Thai baht appreciated sharply against the US dollar in 2006 and reserves accumulated, it is uncertain that this threatened the economy or export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

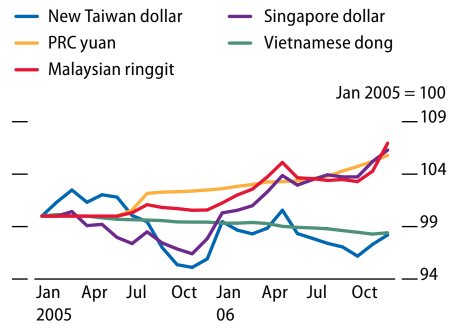
When pressures for speculative capital inflows do need easing, the question arises of how to do this. Precisely because foreign exchange transactions are fungible, designing regulations that are not porous is extremely difficult. Simple approaches that are based on flat withholding taxes and that use existing taxation (and rebate) arrangements may have attractions (Box 1.1.4).

Sustaining growth

Notwithstanding its considerable achievements, developing Asia still lags a long way behind rich industrial countries. Measured at market exchange rates, per capita GDP in developing Asia is estimated at US$1,295 in 2006, compared with US$31,230 in the OECD (Figure 1.1.14). As of 2002, there

1.1.10 Nominal United States dollar exchange rate index





Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of China, available: http://www.cbc.gov.tw; both downloaded 13 March 2007.

Click here for figure data

1.1.4 Withholding taxes on international capital flows

The idea of taxing international capital flows is not new, and was originally mooted as a way of taming the flow of "hot money" across borders. More recently, other objectives have been added, such as raising additional revenues for the provision of international public goods.

There has been extensive discussion of the "Tobin tax," a proposed tax on all transactions entailing currency conversion. By taxing the amount of currency to be converted, the objective is to dissuade short-term capital movements. For a given tax rate, the effective burden would diminish with the horizon of the transaction. Two main criticisms have been leveled at the idea. The first is that by taxing all transactions involving currency conversions it will create distortions, and, for example, could discourage trade. The second is that the Tobin tax presents formidable coordination problems, requiring broad multilateral agreement about implementation and the use of tax proceeds.

Zee (2000) has proposed that if the goal is simply to inoculate an economy against the potential damage of speculative capital inflows, then national authorities could impose a tax without worrying about international coordination. Zee's proposal is to levy a withholding tax at source when inflows enter a country. Those taxes paid on current account transactions, including export receipts, would then be credited against domestic tax liabilities. By taxing inflows rather than outflows, and by refunding taxes paid on current account transactions, the idea is that capital flows would bear the burden of tax.

Spahn (2002) has observed that, like the Tobin tax, Zee's withholding tax would entail a much smaller tax burden for long-term capital inflows. In this way it is different from the nonremunerated reserve requirements used by Chile as well as Colombia, Spain, and Slovenia. As practiced by Chile, nonremunerated reserves had the problem that they imposed a larger effective tax burden, the longer the holding period. Thailand's arrangements allow for repatriation of nonremunerated reserves only after a year, thereby affecting short-term flows most.

Sources: Zee (2000), Spahn (2002).

were still 1.9 billion men, women, and children in developing Asia who subsisted on less than $2 a day. Growth remains the surest means of tackling poverty and other forms of deprivation, but stresses are beginning to arise that may eventually undercut growth and worthy economic ambitions. These show up in different ways in different countries.

Asia is still not creating enough jobs for the burgeoning numbers of young workers that enter the labor market each year. Despite fast growth, open unemployment rates are rising. Today, at least 500 million workers, or about 30% of developing Asia's 1.7 billion labor force, are either unemployed or underemployed. As another 245 million workers will be added to developing Asia's labor force by 2015, 750 million new jobs will be needed if full employment is to be achieved within a decade. Developing Asia's future prosperity depends on its ability to use productively its most valuable resource—its people. Failure to create decent and productive jobs may come at high cost. If many workers get left behind, the legitimacy of growth, and, by extension, support for the reforms needed to sustain catch-up and modernization, could be threatened. The promise of developing Asia's "demographic dividend" could yet prove to be a "demographic curse."

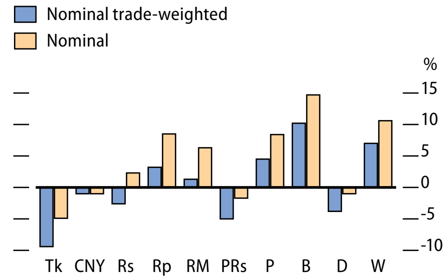
Linked to the problem of job creation is widening disparity in income distribution. Some widening of inequality may be "good" in the sense that it reflects rewards for enterprise and innovation and the incentives needed to apply resources to their most productive uses. But where widening inequality is a consequence of arrangements that restrict access to opportunity, that tolerate asset grabbing and rent seeking, and that perpetuate and widen social cleavages, it is more likely to be symptomatic of institutions that will also eventually stymie growth. The challenge is to formulate policies and to reform institutions in a way that creates and widens opportunities for those who might otherwise fail to share in the fruits of growth, without compromising on growth. *Key Indicators 2007* (ADB forthcoming) will focus on the issue of inequality.

