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PUBLICATION HIGHLIGHTS

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Contents

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The Publication Highlights *summarizes the* Asian Development Outlook, *a flagship annual publication of the Asian Development Bank. The* Asian Development Outlook 2005 *contains three parts. In the first, aggregate trends and medium-term prospects of developing Asia and the Pacific are reviewed in the context of a baseline global economic outlook. The second deals with recent economic developments and prospects for the region from a subregional perspective. The third focuses on competition policy, highlighting the importance of microeconomic reforms to increase productivity, improve competitiveness, and enhance growth potential in Asia.*

Developing Asia and the world

Overview of economic highlights and prospects

The major industrial economies grew at their strongest rate in many years in 2004. In turn, the economies of developing Asia and the Pacific achieved their highest growth since the Asian financial crisis as aggregate gross domestic product expanded by 7.3%. Domestic demand was buoyant and average inflation remained subdued. The strong economic momentum in most regional economies, together with a continued favorable external environment, augurs well for growth over 2005–2007. Average real growth is expected to be between 6.5% and 6.9%, supported by more buoyant domestic demand and strengthening intraregional trade.

Developing Asia: Economic highlights of 2004 and prospects for 2005–2007

In 2004, developing Asia achieved its best growth performance since the Asian financial crisis of 1997–98. The region's aggregate real gross domestic product (GDP) expanded by a strong 7.3% (Table 1.1). In fact, with the notable exception of the Pacific developing countries, nearly all developing Asian economies grew by more than 5% in 2004, a remarkable feature for a region of about 4 billion people. Using purchasing power parity weights, developing Asia's GDP expanded even faster, at 7.7%. Some of the region's best performers were the People's Republic of China (PRC); Hong Kong, China; India; Kazakhstan; Malaysia; Singapore; Uzbekistan; and Viet Nam.

The overall growth performance was underpinned by continued strength in external demand, complemented by more buoyant domestic demand, in particular business investment. On the external front, the economies of the region were the main beneficiaries of robust growth in major industrial countries, in particular the United States (US). Associated with this was a significant revival in the global electronics market, for which many Asian countries are major exporters. In addition, with the economy of the PRC showing hardly any signs of a slowdown and regional economic integration further moving forward, intraregional trade remained remarkably buoyant in 2004 as exports from the economies in the region increased by 27.9% in the year to September. For 2004 as a whole, exports from developing Asia rose by 25.5%, compared with 19.3% in 2003.

However, rapid income growth for several years in a row, together with continued high oil prices, also led to surging imports in most Asian economies, as reflected in narrowing trade and current account surpluses or in widening deficits

Table 1.1 Selected economic indicators, Developing Asia, 2003–2007

	2003	2004	2005	2006	2007
Gross domestic product (annual % change)					
Developing Asia	6.7	7.3	6.5	6.6	6.9
East Asia	6.7	7.8	6.7	7.0	7.2
Southeast Asia	5.0	6.3	5.4	5.6	5.9
South Asia	7.8	6.4	6.7	6.2	6.9
Central Asia	10.0	10.4	8.7	8.8	9.2
The Pacific	2.6	2.6	2.3	1.4	2.1
Consumer price index (annual % change)					
Developing Asia	2.4	3.9	3.7	3.3	3.3
East Asia	1.3	3.3	3.1	3.0	3.0
Southeast Asia	3.3	4.2	4.3	3.9	3.8
South Asia[a]	5.1	5.9	4.9	3.6	3.9
Central Asia	5.7	6.0	6.0	5.3	4.9
The Pacific	8.6	3.6	3.4	4.0	4.0
Current account balance (% of GDP)					
Developing Asia	4.4	3.7	2.6	2.1	1.6
East Asia	4.3	4.1	2.9	2.4	1.7
Southeast Asia	8.1	7.3	6.2	5.3	4.9
South Asia	1.9	-0.7	-1.2	-1.5	-1.9
Central Asia	-2.5	-1.9	-3.2	-0.5	1.8
The Pacific	0.3	-0.7	-0.8	-1.5	-0.5

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

Sources: Asian Development Outlook database; staff estimates.

in some economies. The average current account surplus in the region was reduced to 3.7% of GDP in 2004, down from 4.4% in 2003, as the contribution of net exports to GDP growth was uneven.

A major feature of economic developments in 2004 was a marked revival of business investment, particularly in East Asia and Southeast Asia where it had been lagging since the Asian crisis—with the notable exception of the PRC where it has remained robust over the past decade. In most countries in South Asia and the energy-rich countries of Central Asia, investment spending also showed a healthy upward trend in 2004, a positive sign for stronger long-term growth. High capacity utilization was in part due to robust external demand, low interest rates, and ample liquidity, as well as strengthening business confidence. Almost all countries showed an increase in their investment-to-GDP ratio. The revival of business investment, combined with continuing or strengthening consumption demand in most countries, and partly supported by further expansionary fiscal policies, translated into the robust rates of growth experienced in 2004.

On the supply side, in many countries the agriculture sector accounts for a significant share of GDP. Conditions were favorable in Fiji Islands, Indonesia, Kyrgyz Republic, Mongolia, Nepal, Philippines, and Uzbekistan, but in India, agricultural growth could not match the exceptional recovery of 2003, thus contributing to somewhat lower GDP growth there.

In spite of generally sustained high growth over the past few years and high oil prices, inflation in most countries remained largely subdued in 2004. In the PRC, even with continuing concerns about overheating of the economy, inflation averaged 3.9% in 2004 compared with 1.2% in 2003. There were, of course, exceptions where inflation became a concern over the course of 2004, notably Azerbaijan, Cambodia, India, Mongolia, Pakistan, Philippines, Samoa, Sri Lanka, Thailand, Tonga, and Viet Nam, though inflationary pressures became more apparent across the region as the year progressed. This led several countries to adopt a more flexible exchange rate stance and, as a result, a raft of Asian currencies—including the baht, New Taiwan dollar, Singapore dollar, and won, as well as the yen—appreciated against the US dollar, reducing the impact of imported inflation. Nevertheless, with relatively low inflation, monetary policies remained mostly accommodative during the year.

The strong economic showing by most of developing Asia in 2004 was marked by a further accumulation of foreign exchange reserves, which are estimated to have reached about $1,624 billion at the end of the year. The region benefited from strong capital inflows, notably foreign direct investment that is estimated to have climbed to $69.3 billion (on a net basis) over the year. Foreign exchange reserves increased at about the same rate as in 2003, but were mainly concentrated in the PRC. In several countries, the holding of large amounts of foreign exchange reserves in dollar-denominated assets came under scrutiny in 2004 as the risks of a further substantial depreciation of the US dollar became more apparent and the

need to significantly boost domestic investments, particularly in infrastructure, in order to boost competitiveness was increasingly realized.

Any acknowledgment of developing Asia's strong economic performance in 2004 must be tempered by the fact that too many economies, in particular smaller economies, are still far from closing the income gap with the better-off countries in the region. These economies remain highly vulnerable to external shocks and have weak domestic fundamentals. Among their number are: many of the economies of the Pacific; Mongolia in East Asia; Cambodia, Lao People's Democratic Republic (Lao PDR), and Myanmar in Southeast Asia; Afghanistan, Bangladesh, and Nepal in South Asia; and Kyrgyz Republic and Tajikistan in Central Asia.

Over the forecast period 2005–2007, the overall outlook for developing Asia will of course depend heavily on developments in the world economy as a whole—particularly in major industrial countries and the PRC. The prospects for growth in major industrial countries and for world trade—in spite of significant downward risks—remain relatively buoyant, auguring well for the economies of developing Asia over the forecast period. At the same time, domestic market conditions have become stronger over the past 2 years in most countries, providing some cushion against a potential deterioration in the external environment.

In spite of a rather confident baseline outlook for developing Asia, this environment could become much more somber over the next 3 years, depending on how the current uneven expansion among some major world economies affects key economic variables across the globe. A much more robust growth projection for the US economy, while Japan and the euro zone go through a relatively rough patch, implies that the problem of external imbalances in the US could become worse, triggering a sharp depreciation of the dollar, a spike in inflation, and more sudden increases in interest rates, thus ultimately restraining world growth and trade. In addition, stronger growth in relatively energy-intensive countries, particularly the PRC and the US, points to continued high oil prices and an exacerbation of the global imbalances.

In short, while the region has built up significant resilience against external shocks, many economies remain vulnerable, particularly some of the poorer ones.

The 2005–2007 baseline assumptions for external conditions (Table 1.2) indicate only a moderate slowdown of average GDP growth for developing Asia as a whole to 6.5–6.9% (7.1–7.5% on the basis of purchasing power parity weights). In East Asia, average GDP growth will be in the range of 6.7–7.2% as the PRC economy experiences only a mild slowdown while the economies of Hong Kong, China and Taipei,China perform somewhat better than the average of the past 4 years. In Southeast Asia, average GDP growth is forecast at 5.4–5.9%, higher than the average of the past 4 years, since most countries are projected to perform markedly better. (For Indonesia, the most populous country in the subregion, this is a very positive development.)

In South Asia, growth is projected at 6.2–6.9%, substantially higher than historical averages, largely reflecting continued robust growth in the Indian economy, which accounts for about 80% of the subregional average. In Central Asia, growth rates, though fluctuating widely due to developments in the energy sector in some countries, are expected to settle to more sustainable levels as the effects of economic transition fade. In the Pacific, GDP growth rates will remain on average at around 2%, as the two largest economies—Fiji Islands and Papua New Guinea—are not projected to perform particularly well.

While developing Asia's economies will show significant divergence, domestic demand will increasingly play a significant role in supporting overall growth in 2005–2007. Generally robust income growth over the past few years has boosted consumer confidence and spending. At the same time, investor sentiment is strengthening in many major economies of the region, and increased domestic and foreign investments are forecast in the baseline. Even as the pace of the world economic expansion moderates over the next 3 years, developing Asia will remain a preferred investment location, provided that countries can enhance—or at the least, keep—their competitive advantage. In this context, furtherance of economic, governance, and administrative reforms, as well as improvements to infrastructure, will be particularly important.

Table 1.2 Baseline assumptions for external conditions, 2003–2007

	2003 Actual	2004 Actual	2005	2006	2007
GDP growth (%)					
Industrial countries	2.0	3.5	2.5	2.5	2.4
United States	3.0	4.4	3.7	3.4	3.1
Japan	1.4	2.7	1.1	1.3	1.3
Euro zone	0.5	2.0	1.6	1.8	2.1
Memorandum items					
United States Federal Funds rate (average, %)	1.1	1.4	3.1	4.2	4.4
Brent crude oil spot prices ($/barrel)	28.8	38.3	41.0	39.0	37.0
World trade volume (% change)	5.5	10.2	7.4	6.0	6.0

Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic model.

Sources: US Department of Commerce, Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N; Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/quart&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html; World Bank, *Global Economic Prospects 2005*, available: http://siteresources.worldbank.org/INTGEP2005/Resources/GEP107053_Ch01.pdf; World Bank Commodity Price Data, available: http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html; US Federal Reserve, available: www.federalreserve.gov/releases; staff estimates.

Investment rates are expected to remain firm over the forecast period and to average about 30% for the region.

The potential contribution of domestic demand to growth could, however, be negatively affected by inflationary trends and the response of the monetary authorities. Projections indicate that inflation in developing Asia could, on average, fall somewhat in the forecast period, leveling off in 2006–2007. No significant tightening of monetary policies is required, but it could be if the baseline assumptions are not realized. Higher interest rates would particularly affect countries where household or public debt is high, including PRC, Indonesia, Korea, Kyrgyz Republic, Philippines, Sri Lanka, Tajikistan, and Thailand. As often discussed in the *Asian Development Outlook* (*ADO*) in previous years, fiscal discipline is the best protection against potential external shocks.

The external sector will remain important, but might contribute somewhat less to growth than in the recent past, since imports are projected to continue increasing rather rapidly in many countries. Although projections indicate that export growth will moderate over the next 3 years, the world trading environment remains relatively buoyant compared with historical averages. Moreover, intraregional trade should continue to expand at a brisk pace as the rest of developing Asia integrates further with the PRC and increasingly with India. Robust growth in the region, combined with continued trade liberalization reforms, will also lead to strong import growth, resulting in declining current account surpluses or widening deficits (mainly in South Asia). The external sector might therefore contribute less to growth than in recent years.

As the external environment runs a risk of becoming less bright over the forecast period, initiatives by developing Asian governments to enhance competitiveness and promote stronger regional integration will become more important, and will be key factors in attracting foreign investment flows. In this context, the significant divergence in exchange rate movements in Asia relative to the US dollar could become a significant policy issue over the forecast period. For the countries of the region, some coordination of these movements is a preferred solution, and should be put high on the policy agenda.

Economic prospects for developing Asia remain auspicious over the next 3 years. While inevitably such a vast region presents significant divergences, income growth will generally remain

robust under the baseline scenario. Most of the larger economies in the region are well placed to weather external shocks, which current imbalances in the world economy could very well trigger over the next few years. However, and very importantly, the long-term prosperity of the region can only be built on robust economic growth that is inclusive. There is evidence that inequalities have increased significantly in many of the rapidly growing economies of the region. Policy measures to mitigate these inequalities will be particularly important over the next few years.

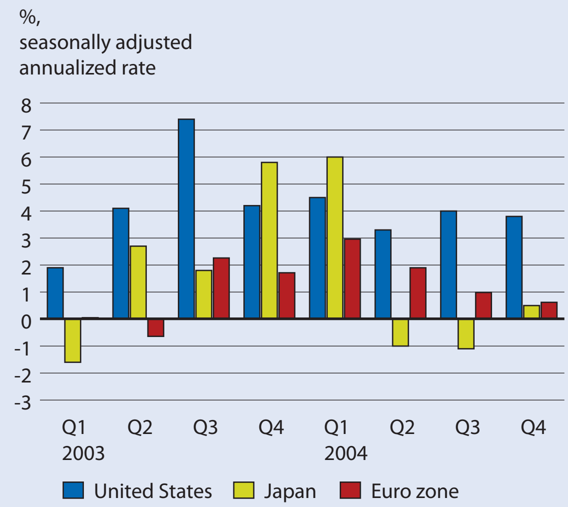
Prospects for the world economy in 2005–2007

The economies of major industrial countries are projected to continue a moderate expansion in 2005, following heady growth of 3.5% in 2004. However, a strong and synchronized recovery in these countries between the latter half of 2003 and the first quarter of 2004 gave way to uneven growth over the course of 2004, which is expected to continue widening the growth gap between major industrial economies in the near term (Figure 1.1). With projected growth in the US again outpacing that in the other major industrial economies, the ongoing problem of large external imbalances of the US economy will likely remain unresolved, casting a shadow over the medium-term sustainability of the current rebound. Reflecting such concerns, the dollar declined sharply against the Japanese yen and the euro in the fourth quarter of 2004.

The US is poised to continue further expansion, whereas Japan and the euro zone have been experiencing an extended setback since the second quarter of 2004. Taking a hard hit from high oil prices and slowing external demand, some large economies—notably Germany, Italy, and Japan—slumped in the second half of 2004. However, economic fundamentals remain relatively sound even in these countries, on the grounds of stronger corporate balance sheets and healthy profits. Business investment has been on the rise, even as export growth has eased. In addition, business surveys point to an improving outlook in industrial production through 2005.

Meanwhile, a broadening of the recovery continues in the US, on the back of robust private consumption and business capital spending. With

Figure 1.1 Real GDP growth rate of US, Japan, and euro zone, Q1 2003–Q4 2004



Sources: US Department of Commerce, Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N, downloaded 28 February 2005; Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/quart&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0, downloaded 4 March 2005; Economic and Social Research Institute of Japan, available: http://www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html, downloaded 14 March 2005.

prospects of a continued benign outlook for some major economies—namely the PRC and the US—exports should start lending help again in Japan and the euro zone over the rest of 2005, although the rate of export growth will be lower than the previous peak.

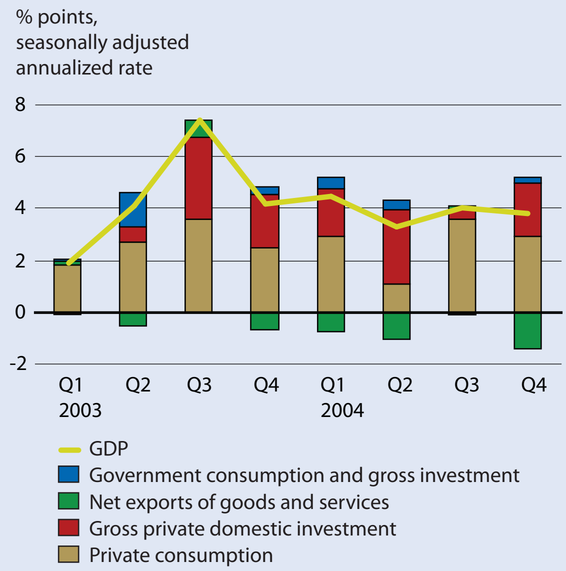
Nevertheless, the widening growth gap entails a significant medium-term risk to the outlook, while sustained high oil prices compound the difficulties for major industrial countries to maintain both internal and external balances. Despite the level of oil prices, core inflation in these economies remained largely under control in 2004. Behind such remarkably subdued inflationary developments lie slow, but accelerating, generation of employment in this economic recovery as well as slackness in most economies. However, excess supply in the labor market in the US is dissipating, with relatively healthy job creation seen in 2004 as a whole.

At the same time, strong US domestic expenditures are deepening the trade deficit, adding downward pressure on the dollar, while

exacerbating inflationary conditions in the medium term. Inflationary risks are tilted up with higher labor and nonlabor costs as well as softening productivity growth in the US. These could lead, later in 2005, to interest rates being considerably higher than currently expected, limiting further expansion in the US economy in the medium term. Against this backdrop, sluggish domestic demand in Japan and the euro zone poses a considerable downside risk. As the rest of the world economy, particularly Japan and the euro zone, still relies heavily on exports for growth, a sharp slowdown in US demand could lead to a worldwide slowdown.

Overall, the economies of industrial countries are projected to grow at 2.5% in 2005 and 2006 (Table 1.2 above), lower than the robust performance of 3.5% last year, but still considerably higher than the average growth rate during the 1990s. Nevertheless, there are signs that a gradual deceleration in the economic growth of these countries is likely to continue. With a number of downside risks weighing on the medium-term outlook, growth in major industrial countries will slow to 2.4% in 2007.

Figure 1.2 Contribution to change in GDP, United States, Q1 2003–Q4 2004



Source: Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/TableView.asp?SelectedTable=2&FirstYear=2002&LastYear=2004&Freq=Qtr, downloaded 28 February 2005.

United States

The US economy continues its healthy expansion on the back of a strong upturn in fixed investment and robust private consumption (Figure 1.2). GDP growth registered a remarkable 4.4% in 2004, up from 3.0% in the previous year. Private consumption expenditure remained a major contributor to the increase in GDP, rising by 3.8% from 2003. The rebound in private domestic investment, aided by a strong pickup in business capital spending since the latter half of 2003, also continued to provide growth impetus. However, renewed vibrancy in exports during the second half of 2003 and the first half of 2004 has waned amid the extended slowdown in the other major industrial countries since midyear, giving rise to the concern that external imbalances in the US economy may further deepen, at least in the near term.

Meanwhile, a weakening in the dollar, together with sustained high oil prices, continues to exert upward pressure on the import bill. A visible reduction in net exports was the primary reason for the deceleration in GDP growth in the fourth quarter: GDP growth fell from a seasonally adjusted annualized rate (saar) of 4.0% in the third quarter to 3.8% in the fourth.

Business activity remains buoyant. Industrial production was 4.2% higher in December 2004 than in December 2003, pushing capacity utilization to 79.1% at year-end, or over 2 percentage points higher than 12 months earlier. The January Institute for Supply Management (ISM) survey suggests healthy expansion in both manufacturing and nonmanufacturing, with the ISM composite purchasing managers index for manufacturing and the ISM nonmanufacturing index reading 56.4% and 59.2%, respectively. (A reading above 50% indicates that business activity generally is expanding.) In spite of slowing exports, manufacturers' new orders and shipments continue to post decent gains on resilient domestic demand. This ongoing demand-side pressure should sustain sound production through 2005.

Strong sales and production have bolstered corporate profits, which grew by an estimated 12.8% year on year in 2004 despite hurricane damage in the third quarter. Solid profit gains as well as a brighter business outlook in 2004 paved the way for a sharp rebound in corporate

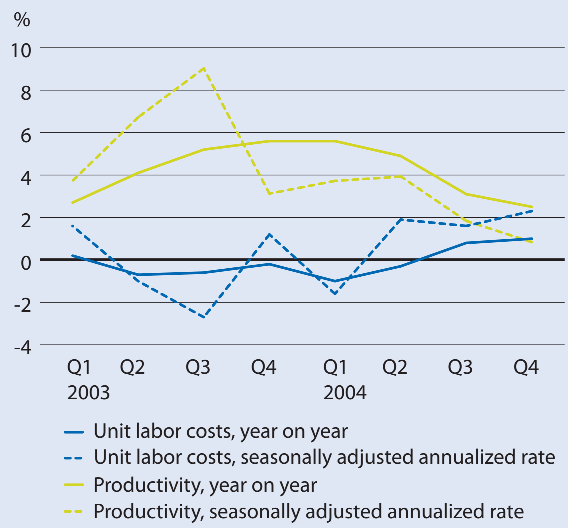
spending. Fixed investment rose by 10.0% year on year, buoyed by increased spending on equipment and software. Following several years of conservative corporate spending, the release of pent-up demand turned out to be enduring. Many firms took advantage of still-favorable tax and financing conditions to replace obsolete computers, software, machinery, and other types of business equipment. However, as interest rates rise further and profit growth slows, the pace of business spending on equipment and software will likely moderate in the latter half of 2005. Enhanced corporate discipline in the aftermath of the high-tech boom of the late 1990s will also keep inventory building under control, restraining excessive capital spending. Residential construction peaked in the second quarter of 2004 and is expected to continue stabilizing with a cooling in the housing market over the rest of 2005.

The labor market is making slow, but steady, progress. Nonfarm payroll employment gained a total of 2.2 million during 2004, lowering the overall unemployment rate to an average of 5.5% in 2004 from 6.0% in 2003. Reflecting the improvement in the job market, hourly compensation in the business sector increased by 4.2% in the fourth quarter (saar) following a 3.8% rise in the previous quarter. Higher compensation has underpinned a strong turnaround in private consumption since the latter half of 2004, while continuing wage increases are expected to exert upward pressure on inflation in 2005. Meanwhile, the household financial position is poised to improve on rising incomes, heralding an orderly consolidation in household balance sheets in the coming years. Personal saving as a share of disposable income appears to have bottomed out, though it remained low at 1.6% in the fourth quarter, while growth in consumer credits outstanding shows signs of stabilization.

Strong domestic demand is being slowly translated into price increases. The consumer price index (CPI)—which measures headline inflation—rose by 3.3% in 2004. The price deflator for private consumption expenditure less food and energy—the basis for a preferred measure of core inflation by the Federal Reserve (the Fed)—edged up by 1.5% over the same period. Although core inflation remains in check and high oil prices have been primarily responsible for headline inflation, there are signs that inflationary risks are inclined upward. With the labor market gradually closing the demand gap, unit labor costs in the nonfarm business sector rose at 2.3% (saar) in the fourth quarter, after a 1.6% increase in the third (Figure 1.3). High productivity growth, which has been a basis for the sound expansion of output without putting undue pressure on inflation, is also reaching a plateau. Fourth quarter labor productivity grew by only 0.8% (saar) in the nonfarm business sector, down from 1.8% growth in the third.

Inflation will be a key variable to watch in the US economy over the forecast period. First, the cyclical demand pressure on overall wages and price levels will likely increase, as the economy continues to work off the slack in the labor market. While wage gains were relatively muted, benefits picked up rather sharply in 2004, pointing to a tightening in the labor market. Second, the downward trend of the dollar is expected to persist, with significant external imbalances weighing on its strength, pushing up import prices. Third, sustained high prices in energy and nonenergy commodities will likely eventually feed into final sales prices. Increasing labor and nonlabor costs, along with slowing productivity growth, suggest dwindling profit margins, which

Figure 1.3 Change in unit labor costs and productivity, United States, nonfarm business sector



Source: www.bls.gov/news.release/pdf/eci.pdf, downloaded 1 March 2005.

may induce many companies to pass on such increased costs to customers.

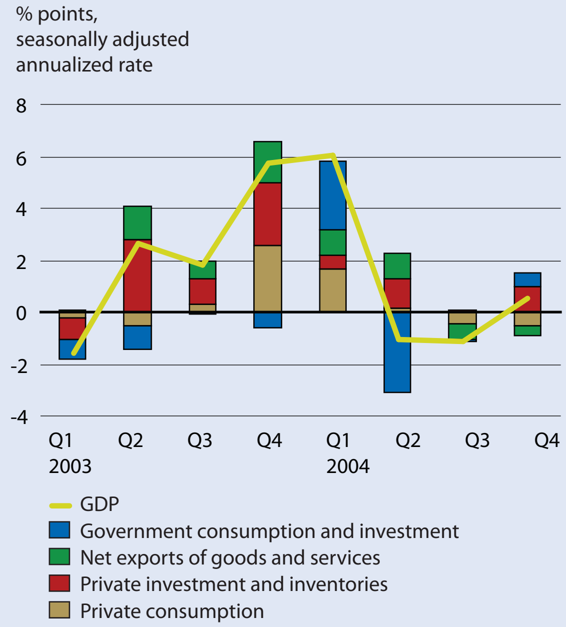
With inflationary pressures building, US interest rates could move significantly higher in 2005. Unlike 2004 when the Fed started raising interest rates from a historically low base of 1.0%, the US economy will begin to feel tightening effects as the Fed continues its rate increases this year. As of March 2005, the Federal Funds rate stood at 2.75%, pushing real interest rates back into positive territory. Meanwhile, the financial positions of both the public and household sectors in the US have yet to improve significantly. The large fiscal deficit aside, the household sector remains considerably indebted. In 2004, the increase in Federal Funds rate notwithstanding, long-term interest rates did not move much, keeping under control the cost of borrowing for the household sector as well as for long-term business investment. However, this could change significantly this year, given the inflationary pressures and the forces of global rebalancing.

Nevertheless, growth momentum still favors the US economy. The baseline GDP projection is 3.7% for 2005. Business surveys point to continued expansion across a broad swathe of business activities, while demand-side pressure will continue to support corporate spending and hiring. As the economy moves toward its potential, higher wages will ensue, slowing further expansion. In spite of significant downside risks arising from inflation, the weakening dollar, higher interest rates, and the global adjustment forces, the relatively controlled pace of job creation and remarkably subdued inflation so far suggest that growth will likely remain healthy at 3.4% in 2006, subsequently moderating toward 3.1% in 2007, nearer its long-term potential.

Japan

The Japanese economy fell into another mild recession after posting encouraging growth of 6.0% (saar) in the first quarter of 2004, followed by 2 consecutive quarters of contraction (Figure 1.4). The exceptional growth witnessed from the second quarter of 2003 to the first quarter of 2004 failed to last, as exports—the major engine of growth during the latest recovery—faltered amid slowing global expansion, a cyclical downturn of the global information technology sector, and rising oil prices. A broadening of the recovery as strong exports helped lift business and consumption spending was also cut short before such a domestic demand recovery could become self-sustainable. Both business and consumer confidence fell, reflecting the lack of growth momentum (Figure 1.5). Future growth prospects are heavily influenced by underlying structural difficulties, which are compounded by the burden of an aging demographic profile.

Figure 1.4 Contribution to change in GDP, Japan, Q1 2003–Q4 2004

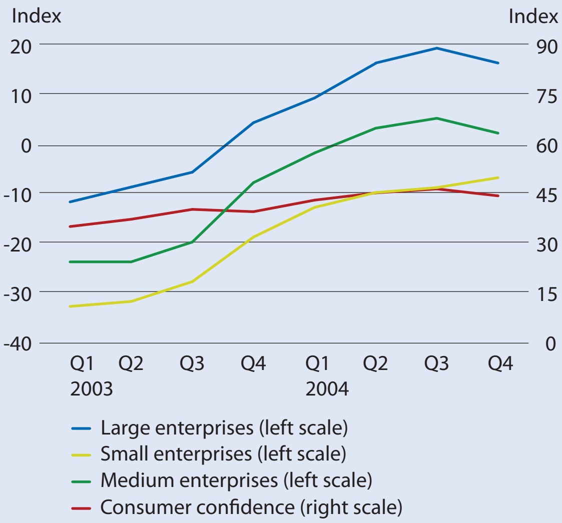


Source of original data: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html, downloaded 14 March 2005.

GDP growth was 2.7% for 2004 as a whole, drawing largely on the exceptional performance of the first quarter. However, softening demand (both external and internal) put a heavy drag on growth in subsequent quarters. Export growth slowed sharply to 2.6% (saar) in the third quarter, although somewhat improving to 4.9% in the fourth, from first and second quarter growth rates of 20.2% and 14.8%, respectively. Meanwhile, high global oil and raw material prices kept import costs up, as a result of which the contribution of net exports to growth turned negative in the last 2 quarters.

A tentative recovery in domestic demand

Figure 1.5 Tankan survey of business conditions and ESRI consumer confidence, Q1 2003–Q4 2004



Notes: ESRI consumer confidence survey is a monthly survey conducted by the Economic and Social Research Institute. Consumer perceptions of the following four categories are surveyed: overall livelihood, income growth, employment, and willingness to buy durable goods.
Sources: Economic and Social Science Research Institute, available: www.esri.cao.go.jp/en/stat/shouhi/0412shouhi-e.html; Datastream, downloaded 26 January 2005.

also petered out. Private consumption rose by 3.0% (saar) in the first quarter, contributing 1.7 percentage points to growth. A gradual improvement in the job market from late 2003, combined with some advance in wages, sent consumer confidence up, boosting household spending until the first quarter of 2004. But the momentum was short lived against the strong headwind of slowing exports and production. Consumer spending has since retrenched, contracting by 0.9% (saar) and 1.0% in the last 2 quarters, consecutively. To make matters worse, a deterioration in the business environment is quickly translating into falling wages and household income. Total cash earnings of employees plunged in December, clouding the prospect of a consumption recovery in the first half of 2005.

Private investment demand was also hit, with gross fixed capital formation growth in the private sector falling from a peak of 13.4% (saar) in the second quarter to 0.3% in the third. However, private investment demand remains a relatively positive spot on the grounds of strong profit gains in the corporate sector and a recovering real estate market since 2003. Final quarter growth in private gross fixed capital formation ended slightly higher at 0.8% (saar) on the back of resilient private residential investment, contributing 0.2 percentage point to GDP growth. Moderately improving machinery orders since late 2004 also supported a turnaround in business capital spending, with private nonresidential investment posting growth of 0.2% (saar) in the fourth quarter, recovering from a contraction of 0.4% (saar) in the third. The strength of business investment remains crucial to putting the economy back on the recovery path. Underpinning continued investment recovery through early 2005, Japan's leading exporters posted strong profit gains even as exports slowed from the second half of 2004. Beneath such resilience lie enhanced operational efficiency and financial stability in the corporate sector, after several years of substantial restructuring efforts.