Environmental stresses are also on the rise. Most people in developing Asia do not yet enjoy a level of affluence where they have a strong demand for improved environment quality. But failures of policy, and a lack of vision, as much as low incomes, are at the root of Asia's environmental problems. Integrating environmental objectives and concerns into broader development plans, giving a larger role to market-based instruments, and strengthening cooperation at a regional and international level, are some of the ingredients of a better approach to reconciling growth with environmental objectives.

In addition to these "macro" challenges are the "micro" challenges of building the markets and institutions needed to support growth, facilitate change, and improve social welfare.

As Asia's crisis painfully illustrated, macroeconomic stability and openness do not completely immunize countries against shocks. In East and Southeast Asia, the failure of institutions and structural policies to keep pace with fast expansion led to vulnerabilities that eventually derailed growth and caused reversals. To sustain growth, but also to improve lives, "second generation" reforms are needed. These reforms aim to develop markets and institutions that may be missing, incomplete, or inefficient. As these endeavors are necessarily shaped by political,

1.1.11 Movements in exchange rates, 2006



Note: Positive (appreciations)/negative (depreciations) movements computed using average rates in December 2005 and 2006.

Sources: International Monetary Fund, *International Financial Statistics* online database, downloaded 15 March 2007; staff estimates.

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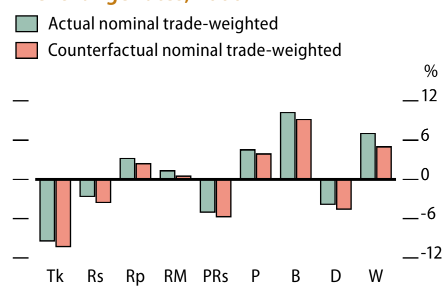
1.1.12 Actual and counterfactual movements in exchange rates, 2006



Note: Impacts are calculated assuming a counterfactual 10% appreciation of the yuan, holding all other variables constant at December 2006 values.

Sources: International Monetary Fund, *International Financial Statistics* online database, downloaded 15 March 2007; staff estimates.

Click here for figure data

1.1.13 Stock Exchange of Thailand equity price index

Source: CEIC Data Company Ltd., downloaded 15 March 2007.

Click here for figure data

social, and cultural factors, second generation reforms are inherently complicated and have a long time frame. Although desired outcomes are often clear—e.g., the elimination of corruption or better delivery of public services—there is much less clarity about how to achieve objectives. Priorities and sequencing are also likely to be sensitive to country context. An assortment of challenges fall within the ambit of these reforms: the building of efficient and safe financial and capital markets; the delivery of high-quality infrastructure services; improvement in the business investment climate and the development of arrangements that allow people, businesses, and countries to share risks and adapt to change. This list can easily be extended.

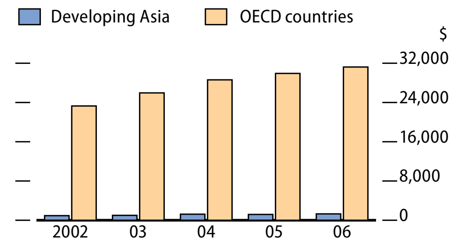
In the PRC, the Government has clearly laid out the challenges: to diversify and balance growth, spread its benefits more widely, and to "harmonize" economic and environmental objectives. But there are hard constraints. Diversifying growth will require a shift away from a bank-dominated financial system. Geared as they are for lending for enterprise investment, they do not do a good job of appraising risks or providing credit to households. Modernizing the PRC's banking system will take time and is already drawing on foreign capital and expertise to support the extension of consumer credit and other new services.

The deepening of equity and bond markets also has a long way to go and will require significant support in terms of improved market infrastructure and better regulation. Widening access to social services, including health and education, is not simple either. In some ways, resources have run ahead of the capacity to deliver quality services. Well-trained nurses, doctors, teachers, and administrators are just as important as hardware but, in the short term, their supply is inelastic. And the solutions to the PRC's environmental challenges do not lie with administrative measures alone. These are often blunt and can be circumvented. Markets have to be developed for environmental services and incentives appropriately geared to objectives.

In a number of countries—though not in the PRC or any longer in India—investment appears to be struggling. The ratio of fixed capital formation to income is falling in the Philippines and industry's share in output is falling. In Pakistan, fixed investment is a constraint in pushing growth to the next level, and modernizing the economy. In Indonesia, the crisis and a comparatively slow recovery appears 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. In important ways, low investment rates appear to be a consequence of deeply embedded regulatory and institutional difficulties that increase risks and uncertainty for potential investors. But blockages to private investment can occur in many shapes and forms (Box 1.1.5).