The significant downturn in exports took a heavy toll on business activity. Industrial production fell by 0.7% in the fourth quarter (quarter-on-quarter), following a decrease of 0.6% in the third. A marked decline in new orders for high-tech equipment corresponding to the cyclical adjustment in the global information technology sector since mid-2004 was primarily responsible for a slowdown in production. There is a glimmer of hope for a production recovery in 2005, as November and December data for machinery orders in manufacturing and shipments of manufacturing goods show a slight improvement on the mild turnaround of exports in the fourth quarter. This is mainly due to robust growth in the economies of the US and the PRC, Japan's major trading partners. However, the weak domestic sector is expected to limit the scope for a swift recovery. Together with a gradual rebound in the export sector, though at a more subdued rate, this suggests only a slight recovery in industrial production for 2005.

On a brighter note, deflationary pressures are slowly easing, with year-on-year growth in the corporate goods price index (which measures inflation at the wholesale level) settling firmly into positive territory over the course of 2004. CPI inflation also turned positive for 3 consecutive months (until December 2004), for the first time

since 1999. Easing deflationary pressures should help the corporate sector sustain profit margins, in the face of high energy costs and slowing sales, both domestic and foreign. However, further deflation remains a considerable downside risk to the recovery, as both the corporate and consumer price inflation rates retreated slightly between December 2004 and January 2005.

In spite of continued capital spending in the export sector, the near-term outlook remains bleak, with GDP expected to grow at 1.1% in 2005. The lackluster growth projection reflects unfinished business in the reform efforts. While the export sector has aggressively clamped down on excess capacity and has strengthened its financial position on rising global demand, the domestic nonmanufacturing sector—consisting mainly of small and medium enterprises—has made only limited progress in restructuring, thus delaying the recovery process in corporate spending and hiring. Meanwhile, the country's unfavorable demographic profile and related high pension burden suggest that the weakness in the domestic sector will persist, limiting any significant growth gains. GDP growth is projected to rise to 1.3% in 2006 and 2007, buttressed by a mild improvement in exports.

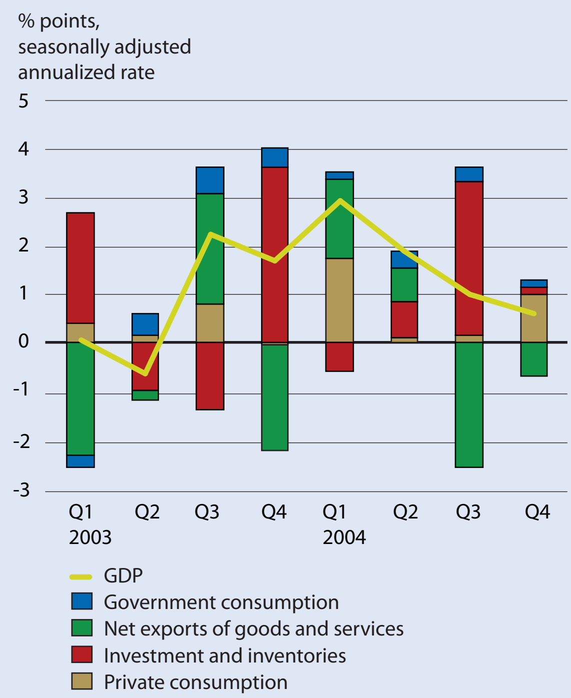
Euro zone

Euro zone GDP grew by 2.0% in 2004, up from 0.5% in 2003. However, final quarter GDP growth in 2004 slid to 0.6% (saar), much lower than the first quarter's 3.0%. A continued appreciation of the euro started to weigh on external trade. Export growth subsided to 5.2% (saar) and to 1.9% in the last 2 quarters, consecutively, from an average growth rate of 8.6% in the first half of 2004. Meanwhile, imports further increased following an improvement in the terms of trade as well as a surge in prices of oil and raw materials, turning the contribution of net exports to a negative 2.6 and 0.7 percentage points, respectively, in the third and fourth quarters, a sharp drop from 1.6 percentage points in the first. A recovery in private consumption remains fragile, with growth falling to 0.2% (saar) in the second quarter (although it has improved somewhat since then) from 3.1% in the first. Rising oil prices appear to be curbing consumption spending by eroding household discretionary income, which was already under pressure from anemic job growth (Figure 1.6).

As external demand softened, some of the larger euro zone economies that relied heavily on exports during the latest rebound slumped over the course of 2004. Germany and Italy, the largest and third-largest economies in the zone, contracted by 0.9% and 1.2% (saar), respectively, in the fourth quarter when the euro, already at its highest level since its launch, further appreciated against the dollar. Other countries—notably France and Spain, where domestic demand strengthened noticeably during 2004 thus exhibiting relative resilience as exports slowed—also remain vulnerable to sustained high oil prices in the face of sluggish job creation. Based on a combination of moderating exports and a slack domestic economy, euro zone GDP is projected to slow to 1.6% in 2005.

Despite the lackluster performance in the second half of 2004 and weakened near-term

Figure 1.6 Contribution to change in GDP, euro zone, Q1 2003–Q4 2004



Source of original data: Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/aggs/aggs_gdp&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0, downloaded 4 March 2005.

outlook, the euro zone economy will likely continue a modest recovery on the grounds of a gradual strengthening of domestic demand over the medium term. In support of the slow, but steady, economic rebound, business investment continues to firm up. Gross fixed capital formation rose by 3.9% (saar) in the final quarter, continuing its rebound from the third. Following years of subdued investment, the corporate sector appears to be in need of replacing old machinery and equipment. Robust export earnings in the past few years have also significantly improved corporate financial positions, underpinning an upward trend in business capital spending. Rising corporate spending should in turn exert a positive influence on the labor market, thus eventually boosting private consumption. Against this backdrop, GDP is projected to grow at 1.8% in 2006, returning to a long-term average growth rate of 2.1% in 2007.

A major downside risk to this scenario is the slow progress in the labor market to date. Jobless rates in the euro zone are persistently high, at an average of 8.9% in 2004. In Germany, the unemployment rate surged to 12.6% in February 2005, while France reported 10.0% in January 2005. Such a dismal job situation in the euro zone, combined with reductions in unemployment benefits and tighter restrictions on eligibility for benefits that came into effect in January 2005 in Germany, could severely dent the prospects of a recovery in consumer spending over the forecast period. Consumer confidence, which showed a mild recovery in Germany, France, and Italy in early 2005 amid tax cuts and stabilizing oil prices (partly due to the offsetting effect of the strong euro), could also sharply deteriorate as a result of the dim job outlook.

Growth performance remains highly uneven across the euro zone economies, exacerbating the difficulties of harmonizing macroeconomic policies in support of a weak recovery. The dampening effect of continued euro strength notwithstanding, headline inflation remained slightly above the European Central Bank (ECB) target of 2% in 2004 due to sustained high oil prices. Moreover, credit growth has been relatively strong, given the resilient business capital spending and buoyant housing markets in many European economies. While the ECB is likely to maintain the current stance—reasonably accommodative at 2%—for the first half of 2005 in the face of a lagging recovery, a gradual pass-through of higher producer prices could trigger a rate hike later this year, barring any significant slowdown in economic activity. Fiscal policies in many euro zone economies remain largely restrictive, reflecting the target limits of the Stability and Growth Pact (SGP). Although some of the larger countries have introduced tax cuts while pursuing SGP reforms to provide a stimulus to weakening domestic demand, persistently large fiscal deficits and pension burdens limit likely expansionary fiscal spending across the region.

The German economy slowed sharply in the second half of 2004, although it posted decent growth of 1.6% for the year as a whole. The continued appreciation of the euro and a moderating global expansion led to erosion of previous export gains. However, new orders, both domestic and foreign, for manufacturing goods increased in December 2004, by 8.1% and 8.3% respectively, from the previous month, gently brightening the growth outlook for this year. Business surveys also suggested a moderate recovery for industrial production. Nevertheless, a modest turnaround in domestic demand is unlikely to be sufficient to accelerate the economy in the face of moderating foreign demand this year. Ongoing reforms in the labor market, health care, and pensions, although beneficial for long-term growth, will dampen near-term prospects.

In France, the recovery has been more broadly based than Germany and Italy, with domestic demand picking up along with exports. Boosted by income tax cuts, robust consumer spending has been sustained despite the weakness of job growth. The release of pent-up demand in the corporate sector has also lifted business investment. However, a mild cyclical correction is expected this year based on waning fiscal stimulus, continued slack in the labor market, and slowing exports.

The Italian economy ended 2004 on a grim note by shrinking in the final quarter. Exports, which had been the main driver of growth, declined as a result of continued euro appreciation and slowing external demand, while domestic demand stagnated. Meanwhile, the rigidity in the labor market is further eroding Italy's competitiveness, as well as hampering a consumption

recovery. Late in 2004, the Government announced tax cuts for 2005 to support domestic spending. However, without significant reforms in public finances, more measures to curb fiscal spending will be required to keep the government budget deficit from exceeding the SGP limit of 3% of GDP, which leaves the net effect of tax cuts largely ambiguous.

Outside the euro zone, the United Kingdom economy continues to expand on the back of strong consumer spending and business investment. Growth accelerated to 3.0% in 2004, although it will likely moderate to 2.7% in 2005 and 2.6% in 2006. In sharp contrast to the euro zone, past reforms have significantly lifted overall economic efficiency and productivity through enhanced flexibility in both labor and product markets. Productivity gains in turn are reinforcing a pickup in corporate profits, which is passed on to household income and net financial wealth, thus underpinning continued strength in private consumption. However, there are signs that the economy has already reached its potential, pushing labor costs higher, particularly in the buoyant private services sector. Household and corporate liabilities also seem overextended, as reflected in a marked reduction of private savings. Over the forecast period, the pace of private sector spending will soften, which will be partly compensated for by a gradual rise in public spending. Private consumption has already slightly retrenched following stabilization in housing prices coupled with rises in interest rates in the latter half of 2004.

World trade and commodity prices

World trade, as measured by world export volume, grew by an estimated 10.2% in 2004, nearly double the 5.5% rate in the previous year. However, the rapid pace of world trade expansion during the first half of 2004 has eased, as a synchronized global economic recovery largely fell apart in the second half. Strong export growth in major industrial countries all but ground to a halt in the third quarter of 2004, as Japan and some of the large euro zone economies slumped amid rising oil prices. Although relatively resilient US demand and robust industrial production in the PRC continue to provide some support to trade dynamics, several factors—including a moderating world economic expansion, slowing global demand for high-tech equipment, and sustained high oil prices—suggest that world trade will slow to 7.4% in 2005. Growth in world trade is likely to settle at about 6% over the medium term, reflecting a deceleration in world economic growth.

In the midst of rising economic uncertainty, a cyclical downturn in global high-tech industries has started to weigh on the export performance of many East Asian economies, which are leading producers of high-tech and electronic items. The year-on-year growth rate of worldwide semiconductor sales peaked at 40.5% in June 2004, weakening to 14.6% by year-end. After soaring in the first half, memory chip prices have fallen, as a result of softening demand and improved production capacity following tight supply conditions during the upswing in high-tech industries in the latter half of 2003 and the first half of 2004.

Despite the slowing pace of sales into 2005, there are signs that the current slowdown will be relatively mild and short lived. First, inventory buildup during the latest expansion period has been limited by enhanced corporate discipline. Indeed, producers have been quick to trim excess capacity, bringing down capacity utilization rates to 86.0% in the fourth quarter from a peak of 95.4% in the second, according to the Semiconductor Industry Association. Second, a decline in new orders and shipments of semiconductors have been stabilizing since the beginning of 2005 on the back of relatively resilient business capital spending around the world, even as the growth outlook for the world economy has eased. Third, the average price of semiconductors has stabilized since the fourth quarter of 2004, reflecting a relatively benign sales outlook for 2005.

In this context, global production and sales of semiconductors will grow modestly in 2005 after 2004's hefty growth, followed by a cyclical upturn as early as 2006.

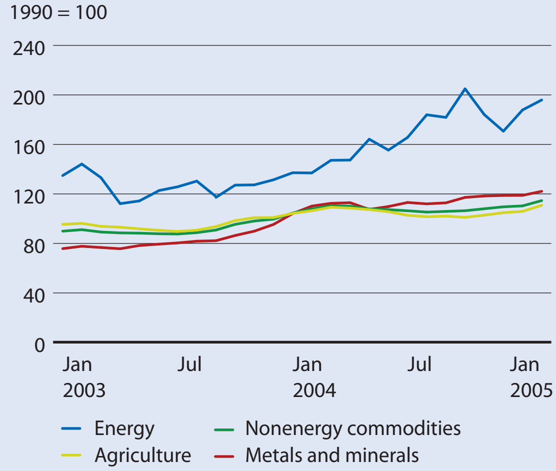
Oil prices surged and remained high at above $40 per barrel for most of the second part of 2004. The price of benchmark Brent crude averaged $38.3 per barrel for 2004, significantly higher than $28.8 in 2003. With tight market conditions and geopolitical uncertainties, any event that could potentially disrupt oil supplies—such as financial troubles at Yukos (a large Russian oil producer);

production delays in the Gulf of Mexico due to a hurricane; an oil rig workers' strike in Norway; and ongoing political unrest in Iraq, Nigeria, and Venezuela—unsettled the market. Last October, the price surged and stayed above $50 per barrel for much of that month. Oil market fundamentals have not improved significantly in the early months of 2005, as strong demand and geopolitical uncertainties continue. According to the February estimate by the International Energy Agency (IEA), global oil demand is 84.0 million barrels per day (mb/d) for 2005, or an increase of 1.5 mb/d from 82.5 mb/d in 2004. Strong demand is expected to continue in the US, the PRC, and the rest of developing Asia, while Japan and the euro zone should see a moderation in oil demand in 2005. Spare capacity of the Organization of the Petroleum Exporting Countries (OPEC) members (excluding Iraq, Nigeria, Venezuela, and Indonesia) remains low, according to the IEA. The growth of non-OPEC supplies, including those from the North Sea, the Gulf of Mexico, and the Russian Federation, is expected to be limited after a number of disruptions in 2004.

Against this background, global oil prices are projected to stay high, with Brent crude averaging $41 per barrel for 2005. Strong demand from developing Asia, especially the PRC, will likely remain supportive of the high oil prices over the forecast period, with the projected prices averaging $39 in 2006 and $37 in 2007.

Prices of nonenergy commodities were up by 10.0% in December 2004 compared with 12 months earlier, following an increase of 12.7% during 2003 (Figure 1.7). The price rally since 2002 stretched into the first half of 2004 on strong food and raw material prices. Prices of agricultural food commodities have generally come down since then, following good harvests of grains including maize, rice, and wheat. After the run-up in 2003 due to drought in major producing countries, prices of fats and oils fell by 17.7% in 2004 on strong production of soybeans. Meanwhile, the prices of beverages are picking up. Coffee prices soared in the last quarter of 2004 on expectations of lower production in Brazil for 2005, while political instability in Côte d'Ivoire, the world's largest producer of cocoa, is keeping the cocoa price up. Nevertheless, reflecting relatively benign supply conditions, the prices of agricultural food and beverage products will further stabilize closer to their long-term trend in 2005, declining by 1.0–1.5%.

Figure 1.7 Commodity prices, January 2003–February 2005



Source: World Bank Commodity Price Data (Pink Sheets), various issues, available: http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html, downloaded 4 March 2005.

Meanwhile, agricultural raw materials such as rubber and timber sustained strong gains during 2004, reflecting robust industrial demand. Rubber prices (Singapore) rose by 20.4% in December 2004 from the previous year, and timber prices by 9.5%. Cotton prices also appear to be strengthening in early 2005, after hitting a 2.5 year low in December 2004.

Prices of metals and minerals continue to rally, increasing by 24.6% in 2004 on the back of strong demand (particularly from the PRC), low inventories, and ongoing weakness in the dollar. Steel production in the PRC, one of the world's largest producers, remains robust (despite the earlier concerns over a hard landing in the sector). Nevertheless, continued strong demand contributed to the largest gains in steel prices among metals. Prices of other metals such as copper, lead, and tin also rose significantly, albeit at a slower pace in the second half of 2004 than in the first.

A healthy growth outlook for the PRC in 2005 is positive for the prices of raw materials, particularly metals and minerals. The prices of agricultural raw materials will likely remain strong,

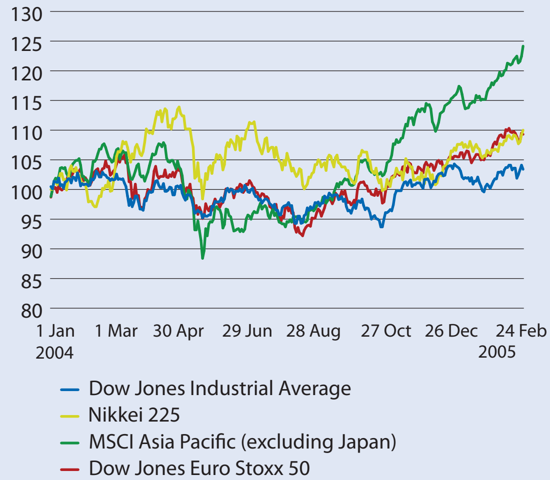
although increasing at a much more subdued rate of 1.0–2.0% in 2005, as they will benefit from resilient industrial production in the US and developing Asia. On the grounds of continued—albeit moderate—demand from the PRC, the prices of metals and minerals are also projected to grow at a more modest rate, likely in the range of 4.0–6.0% in 2005. Over the medium term, decelerating world economic growth, including a moderation in the PRC's expansion, suggests further moderation in the growth of prices of nonenergy commodities.

Financial market developments

Buoyed by generally strong economic growth and a continued low interest rate environment around the globe, international financial markets remained vibrant in 2004. Investor confidence, which was hurt amid surging oil prices and a softening global rebound between July and early August last year, has since recovered. The prospect of continuing global recovery led by still robust economic expansion in much of Asia (including the PRC) and the US—though at a slower pace than in 2004—together with relatively muted inflationary pressures, appears to be underpinning the turnaround in global investment activity. By the end of 2004, both equity and corporate bond prices had climbed higher, recovering most of their earlier losses.

The return of investor confidence was reflected in the rebound of global equity prices (Figure 1.8). Shedding concerns about tight oil supplies, which sent the price of Brent crude beyond $50 per barrel during October last year, international investors quickly resumed the mid-August rally. The focus of investment decisions has been gradually shifted to the resilient growth outlook, as the much-feared inflationary risk from rising oil prices remained largely under control. Strong corporate earnings, despite the sustained high oil prices, also contributed to the revaluation of the international equity markets. In the US, the Dow Jones Industrial Average index rose by 9.9% between its low for the year on 12 August and end-December. The Dow Jones Euro Stoxx 50 index for the European market and the MSCI Asia Pacific index for Asia excluding Japan followed suit by gaining 14.0% and 23.6%, respectively,

Figure 1.8 Major stock market price indexes, January 2004–February 2005 (1 January 2004 = 100)



Note: Morgan Stanley Capital International (MSCI) is a capitalization-weighted index that monitors performance of stocks from Asia-Pacific, excluding Japan.
Sources: Datastream, downloaded 1 March 2005; Bloomberg, downloaded 1 March 2005.

over the same period. Meanwhile, the faltering economic outlook weighed on Japan's Nikkei 225 stock market index, which remained relatively flat, increasing by only 4.2%.

Credit spreads have also been held tight on both investment grade and high-yield corporate bonds since late August. While the credit market remains flush with liquidity from the historically low interest rates of the past few years, the corporate sector, which emerged from credit excesses in the late 1990s with enhanced corporate discipline, has been slow to expand business activities or take new credits in many parts of the world. Overall, such a supply/demand imbalance has kept bond prices high even as the US policy rate has increased. A strengthening of corporate balance sheets on solid profit gains and still soft capital spending have also contributed to improvements in credit ratings of corporate borrowers, thus underpinning the price rally in the corporate bond market.

The gradual increase in optimism regarding the global economic outlook and the pace of ongoing rate movements in the US helped lift investors' risk appetite, which had retrenched significantly during the heavy sell-off of risk assets between April and May prior to the initial Fed decision to raise interest rates on 30 June 2004. Between

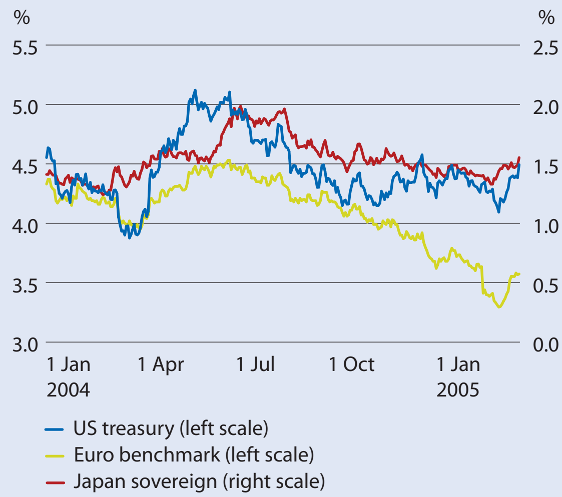
then and March 2005, the Fed raised the policy rate by a total of 175 basis points. The measured pace of the rate hikes by the Fed (now expected as an increase of 25 basis points at each monetary policy meeting) anchored market expectations, contributing to a significant decline in volatility in the US bond market. At the same time, effective communication by the Fed with the market has nurtured some complacency among investors, as they have perceived the ongoing rate movements as a return to a neutral stance in monetary policy, rather than a tightening. Although the range of a perceived neutral rate differs among investors, there appears to be an increasing consensus that the target Federal Funds rate will not rise higher than 4.0%, which is much lower than the end results of previous tightenings, for example, 6.0% in February 1995 and 6.5% in May 2000.

Underpinning the expectation of relatively low, if rising, interest rates, inflation has remained contained in spite of sustained high oil prices. Given the slack in the labor market, the Fed should be able to continue its measured pace of tightening for the first half of 2005, before gradually settling at a "neutral" rate. The target Federal Funds rate is expected to reach 3.75% by end-2005, with an average of 3.1% for the year as a whole. A considerable upside risk remains, as inflation could significantly pick up on the closing output gap as well as rising input costs. The *ADO 2005* baseline assumptions for the Federal Funds rate are an average 4.2% for 2006 and 4.4% for 2007. The 6-month London interbank offered rate ended last year at 2.78% and is projected to rise to close to 4.0% by end-2005. In the euro zone, the faltering economic outlook has lowered expectations of a rate increase by ECB in the first half of 2005. However, the September futures for 3-month Euribor are priced at a discount rate of 2.4% as of 28 February, suggesting that ECB is expected to raise its policy rates in the last quarter of the year in response to persistent inflation and credit growth. The Bank of Japan is unlikely to shift away from its zero interest rate policy. Deflationary pressures, though easing, remain a sizable threat to the fragile recovery.

The subdued inflation rate has kept long-term bond yields low around the world, with the exception of Japan where easing deflationary pressures have kept long-term interest rates marginally up (Figure 1.9). Even in the face of the Fed rate hikes, yields on the 10-year US treasury note have drifted down since the middle of last year. Falling bond yields at the long end, though mainly attributable to the well-anchored inflationary expectations, have partly reflected the bearish sentiment among investors since mid-2004, weighed down by the prospect of moderating growth in the world economy in the coming years. The yield curves have significantly flattened across major industrial countries since mid-2004. The trend of global flattening was underpinned by the demand for bonds with longer duration, which kept the prices up, thus limiting the yield increase at the long end. The revival of carry trades—investing in long-term securities with higher returns by taking on short-term liabilities with low interest rates—also contributed to the demand. Ongoing demand excess will likely continue to put a lid on long-term bond yields until the middle of 2005. However, with increasing inflationary pressures and solid growth prospects in the US, yields on the 10-year treasury note are expected to rise higher in the second half of the year.

Taking advantage of still favorable external funding conditions, emerging market issuers continued to raise significant funds through equities and bonds in international capital markets in 2004. Total equity issuance by emerging Asian market countries amounted to

Figure 1.9 10-year Government bond yields, January 2004–February 2005

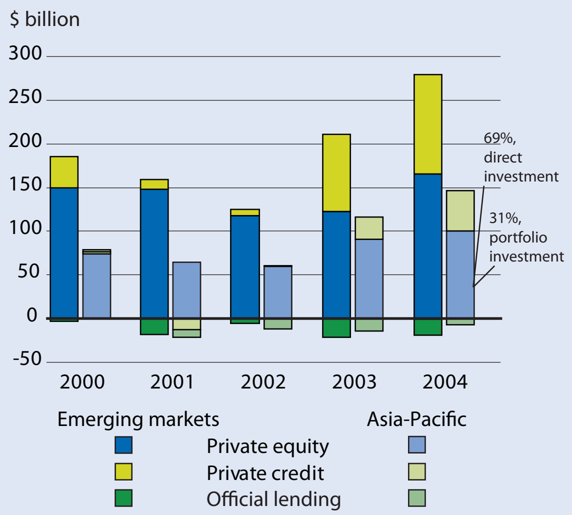


Source: Bloomberg, downloaded 1 March 2005.

$22 billion, about two thirds of which was offered by the PRC. Bond issuance was also active, with total corporate and sovereign bond issuance of $38 billion, up from $22 billion in 2003.

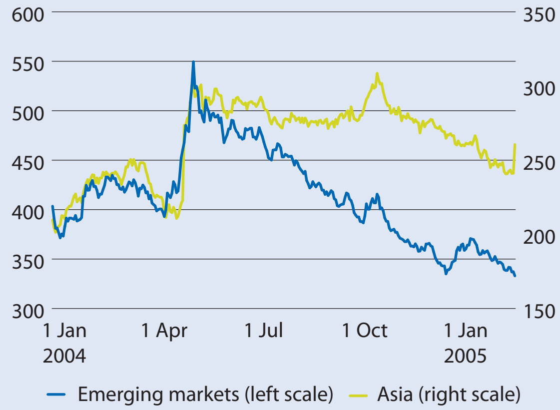
The comparatively more resilient growth outlook for emerging Asian markets than mature markets, even as moderating growth is expected for the world economy, boosted capital inflows to regional capital markets as well, particularly in the latter half of 2004. Net private capital flows to the region amounted to $146.3 billion in 2004, up from an already high $116.3 billion in 2003, bolstered by continuing foreign direct investment flows into the PRC and a surge in syndicated loans (Figure 1.10). According to the Institute of International Finance, Asia-Pacific accounts for nearly 90% of net portfolio equity flows to emerging markets with an estimated total of $31.2 billion in 2004. Net private credit flows in the form of syndicated loans also jumped to $33.5 billion from $13.8 billion in 2003. Such relatively short-term capital flows were particularly strong in the last quarter, driven by increasing speculation on the potential appreciation of regional currencies.

Figure 1.10 Net capital flows to emerging markets and Asia-Pacific, 2000–2004



Note: Emerging markets and Asia-Pacific follow the definition of the Institute of International Finance, Inc., available: www.iif.com/emr/coverage.quagga.
Source: "Capital Flows to Emerging Market Economies," various issues, the Institute of International Finance, Inc., available: www.iif.com.

Figure 1.11 Sovereign risk spreads, emerging markets, January 2004–February 2005, basis points



Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. Emerging markets and Asia follow the definition of JP Morgan, available: www.utdt.edu/~ely/intro_embig.pdf.
Source: Datastream, downloaded 1 March 2005.

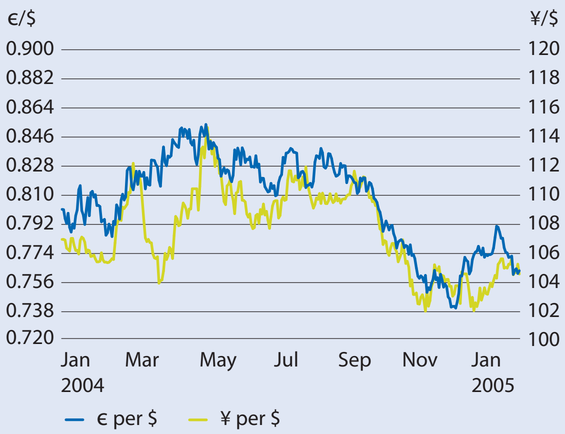
Heightened risk appetite, together with ample liquidity, has also contributed to a decline in emerging market spreads (Figure 1.11). Emerging market bond spreads, which experienced a surge prior to the much-anticipated Fed tightening, subsequently narrowed and ended the year at their lowest level since the 1997–98 financial crisis and subsequent emerging market crises. Falling from a peak of 301.8 basis points during the April–May sell-off, sovereign risk spreads of emerging Asian markets came down to 256.7 basis points by the end of January 2005. Robust, albeit moderating, economic growth, strong trade surpluses, and high levels of foreign exchange reserves, combined with relatively healthy fiscal positions across Asia, have enhanced credit quality and lowered default risk, thus supporting bond prices in the region.

Strong capital inflows—led by significant PRC-bound foreign direct investment flows—will likely continue, based on the robust regional economic outlook over the forecast period. The prospect of strong earnings growth and attractive prices still makes emerging Asian equity markets a top destination for portfolio inflows among emerging markets, while a gradual increase in international interest rates is likely to moderate the pace of private credit flows through bond purchases and syndicated loans. The Institute of

International Finance estimate of total net private capital inflows to developing Asia and the Pacific is $125.6 billion for 2005.

Despite the improved outlook for growth in the US, the dollar resumed its decline, falling by more than 11.0% against the euro and 9.0% against the yen from their respective peaks to troughs during the last quarter of 2004 (Figure 1.12). A significant deterioration in the trade balance and the investor perception that the US Government's measures may be inadequate to curb fiscal deficits exacerbated the dollar's slide. However, widening interest rate differentials, as well as macroeconomic fundamentals in the US that remain considerably stronger than those in the euro zone, suggest that the euro/dollar rate may have reached bottom. Barring any sudden trigger to financial instability, such as higher inflation, another surge in global oil prices, or an unwinding of Asian central banks' dollar assets, the dollar should be able to maintain its current strength vis-à-vis the euro. The pressure on developing Asian currencies to appreciate will likely intensify, on the basis of Asia's relatively robust growth outlook and continuing capital inflows to the region. Against this background, more proactive and concerted regional efforts will be needed to ensure an orderly adjustment among regional currencies in the face of the ongoing global currency movements.

Figure 1.12 US dollar against euro and yen, January 2004–February 2005



Source: Datastream, downloaded 1 March 2005.