One factor that seems to be holding back private investment is poor delivery of infrastructure services. Across developing Asia, complaints are routinely voiced about gaps in infrastructure provision and bad service delivery. Good infrastructure is needed to connect villages and towns, to each other and to the global economy. Infrastructure is also needed to promote public health objectives, support reasonable levels of security and safety, and a decent quality of life. In India, poor

1.1.14 Per capita GDP



Sources: Asian Development Outlook database; International Monetary Fund, *World Economic Outlook* September 2006 database, available: www.imf.org, downloaded 17 March 2007.

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1.1.5 Ten years after the crisis: The facts about investment and growth

Ten years after Asia's crisis, an air of normality would appear to have returned and incomes in all the crisis countries now exceed their precrisis peaks. But a closer look shows that growth and investment rates have settled on a lower trajectory. On average in 2000–2006, growth in the five most directly affected countries (Indonesia, Korea, Malaysia, Philippines, and Thailand) ran some 2.5 percentage points behind performance in 1990–1996. Viewed over longer periods, performance also seems to have slipped a gear. Investment rates have tumbled. Although investment may have been too high before the crisis, on a variety of measures it now seems to be low. Slower growth and low investment rates may be linked.

A variety of possible explanations for slower growth and low investment rates are examined in *Ten years after the crisis: The facts about investment and growth* in Part 1. Different factors have been at work in different countries. Poor infrastructure may be holding investment back in Indonesia and the Philippines, and slower growth of employment and the labor force may be playing a role in Malaysia. In Korea, growth and investment may not be of such concern, given the country's high income levels and economic maturation.

An investigation of a range of possible explanations for low investment and slower growth draws out little that is concrete. Credit and loanable funds do not seem to be constraints, and capacity utilization rates appear to have returned to "normal" levels after a period of marked weakness. The idea that investment has been redirected to the People's Republic of China (PRC) is also difficult to square with the facts. As noted in several places in *ADO 2007*, the PRC and East and Southeast Asia show much complementarity in trade and investment.

The analysis then sifts through factors that might influence perceptions of risk and uncertainty. Information on risk ratings, equity prices, economic forecasts, corporate balance sheets, and the quality of governance in the crisis countries is presented. These data do not rule out the idea that, compared to the precrisis period, perceptions of risk and uncertainty in the crisis-affected countries (other than Korea) are now raised or that private sector investors have elevated precautionary motives (deterring investments in hard projects, but not in more liquid assets). The analysis ends by identifying some of the things that might be done to stimulate investment, drawing on information from business investment-climate surveys.

rural infrastructure is taking its toll on agricultural productivity. In the Philippines, conspicuous 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. Indeed, the absence of upstream and downstream infrastructure can block altogether what might otherwise be lucrative private investments.

The neglect of infrastructure reflects a variety of deeper problems, including low levels of public sector revenue mobilization, misplaced public spending priorities, weak institutions, and regulatory failures. Private investors' enthusiasm for infrastructure investment, which could be detected in the early 1990s, has ebbed largely because of failures in policy and regulatory environments. By raising costs and risks and lowering expected returns, these failures have discouraged private investors. Business investment climate surveys point to a raft of impediments. These vary widely in nature and by degree across countries. Some countries, such as Malaysia, do well by international standards, but many do not. Heavy regulation, corruption, onerous and costly administrative requirements, and difficulties with contract enforcement can quickly turn profits to losses, and assets into liabilities. A stable and predictable macroeconomic environment is critical, but without complementary micro and institutional reforms, investment is unlikely to prosper.

In *Growth amid change* (Part 3), it is seen that rapid growth in developing Asia has not simply been about economies replicating

themselves on a larger scale. Countries become different as they grow, not only in terms of *what* they produce, but also *how* they produce. And the ways in which they change matter for growth. It is therefore important that countries develop systems that allow them to activate, manage, and capitalize on change. Policies for growth are policies that allow countries to learn, become more diverse, build on their successes, and, not least, put their failures behind them.

Approaches will have to be sensitive to country circumstances but some familiar ingredients will be important. High investment rates are required to build, expand, and upgrade economic activities. Support for infrastructure and a variety of other services is vital for economies of scale. Relevant and purposeful education is needed (Box 1.1.6). Labor mobility and flexibility need to be complemented by affordable social insurance and protection. As businesses create wealth, obstacles that raise costs and risks need to be removed. And economic openness is needed not just to enlarge markets, but also to increase variety and expose countries to modern technologies and new institutional designs.