Risks to the outlook, and challenges for developing Asia

While developing Asia continues to add a strong impetus to the world economic expansion, the risk of global imbalances looms greater than ever. As discussed in *ADO 2004*, developing Asia has been an intrinsic part of the global imbalances, by producing large current account surpluses and financing a significant share of the US twin deficits mainly through large purchases of US securities. Ongoing weakness in the US dollar suggests that the adjusting forces for such imbalances might already be at work. As Asia is increasingly expected to share the burden in the adjustment process, Asian currencies may experience proportionately larger appreciation over the forecast period.

The other risks identified in *ADO 2004* and *ADO 2004 Update* are still very relevant: the risk of epidemics, the threat of terrorism, the growing interdependence of regional economies, and sustained high oil prices. As evidenced by the recent resurgence of avian flu in Viet Nam and Cambodia, the risk of broader and more life-threatening epidemics remains a very serious concern to the region. In addition, the disastrous tsunami that struck the countries bordering the Indian ocean and its impacts—including the huge loss of human life and a sharp increase in poverty in the affected areas—underscore the need to reinforce regional cooperation in Asia to effectively deal not only with the aftermath of such natural disasters but also the continuing threat of terrorism—and all the more so in the context of increasing economic linkages across the region.

Global economic risks

Forces of global rebalancing unfold. The risk of global disruption stemming from large external imbalances in the US has been on the radar for some time, but the timing and impact of the inevitable adjustment process remain uncertain. Prior periods of adjustment and resultant weakness in the dollar have proved quite painful for the world economy. In the early 1970s, following the collapse of the Bretton Woods system, exchange rate volatility, inflation, and oil price shocks presented major economic challenges to policy makers around the world. In the late 1980s,

the dollar's decline contributed to the stock market crash in the US and financial turbulence. Moreover, overinvestment in Japan led to a decade of recession there, limiting that country's contribution to global growth, while structural problems in the EU have played a similar role with regard to global growth.

With US growth outpacing that of other major industrial economies, its current account deficit is expected to rise further. On the back of robust domestic demand and considerable fiscal outlays, the US current account posted another deficit of $665.9 billion, or about 5.7% of GDP, in 2004, up from $530.7 billion in the previous year. Although the budget deficit came in smaller than expected at $412.1 billion in 2004, as a result of ongoing efforts by the US government to curb fiscal spending, the deficit is still up by $34.5 billion from $377.6 billion reported in the previous year. Behind the sustained increase in the US twin deficits has been strong reserves accumulation by Asian central banks. At the end of 2004, developing Asia's foreign exchange reserves were about $1.6 trillion, with the majority held in dollar assets; including Japan, the figure is estimated to amount to more than $2.4 trillion. According to estimates by the Bank for International Settlements, the reserves accumulation of Asian central banks financed more than 70% of the US current account deficit in 2003. However, the increasing exposure to a weaker dollar may prompt Asian central banks to consider rebalancing their reserves portfolios. Corroborating this view, a recent survey of central bank reserve managers published by Central Banking Publications—a London-based private think-tank—indicated a tendency of shifting reserves away from dollar assets into euro assets.

Two main implications for developing Asia flow from this. First, the dollar could depreciate faster and more sharply than assumed in the baseline scenario, deeply eroding the value of dollar reserves, while constraining Asia's exports before its domestic demand reaches firmer ground. Second, US interest rates could rise rapidly to break the dollar's fall and ensure the financing of the US budget deficit, thus triggering a major adjustment in international financial flows. Combined, these two factors pose a significant risk to the regional outlook.

Developing Asia will have to play a key role in bringing about a smooth adjustment without incurring too steep an economic cost, both for the region and the rest of the world. Reducing the US current account deficit requires faster growth in US savings. While the US Government must take the necessary steps to contain an unsustainable rise in the fiscal deficit, US income growth should also exceed growth in private consumption. The only way this will occur without a major slowdown in consumption and investment spending is with increased net exports. Such an outcome can be attained only if domestic demand in the rest of the world—particularly Japan, EU, and developing Asia—grows much faster. An orderly adjustment in Asian currencies along with strengthening regional demand could help achieve this result. Thus a major agreement among the key players would be needed to ensure a smooth and orderly adjustment of global imbalances.

A sharp increase in US interest rates could have negative impacts. The ongoing weakness of the dollar, the gradual working off of slack in the labor market, and sustained high oil prices all point in one direction—a bout of inflation in the US. With inflationary pressures building up, US interest rates could rise significantly higher in 2005. A sharp acceleration in these rates can exert significant influence on both the US and global financial markets. Over the past few years, a low interest rate and high liquidity environment have nurtured investors' risk appetite, thus tightening credit spreads for both sub-investment grade and emerging market corporate and sovereign borrowers. Increasing carry trades have been also undertaken, reflecting a significant flow of funds into risk assets. A weakening of such international capital flows, in the event of a steep rise in US interest rates, could jeopardize generally heightened prices of risk assets around the world. Housing prices may also come under pressure in some industrial countries, including the US and the United Kingdom. More importantly, abrupt changes in financing conditions might expose emerging market economies in the region to some disruption. The wave of unwinding speculative positions and rising cost of international borrowing could also have negative impacts on emerging economies with large fiscal deficits and external debts.

High oil prices pose an added threat to the financial risks. While the economy of developing Asia appears to have gained considerable growth momentum to avoid a major slowdown from currently high oil prices, another steep rise in oil prices in combination with inflation and high interest rates could add significant strains on the regional as well as global outlook. Brent crude is projected to average $41 per barrel in 2005, much higher than its post-1990 long-term average of $20–25. However, as of 16 March, the Brent crude price surged again to $53.8 per barrel, exceeding last year's peak of $51.4. This current price run-up beyond $50 per barrel is a vivid reminder that high oil prices remain a major risk for the region, given Asia's high dependence on oil imports. (As reported in *ADO 2004 Update*, a $10 increase in oil prices for 1 year could shave an estimated 0.8 percentage point off growth in Asia excluding Japan.)

Regional risks

Greater regional exchange rate coordination is necessary. The rapid depreciation of the US dollar has put Asian foreign exchange policies in the spotlight. With increasing risks of global imbalances, pressure on the region's currencies is rising. Equally important is the increasing cost of maintaining a dollar peg, due to a rapid accumulation of foreign exchange reserves across the region and upward pressure on inflation. Reflecting these factors, some Asian currencies—including the baht, New Taiwan dollar, Singapore dollar, won, and yen—have already appreciated in the last quarter of 2004.

As de facto US dollar pegs become more difficult to maintain, varying degrees of exchange rate flexibility across the regional economies pose a risk to currency and financial stability. Regional economies currently exhibit a wide range of foreign exchange policies, from fixed exchange rate regimes to managed floats and flexible exchange rates. Nevertheless, by keeping local currencies relatively stable against the dollar, these economies have been able to achieve stable cross-currency exchange rates within the region. However, without concerted efforts among regional economies to maintain intraregional currency stability while introducing more flexibility vis-à-vis the US dollar, the recent divergence in exchange rates may lead to greater volatility of regional currencies against each other. Contrary to popular belief, the US economy is no longer developing Asia's largest trading partner—developing Asia itself is. Increasing regional integration implies that greater volatility in cross-currency exchange rates could widen trade and financing gaps within the region, putting undue pressure on certain countries during the course of international currency adjustments. The challenge lies in further strengthening regional cooperation to address and contain such volatility while extending support to an agreement for the orderly adjustment of global imbalances (as noted in the section "Global economic risks").

Meanwhile, look out for speculation. Speculation on regional currency appreciation has already triggered substantial private capital inflows to the region. Relatively short-term flows, such as portfolio equity investment and commercial bank lending, were particularly high in the last quarter of 2004. With the majority of such capital flows destined for the PRC, the increasing volatility of capital flows compounds the difficulties of sterilization, exacerbating the overinvestment problem. The speculative capital flows also increase the risk of a sharp unwinding, if US interest rate increases accelerate as inflation takes off or if investors simply change their expectations. Although ample official foreign reserves and strong macroeconomic fundamentals limit the risk of a financial crisis recurring, sound management of capital flows is particularly important for these countries to arrest excess volatility in their currency and financial markets. To this end, regional diversification and specialization can help underpin the efficient allocation of financial resources for more productive uses across the region. Alleviation of financial risks may result from enhanced dynamic competitiveness of individual countries in the region and from intraregional trade—through greater diversification and specialization in goods and services—which will not only broaden the use of increasing capital inflows across the region, but also reinforce regional economic growth and integration.

Overheating in the PRC is still a possibility. *ADO 2004* warned against the risk of overinvestment in some sectors and the related increase

in nonperforming loans in the banking sector. The PRC Government has taken a series of steps to slow investment and credit growth in some sectors, which include tightening liquidity and employing administrative measures to contain overheating in the concerned sectors. Despite such measures to engineer a soft landing, the PRC economy is still performing strongly, growing by 9.5% in 2004. Fixed asset investment rose by 25.8% that year, only 1.9 percentage points lower than in the previous. Although there are signs that government policies have been effective in reining in inflationary pressures and generating more balanced growth, the latest growth figures suggest that more austere measures of tightening may be necessary to curb overinvestment and achieve a soft landing. Failure to do so in the near future may increase the risk of a hard landing at a later date.

Epidemic outbreaks remain a very significant risk. Strong regional cooperation is absolutely vital in mitigating the risk of various epidemics. The tsunami that devastated coastal areas of the Indian Ocean left these areas vulnerable to epidemics. While the immediate economic consequences remain under control in many affected countries, poor sanitary conditions alongside the lack of sound health systems are risk factors for epidemic outbreaks of typhoid, hepatitis, diarrhea, and cholera across the region. The outbreaks of avian flu in 2004 reportedly killed 29 people out of 37 affected in Viet Nam and have affected some parts of Asia. The risk of an avian flu pandemic cannot be ignored, as the persistent fear that the virus could mutate into a form that can spread efficiently from human to human remains. The threat of diseases is significant, and the region still remembers the grim impacts of severe acute respiratory syndrome on overall economic activity, let alone the loss of human life. In order to avert another disease-related disaster, strong regional cooperation, together with help from international aid agencies, is needed to ensure early detection of outbreaks, effective treatment of the affected, protection of the public against contagion, and minimization of the spread across borders.

Challenges to developing Asia's policy makers

Developing Asia and the Pacific has exhibited remarkable resilience while continuing to adjust to the emergence of the PRC as a major economic power, and more recently to the rise of India. Taking advantage of enormous opportunities that these potential economic powerhouses should bring to the region, developing Asia is expected to continue rapid and robust growth in 2005–2007 and beyond. Nevertheless, Asian policy makers face significant challenges to maintain sound macroeconomic fundamentals while nurturing domestic demand conditions to sustain strong growth momentum. Overall, the downside risks are considerable, particularly as some external factors—such as the moderation of the world expansion, the downturn of global information technology industries, and sustained high oil prices—weigh on the regional outlook over the forecast period.

Sound macroeconomic policy is integral to sustaining high growth. There are growing concerns that the basis of sound macroeconomic conditions needs to be reinforced. First, headline inflation has picked up across the region. Higher food and energy prices have been mainly responsible for the rise in CPI inflation. Although supply-side pressures have yet to trigger a full-blown price effect through a wage-price spiral, a pickup in CPI inflation complicates the monetary policy decisions of Asian central banks. Some countries, including the PRC where strong consumption and investment growth is already stoking inflationary pressures, have taken tightening measures. In other countries where domestic demand remains a concern, monetary policy remains flexible, providing necessary support to underpin a nascent recovery in domestic consumption and investment demand. However, the monetary authorities face increasingly limited room to maneuver, as the region has been flush with liquidity due to strong private capital inflows, thus building greater external reserves and further exacerbating the difficulties of sterilized interventions. In these countries, the central banks need to closely monitor monetary and financial conditions over the rest of this year. As the domestic demand recovery reaches a firmer footing, the eased monetary policy should gradually reverse to keep price stability.

Second, behind the modest inflation (despite Asia's high dependence on oil imports) have been

policy efforts to contain the price pass-through of high oil prices. Many Asian governments have increased oil subsidies, strengthened price controls, or cut import duties on oil during the price run-up. While protecting consumers from higher global oil prices, the incomplete pass-through has led to a deterioration in the fiscal position in these countries, particularly in India and Indonesia where budget conditions have been an ongoing problem. As noted in *ADO 2004 Update*, heavy debt burdens—which will become heavier if international financing costs rise—continue to be a threat to the medium-term outlook for many countries in the region. Large fiscal deficits have been a persistent problem in South Asia and the Pacific for many years. Many countries in Central Asia and some in Southeast Asia also run high levels of external debt. With the cost of international borrowing rising and inflation picking up, these economies are vulnerable to rising debt-servicing burdens. Taking stock of ongoing economic strength, these regional governments should continue their efforts to enhance their fiscal position by consolidating the budget deficit and promoting effective public debt management. Phasing out oil subsidies, along with deregulation in energy prices, also needs to be considered as part of the fiscal reforms.

Successful implementation of structural reforms remains a priority. Looking ahead, Asia's growth strategy needs to focus on balancing domestic growth and enhancing resilience to external shocks for long-term sustainability. To this end, policy priority should be given to creating a positive investment climate for enhancing competitiveness (see *ADO 2003*, Part 3: "Competitiveness in developing Asia"), to generating sustainable increases in domestic demand across the region, and to further strengthening regional economic cooperation to improve the region's resilience against adverse external conditions. The following are worth noting in this respect.

First, broadening intraregional trade and investment underpins strong regional dynamics to allow extra resilience against adverse shocks from the rest of the world. Along these lines, recent initiatives to increase regional economic integration through Asian bond market development and regional trade agreements are welcome, to the extent that these efforts help strengthen regional cooperation as well as broaden its economic linkage to the rest of the world economy.

Second, Asian economies should continue to strengthen their financial systems to underpin the efficient use of financial resources. Financial sector weaknesses coupled with lack of prudential oversight have often led to credit and asset price booms during the era of liquidity in Asia, only to be followed by painful corrections. In order to strengthen its financial sector, developing Asia needs to enhance risk management, strengthen prudential oversight, establish healthy credit systems, and improve governance. Continuous progress in financial sector reforms combined with sound macroeconomic management will be key to ensuring currency and financial stability in the region, as some large economies such as the PRC and Korea are experiencing increasing capital inflows. To channel such resources to productive uses, the sound management of private capital flows is crucial, to be achieved by broadening financial markets, strengthening market infrastructure, building a sound legal and regulatory framework, and enhancing market transparency.

Third, it is imperative for the region to increase domestic absorption by nurturing local investment conditions (see Part 3: "Promoting competition for long-term development"). In line with the above financial sector reforms, further comprehensive structural reforms should follow to improve overall economic efficiency and competitiveness. Such reforms include the successful implementation of corporate and financial sector restructuring through strengthening the balance sheets of companies in these sectors while creating an investment-friendly environment through minimizing unnecessary regulatory barriers in business activities, encouraging private incentives toward more dynamic market economies, opening domestic markets to international competition, and creating a level playing field across all sectors. Over the forecast period, strong growth in Asian demand is not only important for more balanced and resilient regional growth, but is also essential for alleviating the pressure of global imbalances.

Developing Asia: Subregional trends and prospects

Against the buoyant outlook for developing Asia during 2005–2007, the subregional trends, prospects, and challenges demonstrate considerable diversity. Initial conditions—as gauged by macroeconomic management, microeconomic reforms, institutional capacities, resource endowments, and sizes—differ significantly among the subregions. These initial conditions, together with the external environment, determine the subregional medium-term outlooks.

In the aftermath of the tsunami disaster that struck some parts of developing Asia on 26 December 2004, the new year began on a sober note. While the human dimensions of the disaster were tragic, recovery is expected to be rapid, with minimal downside effects at the macroeconomic level.

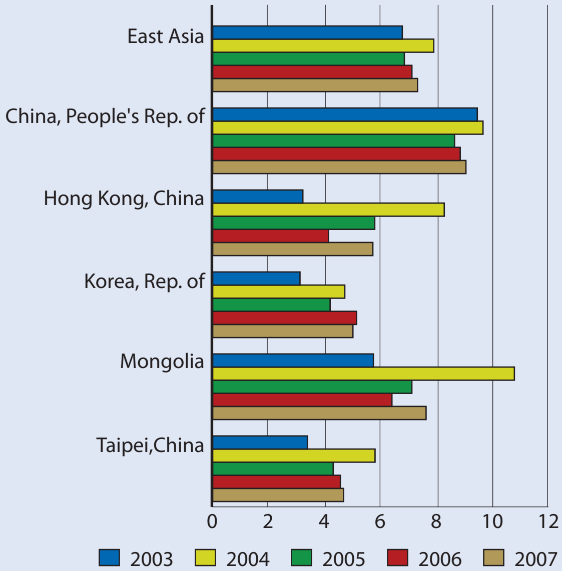
East Asia

The economies of East Asia performed strongly in 2004, recording aggregate growth of 7.8%, about a percentage point higher than in the previous 2 years (Figure 1.13). As conditions improved during the year, expectations for growth were ratcheted up, and actual aggregate growth surpassed the forecast in *ADO 2004* by nearly a percentage point. The five East Asian economies benefited from strong external demand for their mainly manufactured products. Investment was robust in most of them, joining with generally buoyant consumption spending to lift domestic demand.

Growth in the PRC was expected to decline as the Government introduced a range of controls starting in September 2003 to limit excessive investment in some industries. As it turned out, though, GDP growth edged up to 9.5% in 2004, the highest level in 7 years. Fixed asset investment grew more slowly, but still rose by a steep 25.8%. Actual net FDI reached a huge $60.6 billion (up by 50% in 4 years) as global companies continued to relocate labor-intensive and export-oriented industries to the PRC. FDI in services has also surged since the country joined the World Trade Organization (WTO) in 2001 and opened more services to foreign competition. Consumption, driven by rising incomes, grew faster and merchandise trade—both exports and imports—soared by about 36%. Adding to the strong year, the growth rate of agriculture more than doubled.

Growth in Taipei,China and Hong Kong, China rose sharply, the former by 2.4 percentage points to 5.7% and the latter by nearly 5 percentage points to 8.1%. The recovery of the ICT industry was of particular benefit to Taipei,China. As production and export shipments rose, so did the need for further investment in this important industry. Domestic demand, mainly private consumption and investment, was the driver of growth. Services such as tourism and retail trading had been hit hard in 2003 by the outbreak of SARS in Taipei,China; PRC; and Hong Kong, China, so that a services sector rebound in 2004 contributed to growth in these three economies. Hong Kong, China had suffered 3 years of weak growth until 2004, so its bounce was particularly marked. The economy's property market recovered from a prolonged slump, helping drive consumption and investment.

Figure 1.13 GDP growth, East Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

In Korea, a surge in global demand for electronic products and motor vehicles pushed up manufacturing output and exports, and helped lift investment slightly. However, private consumption fell for a second year in a row because of high household debt levels, acting as a drag on GDP growth. For the year, GDP growth picked up by 1.5 percentage points to 4.6%, which was the lowest rate of increase in the subregion. In contrast, Mongolia, from a much lower level of economic development than others in East Asia, recorded growth of 10.6%, nearly double the 2003 pace and the strongest since the country began its economic transition in 1991. Mongolia's economy got a lift from the expansion of mining and a milder winter, which allowed the livestock industry to expand rapidly.

Several East Asian economies have battled deflation in recent years. That was not a problem in 2004. A combination of stronger economic growth, together with much higher prices for imported fuel and raw materials plus price increases in domestically produced food in the PRC and Mongolia, revived inflation. Consumer price inflation averaged 3.3% for the subregion, up by 2.1 percentage points from 2003. In the PRC, inflation rose to above 5% in the third quarter, prompting the first increase in interest rates since 1995. Inflation moderated later in the year to leave the PRC's full-year average rate at 3.9%. In Mongolia, inflation hit 10.6% for the year. Korea's inflation rate was unchanged from 2003 at 3.6%. Taipei,China recorded 1.6% inflation after almost 3 years of deflation. In Hong Kong, China the CPI recorded year-on-year increases from July, which still left the price index down by 0.4% on average for the year.

East Asia's growth will slow in 2005, but economic activity will remain robust in most economies. Aggregate growth for the subregion in 2005 is forecast to decline by about 1 percentage point from 2004's high rate, to 6.7%, before rising to 7.0–7.2% in the following 2 years. All of the subregional economies are expected to see easing growth rates in 2005. One reason is an expected halving of the expansion in subregional merchandise exports, from 2004's unsustainably rapid rate of 28.0%. Demand for high-tech products started to soften in late 2004, though the cyclical downturn is expected to be mild and relatively brief. In the PRC, growth is projected to decline to 8.5% in 2005, but this would still put the economy on a higher growth track than other subregional economies. Mongolia is projected to grow by 7.0% in 2005, and the other three economies in the 4–6% range.

A key to this scenario is a soft landing of the PRC economy. The authorities have used administrative, fiscal, and monetary controls to cool investment in industries considered overheated, including cement, steel, and real estate. They are expected to rely more on market-oriented pricing measures from this year. But there are risks on both sides: substantial investment under way will not be stopped and large pools of funds are still seeking new investment outlets. Any relaxation of the investment controls could spark another round of overheating, which eventually could end in a very hard landing. At the same time, there are reasons to think that the slowing in economic growth could turn down sharply in the medium term. Administrative controls have had some unintended adverse effects, mainly on SMEs, which are struggling to secure working capital loans. That could hurt employment creation. Rapid increases in farmers' incomes may be unsustainable if prices of agricultural products fall, which would reduce consumption spending.

Additionally, the PRC financial sector faces a big challenge over the next 2 years when it is opened to foreign banks as the country meets its WTO commitments. A heavy flow of funds out of the state-owned commercial banks to competitors would further strain these major lenders.

On expectations that the country will make a soft landing, fixed asset investment growth in 2005 for the PRC is projected to be near 20%, with exports growing at this same high rate, and consumption growth likely maintaining double-digit growth rates. As imports will outpace exports, economic growth will depend on consumption and investment. In Taipei,China, private consumption is forecast to keep rising. Growth in private investment will slow from 2004's high levels, but government spending on infrastructure will support overall investment.

Hong Kong, China's more moderate growth rate, too, will be driven by consumption and investment, rather than net exports, with a revival of construction bolstering investment. Mongolia is set to continue to benefit from the PRC's demand for minerals and expansion of the livestock industry (depending heavily of course on weather conditions). In Korea, the prolonged slump in consumption appears to be ending as household debt and credit card delinquency rates stabilize. Expansionary macroeconomic policies and stronger corporate balance sheets provide a favorable backdrop for investment. However, these factors will take some time to lift Korea's growth rate.

The expected sharp fall in the growth rate of subregional merchandise exports will be matched by a drop in merchandise import growth rates as GDP expansion slows. Moreover, growth of both exports and imports is projected to slow further through 2006–2007. Trade surpluses run by the PRC and by Taipei,China are forecast to fall significantly over the next 3 years, and Korea's surplus will be little changed. The subregional current account surplus will slide to 1.7% of GDP by 2007, from 4.1% in 2004, mainly because the PRC's small current account surplus will move to a deficit over 3 years. International reserves are high and rising in the major subregional economies.

Although most East Asian economies are major importers of oil and other commodities that shot up in price last year, consumer inflation rates are expected to be moderate in 2005. Indeed, average inflation for the year will slow in some economies and hardly move in others. For the subregion as a whole, annual consumer inflation is likely to be about 3.0% over the next 3 years. In the PRC, smaller price rises for grains and overcapacity in many industries will offset much of the upward impact of imported inflation, to put inflation in the 3.2–3.6% range in the forecast period. Higher exchange rates in Korea and Taipei,China will help counterbalance imported inflation in those economies. Hong Kong, China will record inflation of 1.5% in 2005, its first full year of price rises since 1998. Even Mongolia, which is susceptible to bouts of double-digit inflation, is expected to keep price increases to around 5.0%.

With subregional economies generally growing at a reasonable pace, fiscal policy is being tightened in the PRC and Hong Kong, China. The PRC, as part of its effort to cut investment in overheated industries, is sharply reducing issuance of long-term bonds that are used to finance fixed assets. Taipei,China aims to narrow its fiscal deficit over the medium term by broadening the tax base, raising some tax rates, and selling stakes in government-owned companies. However, resistance to these revenue-raising measures within Parliament, labor unions, and some companies has so far frustrated that goal. Mongolia has reduced its fiscal deficit over the past 2 years, although the gap will widen a bit in 2005. Korea, though, still is operating a budgetary policy that aims to stimulate sluggish economic growth.

Monetary policy, too, is being tightened in most of East Asia. Historically low interest rates were no longer considered appropriate as 2004 progressed; inflationary pressures built up, economic activity was robust, and US rates were raised. The People's Bank of China increased rates in October and indicated that it will use them to help control inflation and investment. The Bank of Mongolia sharply raised rates on its benchmark bills to damp inflationary pressures. Taipei,China moved up its official discount rate three times between September 2004 and March 2005, the first increases since mid-2000.

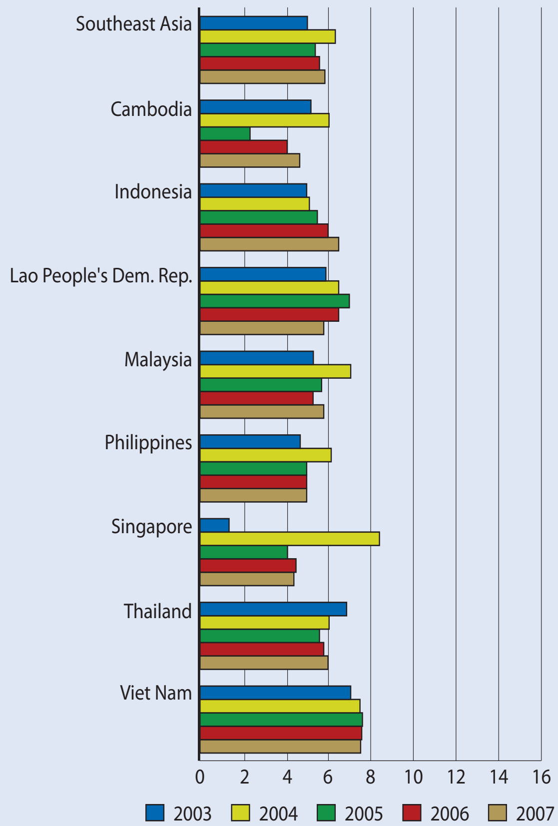
In March 2005, banks in Hong Kong, China lifted rates. The banks had been able to keep rates steady in the second half of 2004, despite the currency's link to the US dollar that usually

requires parallel rate moves, because of flush liquidity in the domestic banking system. Again, Korea went against the trend because of its below-potential economic performance. The Bank of Korea cut its policy rate in August and October and this accommodative stance is expected to be maintained while the financial position of households and small businesses remains weak.

Major challenges for East Asia in the medium term include the PRC guiding its economy to a more sustainable growth path, and its neighbors standing ready to handle any disruptions that may occur if the PRC's efforts overshoot. The economic links between the PRC and other East Asian economies have become much more extensive in recent years.

Another challenge is to strengthen financial systems. The PRC has injected huge amounts into state-owned commercial banks to repair their balance sheets, has plans to sell stakes in some banks to investors, and is shaking up the management of banks, but action on all these fronts needs to be accelerated, since the PRC's banks will face greater competition in the next few years as the country opens the sector to meet its WTO commitments. Taipei,China is pushing consolidation and privatization in the banking industry to build some bigger, stronger institutions. Finally, Korea needs to complete work started on restructuring its troubled credit card companies and to improve risk management in the financial sector.

Figure 1.14 GDP growth, Southeast Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

Southeast Asia

The economies of Southeast Asia expanded on aggregate by 6.3% in 2004, with Malaysia, Singapore, and Viet Nam the fastest growing (Figure 1.14). In spite of some improvement, Indonesia, the third most populous country in Asia, continued to perform well below potential, a matter of concern. Based on their level of per capita income, the economies of Cambodia and the Lao PDR fell further behind relative to the rest of Southeast Asia.

The economic performance of the Southeast Asian economies in 2004 rests on three pillars: robust consumption growth, a strong revival of business investment, and an unusually favorable external environment. Private consumption expenditures continued to contribute significantly to overall growth. With inflation relatively subdued for most of the year, macroeconomic policies, both monetary and fiscal, remained generally supportive.

The most remarkable feature of the 2004 performance was the upsurge in investment in many subregional economies and its large contribution to overall growth. In all countries except Cambodia, investment-to-GDP ratios increased in 2004. *ADO 2004* projected a revival of business investment in most of the subregion, but the outcome turned out much stronger than expected. A combination of factors contributed to the surge in investment: reduced political uncertainties following peaceful elections in Indonesia, Malaysia, and Philippines; reform measures in several countries to improve investment climates and reduce the cost of doing business (e.g., Singapore);

much reduced excess capacity; and continued improvement in FDI flows to the subregion.

On the external front, the subregion experienced its best environment in many years, as major industrial countries grew rapidly and the rest of Asia, in particular the PRC and India, also experienced solid economic growth. The result was that exports shot up in 2004 by an average of 20.3%, compared with a 12.7% rise in 2003. The outcome was well above the expectations of early 2004. The pickup in exports was particularly robust in Cambodia, Malaysia, Singapore, Thailand, and Viet Nam. Increased demand for electronic products as investment spending strengthened in major industrial countries benefited many subregional countries. But the strong performance of exports was broad based. Cambodia's merchandise exports were boosted by garments and rubber, while petrochemicals and pharmaceuticals contributed significantly to the growth of Singapore's exports. At the same time, buoyant world prices for oil and agricultural products boosted Viet Nam's export revenues by 30.3%.

Given high income growth in the subregion over the past few years, imports also rose very fast in 2004, on aggregate by 23.3%, up from 10.8% growth in 2003. With the exception of the Philippines and Singapore, net exports subtracted from growth in other economies. Developments in the external sector also led to a reduced current account surplus on aggregate, which fell to 7.3% of GDP in 2004 from 8.1% in 2003.

Finally, a notable feature of the 2004 outcome is that in spite of a robust economic performance and high oil prices throughout the year, inflation remained relatively subdued in most countries, with the exception of the Lao PDR and Viet Nam. Inflation averaged 4.2% for the subregion, up from 3.3% in 2003. In some countries, appreciation in exchange rates helped keep inflation under control, notably in the Lao PDR and Thailand. As the year advanced however, inflationary pressures increased in some countries, prompting Thailand's monetary authorities, for instance, to start raising interest rates. Inflationary pressures will be an important variable to watch over the forecast period.