Yet markets alone cannot be expected to instigate all these changes, and catalytic elements may be required. In particular, so as to remove obstacles to innovation and to the creation of new activities, partnerships between government and the private sector will be needed. Among other elements, viable operational approaches must embody learning, strong

1.1.6 Education and structural change in four Asian economies

Labor force surveys from India, Indonesia, Philippines, and Thailand are used to examine the linkages between rising education levels and changes in the structure of economic activity. The chapter in Part 3, *Education and structural change in four Asian economies*, documents what workers of different education levels do for a living, what they are paid for doing it, and how this has changed over time.

From an employment perspective, the importance of the "knowledge economy" is often overstated. Most workers labor in agriculture and lower-status services—activities that pay modest premiums to educated workers. While high-end services produce a rapidly growing share of GDP, especially in India, this reflects rocketing labor productivity, not a boom in their employment share. Overall, educational attainment has steamed ahead of job creation in sectors that historically hired the educated. These results are ambiguous, as they are consistent with at least two distinct views: the labor force is becoming more educated than is necessary given the jobs available; and the labor force was initially undereducated, so rapidly rising education levels are necessary to ensure competitiveness.

The correct interpretation differs across countries and is hard to pinpoint. However, a more detailed examination of the wage premiums received by educated workers in different activities is revealing. Returns to basic education have fallen over time. This is especially true in industrial jobs, and among junior workers. This implies that if inadequate education levels have been inhibiting industrialization, the constraint has eased over time. Moreover, the least educated countries—India and Thailand—are industrializing the fastest. In contrast with findings during the "green revolution," returns to education in agriculture are generally low, consistent with the notion that education carries returns when it facilitates the adoption of new technologies and activities. More positively, returns to basic education in services and tertiary education everywhere have typically risen.

In all jobs, Filipinos are the most educated, followed by Indonesians, and then Thais and Indians, including some in which more-educated workers do not command a premium. Such jobs are becoming more common and are employing increasingly educated workers in the Philippines, suggesting that the country is "overeducated."

These results suggest that the benefits of schooling depend as much on conditions outside the classroom as inside it. They also leave open the possibility that raising the quality of education will carry greater benefits than increasing the quantity of workers with various levels of education. Education policy makers and development agencies are therefore strongly urged to measure the effects of education policies on quality and relevance, rather than focusing exclusively on raising attainment.

incentives, and mechanisms that minimize risks of moral hazard and rent seeking, and remove subsidies for failed experiments (Rodrik 2004).

Risks

The outlook naturally rests on a large number of assumptions. It is always possible that events could evolve in surprising and unexpected ways, and derail projections. Given underlying economic momentum, risks remain tilted down.

Markets have moved to reprice risks so far this year in a calm manner, but this could yet give way to less settled conditions. Policy mistakes, geopolitical or other shocks, or unexpectedly bad news about economic direction could lead to a much bumpier time for markets. If asset prices get badly punctured and decisively reverse, the chill would soon be felt.

Although dissonance about the US outlook seems to be receding, the possibility of a sharper slowdown cannot be ruled out. A particular source of uncertainty is in how nonconstruction investment will hold up. If the US were to slow sharply, there would be knock-on effects on global industrial output growth and trade. Developing Asia would certainly not be insulated from such developments (Box 1.1.7). Failure of the Doha Round, too, could easily aggravate any slowdown in trade caused by slower global demand growth. In this regard, the condition of the Doha Round remains critical. Although negotiations are continuing among a small group of key members, time will finally run out at the end of June 2007, and even if an agreement can be brokered, it may not get the go ahead from the US Congress. In the growing vacuum left by any failure of Doha, preferential trade agreements would thrive further and already audible protectionist calls would be amplified.

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. The relief that lower prices are currently bringing to budgets, to inflationary pressures, and to import bills is welcome, but should not be counted on. In the event of a human flu pandemic, developing Asia would bear a disproportionately large cost.

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

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1.1.7 Uncoupling Asia: Myth and reality

Is developing Asia uncoupling from the global business cycle? The chapter, *Uncoupling Asia: Myth and reality* in Part 1, presents evidence to show that the global business cycle is still important for Asia.

Recently, some commentators have argued that the fast-growing Asian economy and its potentially large spending power might represent the emergence of a powerful regional economy that can sustain its own momentum, largely independently of the business cycle in industrialized countries.

However, no evidence points to Asia's uncoupling, either structurally or cyclically. In fact, a renewed process of rapid economic growth and development has been accompanied by increasing economic integration, both intraregional within Asia and interregional with G3 (United States, European Union, and Japan).

Investigating the structure of Asian trade, the chapter demonstrates the close relationship between intra- and interregional trade, with the PRC playing the crucial role. The G3 economies are still the main export destinations for final goods leaving the region. Asia's economy is increasingly integrated both regionally and internationally. These are connected facets of globalization.