GDP growth in Southeast Asia is forecast to remain robust in 2005–2007, albeit at a slower pace than in 2004. Average GDP growth is forecast at 5.4–5.9% over the medium term. In a welcome development, and in spite of the negative impact of the Indian ocean tsunami, somewhat faster expansion is projected for Indonesia, mainly in 2006 and 2007 when GDP could expand at an average of 6.2%. In Cambodia, however, a less favorable external environment due to the termination of the MFA in January 2005 is expected to lead to a significant slowdown. In the Philippines, a weak fiscal situation and hesitant investment could lead to growth below potential, at around 5.0%.

The outlook remains optimistic both with regard to private consumption expenditures as well as investment, which are projected to be the main contributors to GDP growth over the forecast period. However, the forecast depends critically on inflation remaining moderate. This would mean that monetary policies could remain generally supportive, with low interest rates, although some monetary tightening is expected in most countries. In some countries, fiscal support to private consumption can be expected to abate because the economies are on a firmer footing. This is the case in Singapore and to a lesser extent Thailand, as well as in the Philippines where fiscal consolidation will be a policy priority.

In Singapore, Thailand, and Viet Nam, and to a somewhat lesser extent, Indonesia and Malaysia, robust investment, both public and private, will be the most dynamic variable in the economy. While in Viet Nam, strong investment spurred by FDI inflows will remain part of the economy's transition and its catching-up process, in Singapore and Thailand, higher investment will be focused on restructuring of the economies to raise productivity and maintain their competitiveness in the regional and global context. In Singapore over the past few years, government policies, including tax policy, have been strongly oriented toward making the economy more competitive by reducing business operating costs and attracting new forms of FDI. In Thailand, the Government intends to pursue active policies over the next few years to spur investment in small and medium enterprises. It has also announced a major 4-year infrastructure development strategic plan, focusing on large-scale investments in transport and energy, which could push up GDP by 0.2 percentage point annually.

In Indonesia, the Government is struggling

to make the legal and regulatory environment for investment more transparent and to open new sectors to foreign investors. Subject to satisfactory progress in the reforms, the country's natural resources and its large domestic market are expected to spur domestic and foreign investment over the forecast period. In a similar manner, policy reform measures to improve the investment climate and reduce the cost of doing business are being enacted in Malaysia. Public investment, though, is expected to be scaled back in a drive for fiscal consolidation. In the Philippines, there is a need to significantly raise the investment-to-GDP ratio, a major challenge if economic growth is to improve in the medium term. Some positive developments are expected, but a tight fiscal situation will limit the scope of public policy. Reviving private sector investment will be the main challenge over the next 3 years.

In the external sector, while global prospects remain relatively bullish, the exceptional performance of exports in 2004 cannot be sustained in 2005 and beyond, as already suggested in many countries over the last quarter of 2004. The downturn in the electronics sector evident at the end of 2004 is projected to be relatively mild and short lived. While exports to industrial countries are likely to expand more slowly in 2005, before leveling off in 2006–2007, intraregional trade should remain dynamic as only a mild slowdown is projected in the PRC and India's economy is expected to continue its solid expansion.

Both developments should boost trade opportunities for the economies of Southeast Asia, which are in between the two regional growth poles. The PRC absorbs 6% of Southeast Asian exports, and these exports to the PRC have been growing at rates of about 37% over the past 2 years. Exports to India have been growing at rates of about 26% over the same period, accounting for about 2% of Southeast Asia's exports. Over the forecast period, South Asia is likely to emerge as a growing and dynamic market for Southeast Asia. Already several countries, such as Indonesia, Malaysia, Thailand, and Singapore, are negotiating preferential trade arrangements with India and other South Asian countries. A moderation in growth will damp import growth. Southeast Asia will continue to exhibit a sizable—albeit reduced—current account surplus of about 6.2% of GDP in 2005 and just above 5.0% on average in 2006–2007.

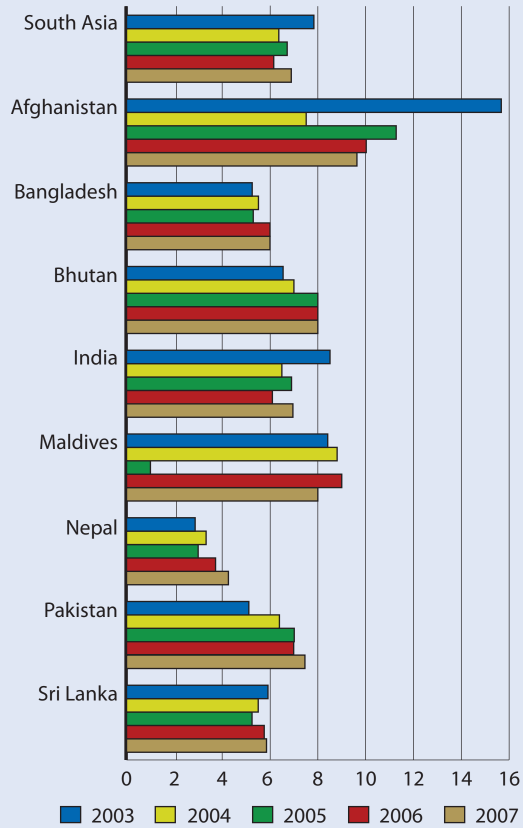
The need for fiscal consolidation in most subregional economies has been noted in recent *ADO*s. Budgets, at least for 2005, show mixed outcomes. In the Philippines, where fiscal problems are most acute, a progressive reduction in budget deficits is projected over the forecast period as new revenue measures are introduced and as expenditures are curtailed. In Malaysia, too, the Government has indicated its intention to rein in the fiscal deficit by selectively cutting expenditures and improving revenue collection. Gasoline subsidies are being phased out, and changes in the tax structure and the introduction of a GST in January 2007 are expected to narrow the deficit by half by 2007. In Indonesia, the fiscal deficit is expected to be brought down further over the next 3 years, to below 1% of GDP. In Singapore, tax reforms will continue to support the restructuring process but the need for large fiscal stimulus packages will no longer exist. Significant surpluses of around 3% of GDP are projected. Thailand, which posted a surplus in 2003–2004, expects a balanced budget in 2005. In Viet Nam, the budget deficit will widen to around 5% of GDP as expansionary fiscal policy continues to support implementation of economic reforms and development of infrastructure. Planned cuts in import tariffs will also affect revenues. In Cambodia and to a lesser extent the Lao PDR, fiscal deficits are projected to remain substantial, threatening macroeconomic stability.

While the forecast remains optimistic for the economies of Southeast Asia, the high global and regional risks in the outlook could affect this group of countries more severely than others. First, what happens to inflation globally and in the subregion, and as a consequence, to interest rates, will be of paramount importance. In this context, the subregion is highly sensitive to further increases in oil prices, particularly as there is a need to further rein in rising subsidies. While damping consumer demand, a sharp rise in interest rates also could derail the recovery in investment that is needed to support high long-term growth. In addition, some countries such as Indonesia, the Philippines, and possibly Thailand, where public or household debt stocks are larger, could be significantly affected by high interest rates.

As they are extremely open, a second main concern in subregional economies is what happens to the value of the US dollar. Should it fall precipitously, the upward pressure on the subregion's currencies would increase substantially. While this would contain inflation somewhat, it would damage the important export sectors and exacerbate competition from the PRC. Obviously, if a further weakening of the US dollar and higher world interest rates lead to a major slowdown in the world economy, the impact on Southeast Asia would be very severe. Hence the importance of sound macroeconomic policies, in particular fiscal restraint. At the same time these policies need to be complemented by microeconomic reforms to continuously enhance the competitiveness of the economies of the subregion. In part, this means keeping investment rates high.

Finally, the subregion remains particularly vulnerable to the impact of epidemics. The continued resurgence of avian flu should not be underestimated. Governments and the international community need to significantly enhance collaborative efforts to ensure that risks of transmission of the virus are kept to the absolute minimum and prepare contingency plans in case it becomes transmissible among humans.

Figure 1.15 GDP growth, South Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

South Asia

South Asia's aggregate GDP is estimated to have expanded by 6.4% in 2004, substantially slower than in 2003 (7.8%), and below the 7.0% expansion projected for the subregion in *ADO 2004* (Figure 1.15). The divergence in performance stems from developments in India, which accounts for nearly 80% of the subregion's output, as all countries except Sri Lanka grew more rapidly in 2004 than in 2003.

India GDP growth is estimated at 6.5%, 2 percentage points below 2003, with the marked change in outcome mainly due to the vagaries of the monsoon that sharply depressed agriculture sector growth from its normal rate in 2004 while a recovery from an earlier poor monsoon inflated it in the previous year. Developments in the industry and services sectors remained buoyant on the grounds of strong consumer and investment demand. The 26 December tsunami, which affected the coastline of some mainland southern states as well as the Andaman and Nicobar Islands, led to heavy loss of life and great destruction; however, the impact was localized and has not significantly affected national economic activity. Pakistan saw GDP growth accelerate to 6.4%, the highest rate in 7 years. Investment in key large scale sectors picked up and consumer demand was energetic, even as the fiscal position strengthened, the balance of payments remained in surplus, and foreign exchange reserves touched new highs. Growth in Bangladesh, at 5.5%, was only slightly higher than a year earlier, as a strengthening in export-oriented manufacturing was in part offset by weakness in crop production. Though larger imports outweighed larger exports and increased the trade deficit, further gains in large workers' remittance inflows, which markedly boosted domestic incomes, kept the current account at a

small surplus. After 2 years of double-digit GDP growth, estimates for Afghanistan indicate that recovery of its war-racked economy slowed to 7.5% in 2004 as another drought brought cereal production down by 25%. The year, however, was marked by considerable progress in that the first ever presidential election was held and economic structural reforms continued to advance at a good pace, especially with respect to budget implementation. Rapid growth of the opium economy, however, has emerged as a major issue in the country's development.

Sri Lanka saw its GDP growth moderate slightly to 5.5%, which remained driven by domestic consumption and fast growing exports, with performance underpinned by the continuing ceasefire. With two elections—for parliament in April that resulted in a change in government and for provincial councils in July—most progress on the previous government's structural reform policies stalled and await determination of a new direction. The year ended in tragedy with the tsunami.

In the Maldives, tourist arrivals and hotel capacity utilization expanded at a strong pace to reach record levels, where the economy grew by 8.8% in 2004. While loss of life from the tsunami was less than in most other affected countries, the damage to the economy was substantial. Economic growth may fall to as low as 1.0% in 2005 as the high tourist season was lost, and there will be a substantial widening of the fiscal and balance-of-payments deficits. However, most resorts were unaffected and 2006 should see a marked economic rebound

In 2004 the economy in Nepal continued to recover from the downturn of 2 years earlier. Improved performance in agriculture and services marginally raised GDP growth to 3.3%. The economy has performed weakly since the second half of 2001 as a result of a worsening insurgency and political instability, while the royal proclamation of emergency rule in February 2005 has increased political and economic uncertainties.

Bhutan's economy continued its steady growth at 7.0% during the year, reflecting sound economic management and further development of its hydroelectric resources.

South Asian growth is projected to move up to 6.7% in 2005, dip to 6.2% in 2006, and then recover to 6.9% by 2007. While Afghanistan, Bhutan, India, and Pakistan are projected to have somewhat stronger growth in 2005, the rest of South Asia is likely to experience slower growth—Bangladesh because of serious flooding, Maldives and Sri Lanka due to the tsunami and its aftermath, and Nepal as a result of weaker paddy production. The subregional slowdown in 2006 reflects a slowing in India's growth, which will rebound in 2007. Although Afghanistan's growth is expected to slow marginally after 2005, other subregional countries are expected to match or exceed the 2005 growth performance in the 2 subsequent years. The South Asia forecasts assume continued cooperative efforts between India and Pakistan and no deterioration in the security situations in Afghanistan, Nepal, and Sri Lanka.

India's growth outlook is buoyant—6.9% in 2005, 6.1% in 2006, and 7.0% in 2007. Agriculture is projected to recover in 2005, and expand at normal rates subsequently, though expansion in the industry and services sectors will slow. The industry slowdown in 2005 is attributable to cost-smoothing behavior of firms to tide themselves over an anticipated cost escalation. In 2006, GDP is projected to decline on account of a further deceleration in growth of the industry and services sectors, but these sectors should experience a revival in 2007.

In Pakistan, with sound macroeconomic fundamentals achieved and key sectors strengthened by reforms of recent years, the projection is for stronger growth of 7.0% in 2005 and 2006, nudging up to 7.5% in 2007. Notably, private investment is on the rise and fiscal consolidation and structural reforms have made space for increased social and infrastructure expenditures that underpin this upbeat outlook. Growth in Bangladesh is projected to slow only slightly to 5.3% in 2005 despite widespread and destructive flooding, as activity is to be sustained by donor-supported reconstruction efforts and continued expansion in export-oriented production and greater workers' remittances. Growth may reach 6.0% in the following 2 years; however, it is necessary that strong economic reform efforts be carried out and that downside pressures associated with a loss of MFA quotas and current confrontational domestic politics kept to a minimum.

Afghanistan's economic prospects are good, with growth expected to recover to 11.3% in 2005,

on the assumption of better rainfall, and then moderating slightly in 2006–2007. This outlook assumes continued support by the international community in economic assistance and in security efforts, as well as continued strong efforts in structural reform.

Sri Lanka's growth is expected to tail off only a little to 5.2% in 2005, as the tsunami did not damage areas of major economic activity, though there was great loss of life. Assuming that reconstruction plans are implemented smoothly, growth should pick up to just under 6.0% in the following 2 years. The major risk to the outlook, as in the past, is uncertainty in the peace process. Also, it will be important for the new Government to define its plans for economic and structural reforms needed to achieve a high, sustainable growth path.

Economic growth in the Maldives is expected to drop sharply in 2005 to about 1.0% due to extensive damage to the fishing fleet, hotel closures, and the loss of tourism during the high season. A recovery in tourist arrivals could bring GDP growth to 9.0% in 2006 and 8.0% in 2007.

Growth in Nepal is projected to fall to 3.0% in 2005 due to weather-related weaker performance in agriculture and a deterioration in other activities, especially those connected to tourism, due to insurgency activity. Growth is expected to slowly strengthen to 3.7% and 4.3% in the subsequent 2 years, on the basis of no further deterioration in the security situation. However, the outlook is highly uncertain and depends crucially on how parties respond to developments in the period of emergency rule. Bhutan's economy is projected to grow by 8.0% over 2005–2007, reflecting the steady expansion in the power sector and the country's new economic strategy for poverty reduction.

Exports in 2004 surged by 20.8% in South Asia, on top of the strong 18.3% gain in 2003, with almost all countries bettering their earlier performances. At the same time, imports shot up by 33.5% due in the main to continued strong growth in domestic demand and in part to the steep increase in global oil prices and the subregion's import dependence. The subregion's current account balance moved to a deficit of 0.7% of GDP in 2004 from the solid 1.9% surplus recorded in 2003. The main player in this swing was India, which recorded a deficit of 1.0% of GDP during the year, the first since 2000, in marked contrast to a 1.8% surplus recorded in 2003. For 2005 South Asia's current account deficit is expected to widen further to 1.2% of GDP, with every country but Nepal recording a deficit and India maintaining a deficit of 1.0% of GDP. These deficits are moderate and are readily financed. Exchange rates against the dollar appreciated modestly in 2004 in most countries in the subregion and all countries but Sri Lanka recorded gains in gross international reserves.

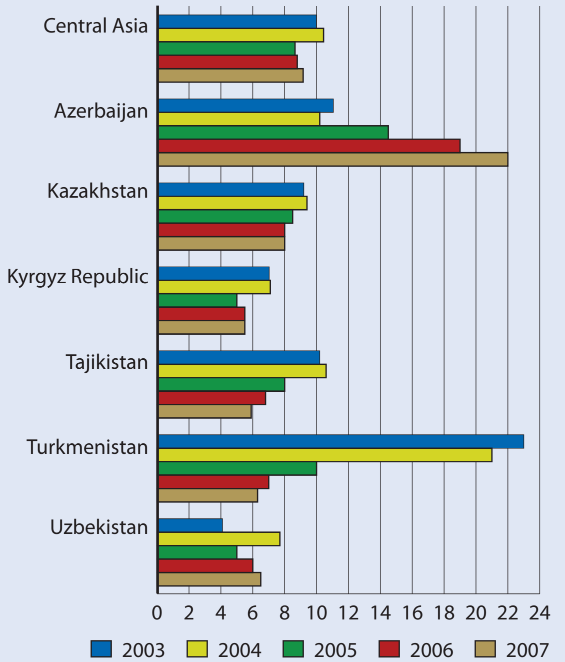
Average inflation for South Asia rose to 5.9% in 2004, up from 5.1% a year earlier, reflecting increases in all countries except Afghanistan, Bhutan, and Nepal. In response to growing price pressures, monetary polices were tightened during the year in Bangladesh, India, Pakistan, and Sri Lanka. Moreover, many countries took measures to delay and not fully pass through the cost of global oil price rises.

Central Asia

Economic growth in the six Central Asian republics (CARs) as a group is estimated at 10.4% in 2004, higher than the 8.1% projection made in *ADO 2004*, and representing a continuation of the very strong performance of recent years (Figure 1.16). Nearly all of the countries in the subregion performed better than expected. A notable and welcome feature was unexpected strength in the Kyrgyz Republic, Tajikistan, and Uzbekistan, countries that have the lowest per capita incomes in the CARs and that had seen various economic difficulties in recent years. Higher than expected commodity prices for the region's main exports, not only oil and gas but also for gold, cotton, and aluminum, were the principal stimulus underlying the strong gains made during the year.

Indeed, exports surged by about 38.9% for the subregion as a whole in 2004, up from 25.0% growth in 2003, at country rates that varied from 9% to 54% in dollar terms. Kazakhstan, where substantial FDI has developed the oil and gas sector in recent years, recorded the highest export gain of 53.7%, with expanded oil volume boosting the step rise in export prices. Kazakhstan now accounts for about 60% of aggregate CAR exports.

Figure 1.16 GDP growth, Central Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

An upturn in domestic consumption demand as well as continued investment boosted the CARs' imports at essentially a matching pace of 38.1%, again well above the 2003 expansion (19.0%). Consequently, as a group, the CARs' current account deficit at 1.9% of GDP was only slightly improved from a year earlier. Kazakhstan and Uzbekistan recorded a surplus on the current account. Deficits were fully financed by FDI and other capital flows to allow all countries to post moderate increases in official reserves. Both Azerbaijan and Kazakhstan, which saw particularly heavy FDI inflows in 2004, are experiencing upward pressure on their exchange rates.

The medium-term outlook—2005, 2006, and 2007—for the CARS is quite favorable, pointing to a moderate slowing in growth for the subregion as a whole to 8.7% in 2005 but then a mild advance to 8.8% and 9.2% in the following 2 years. Even though the oil and gas sector will continue to drive growth for the region, some change is foreseen in the country pattern. Notably in Azerbaijan, growth is expected to accelerate sharply to 14.5% in 2005 and to 19.0% and 22.0% in 2006 and 2007, respectively. This impressive outlook reflects the phasing in of production from investments in oil and gas fields and pipeline facilities. Conversely, growth in Kazakhstan is projected to moderate to 8.5% in 2005 and 8.0% in the following 2 years as additional petroleum sector production in this period builds on a larger base. Since Kazakhstan is the bigger economy, the differing outlooks in the two countries are largely offsetting for aggregate CAR growth. In Turkmenistan, a large producer of natural gas, the outlook is underpinned by long-term export contracts with the Russian Federation and Ukraine. GDP growth is projected to be strong at 10.0% in 2005, but then to slow to about 6.3% in 2007. Any assessment of the country outlook is difficult, however, because of the limited information available.

The outlook for Kyrgyz Republic, Tajikistan, and Uzbekistan is for a slight easing in growth in 2005 as circumstances are expected to be generally less propitious. In the Kyrgyz Republic, GDP growth is expected to decelerate to 5.0% in 2005, reflecting depleting reserves and consequent declining production at the Kumtor gold mine, though growth may be lifted to 5.5% in subsequent years as deposits elsewhere are developed. The March 2005 uprising and apparent change of government appear related mainly to governance issues rather than to economic policy. However, it will take some time to assess the full impact of these events on the economic outlook. In Tajikistan growth is expected to slow to 8.0% in 2005 and then to 5.9% by 2007 because of capacity limits on expansion in aluminum and cotton production, the two main economic activities. With cotton and gold prices less favorable in 2005, a moderate deceleration in Uzbekistan's growth to 5.0% is expected; however, growth is projected to pick up to 6.0% and 6.5% in the 2 following years, on the assumption that policy reforms are adopted, which would boost agricultural, manufacturing, and trade activity.

Inflation is not a central policy issue in the CARs. However, in Turkmenistan and Uzbekistan subsidies and controls keep official inflation rates lower that what would be determined by the operation of fully free market forces. Implementation of more effective monetary polices sharply reduced Tajikistan's average inflation

to 6.8% in 2004 from 17.1% a year earlier. Azerbaijan and Kazakhstan experienced some price pressure during the year and as a result tightened monetary policy. Average inflation in the subregion in 2004 was 6.0% with little country variation. This rate is likely to be maintained in 2005 and is projected to moderate slightly to about 5.0% by 2007.

As countries in transition to market economies, the CARs have made varying degrees of progress in their reform efforts. Kazakhstan and Azerbaijan have attracted by far the bulk of FDI made in the subregion and have built substantial oil and gas sectors that have buttressed very rapid rates of growth. Both countries, however, are struggling to deepen economic diversification to expand employment opportunities that have grown only slowly because of the capital-intensive nature of their resource-based growth. To this end, Kazakhstan adopted its Innovative-Industrial Development Strategy while Azerbaijan has drawn on its State Program on Poverty Reduction and Economic Development. Whether the two countries can avoid "Dutch disease," which could stymie broad-based rapid growth, is a major concern.

Among the other countries, the Kyrgyz Republic and Tajikistan have developed medium-term poverty reduction and growth strategies supported by IMF economic programs and development assistance. Heavy external debt burdens and a limited resource base make rapid growth an arduous process, despite very substantial macroeconomic and structural reforms that the countries are undertaking. More recently, Uzbekistan has tightened economic policies and maintained current account convertibility, and is in the process of developing a wide-ranging framework to accelerate broad-based growth. Its longer-term outlook depends on whether it adopts a substantially reinvigorated structural reform program or continues with its present policies. Turkmenistan is relatively wealthy based on energy production and exports that will underpin reasonable rates of growth in the medium term. Central planning and management of the economy persist and a substantial change in policies would be required to move from growth that relies primarily on exploitation of natural resources to broader-based growth that would reduce exposure to volatility in the energy markets.

The Pacific

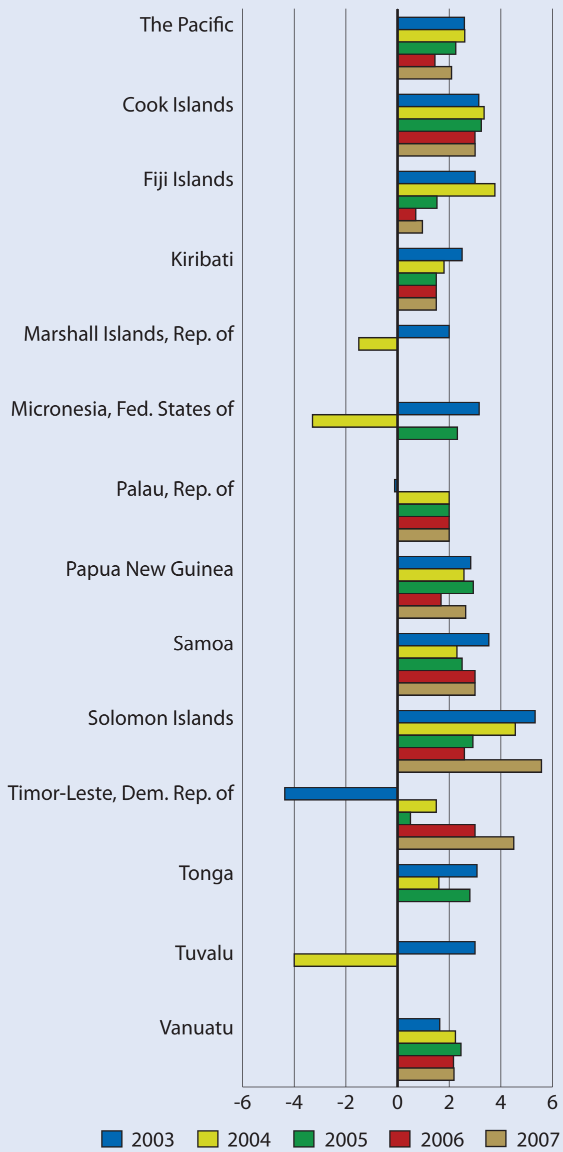
Aggregate GDP growth of the Pacific developing member countries (DMCs) was unchanged at an estimated 2.6% in 2004 (Figure 1.17). Increases in GDP ranged from 1.6% (Tonga) to 4.6% (Solomon Islands). The Federated States of Micronesia, Republic of the Marshall Islands, and Tuvalu registered contractions because of reductions in public sector activity.

The maintenance of high international prices for primary commodity exports benefited those economies with relatively large natural resource endowments. Solomon Islands' second year of relatively rapid growth was led by agriculture, forestry and fisheries, though this entailed harvesting of the natural forest at an unsustainable rate. Primary production also led a mild acceleration of growth in Vanuatu and contributed to a pickup in growth in the Fiji Islands, the second-largest economy. The agriculture and mining sectors of the largest economy, Papua New Guinea, expanded at around 3.0%, but the oil and gas subsector contracted significantly because of the depletion of oil reserves. As a result, growth decelerated slightly to 2.6%, from 2.8% in 2003.

Tourism continued to grow across the subregion, partly because of lower airfares that resulted from increased competition in airline services to several destinations. Consequent stimulation of the services and construction sectors was important to the economies of Cook Islands, Fiji Islands, Samoa, and Vanuatu. In contrast, tourism contracted in the Federated States of Micronesia where the lack of sustained competition in airline services provision left airfares at a high level compared with other subregional destinations. The recovery in international capital markets improved returns for the long-established Kiribati and Tuvalu trust funds and for the newly established trust funds in the Federated States of Micronesia and the Republic of the Marshall Islands.

Economic growth at modest rates generated an increase in employment levels across the subregion, but growth in labor supply continued to outpace labor demand. Inflation decelerated to an average 3.6% in the subregion, largely because of a sharp drop in inflation in Papua New Guinea. Inflation fell in the majority of other Pacific

Figure 1.17 GDP growth, The Pacific, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

DMCs, the notable exceptions being Samoa and Tonga, which both registered double-digit rates.

Fiscal outcomes improved in most Pacific DMCs plus Palau during 2004. In Papua New Guinea, the budget balance moved from deficit in 2003 to surplus in 2004 as total revenues and grants exceeded budget projections and fiscal management improved with assistance under an Enhanced Cooperation Program with Australia. The fiscal deficit exceeded the budget estimate in the Fiji Islands because of unanticipated expenditures, but was lower than the 2003 deficit. Public financial management in Solomon Islands demonstrably improved with the continued assistance of the Australian budget stabilization team. Budget outcomes worsened significantly in the Federated States of Micronesia and the Republic of the Marshall Islands as "bump-up" funding under the previous Compact of Free Association with the US ended; and Palau continued to fund a large budget deficit by drawdowns from its Compact trust fund.

External accounts generally improved in 2004 as export growth accelerated faster than import growth and tourism earnings strengthened. International reserves in the Fiji Islands and Papua New Guinea rose markedly from their 2003 levels.

Political uncertainty continued to be a concern in a number of Pacific DMCs, most conspicuously in Vanuatu; and corruption and poor governance remained as major obstacles to improving development outcomes in the subregion. On the positive side, Nauruan voters rejected the leadership that had mismanaged the economy for years and elected a reformist government.

Some progress was made in 2004 in formulating and implementing economic and public sector reform strategies aimed at improving public service delivery and the enabling environment for private sector development. However, reforms needed to be extended and consolidated. For most Pacific DMCs, physical infrastructure development and creation of an effective legal and regulatory environment for business (including property rights) remained major challenges. Relatively large civil services still needed rightsizing and refocusing on performance, and the importance of public enterprise reform was underlined by the bankruptcy of Royal Tongan Airlines.

At the regional level, Pacific Island Forum leaders decided in 2004 to create a Pacific Plan for Strengthening Regional Cooperation and Integration. This will potentially strengthen the contribution of regional institutions to achievement of sustainable development, good governance, and regional security.

In the context of a weaker international economic environment, economic growth in the subregion is forecast to slow slightly to around

2.0% in 2005–2007, while inflation is expected to be in the 3.4–4.0% range. Papua New Guinea is forecast to grow at an average annual rate of 2.4% as depletion of minerals reserves continues and logging is curtailed. A major growth slowdown is forecast in the Fiji Islands, as the garment industry loses concessionary access to export markets and the sugar industry confronts structural adjustment. Modest growth is expected in most other Pacific DMCs. This aggregate growth outcome will mean that a substantial proportion of the annual net increase in labor market entrants will continue to flow into the pool of the under- and unemployed, increasing hardship in both rural and urban areas. The main downside risk to the growth forecasts is that governments will fail to implement the structural reforms necessary to stimulate private sector development.

Promoting competition for long-term development

Competition is advantageous to consumers. This stems from the fact that competition encourages productivity improvements that propel economic growth. It also ensures that the more productive and efficient firms expand, take market share from less productive firms, and offer better products at lower prices. This in turn unleashes new demand. Competition laws and policies to promote competition are becoming increasingly important as developing Asia steps up the pace of its economic development.

In the past two decades, many countries in Asia and the Pacific have adopted market-based reforms and reduced government intervention in their economies in response to heightened regional and global integration. Trade barriers have been lowered, foreign investment encouraged, exchange rate pegs removed, protection of domestic industries withdrawn, and government enterprises privatized. These changes reflect confidence that open-market forces will strengthen firms' productivity and competitiveness, contributing more to growth and development than a closed, centralized orientation. As a result, policies to promote competition have risen up the domestic and trade agenda in Asia.

Countries with different initial conditions of competition and at different stages of reforms or integration with global trade and investment flows may follow different paths to reaping the gains from competition. However, the globalizing economic environment imposes a form of discipline on domestic economic activity, creating pressure for promoting the sort of efficiency improvements that competition can bring.

Greater competition in product markets can lead to lower prices, greater choice, and increased production efficiency, ultimately contributing to growth and development. Restrictions to competition thus must generally be removed to enable markets to deliver the benefits of competition.

At the same time, the greatest degree of competition possible may not be optimal, and increasing economic growth requires a policy mix promoting both cooperation and competition, balancing short-term (static) efficiency improvements with long-term (dynamic) efficiency and development.

Competition policy is concerned with both private anticompetitive practices and government measures or instruments that affect the state of competition in markets. It is usually aimed at enhancing consumers' freedom of choice and firms' freedom to access markets. There are some instances where consumers will prefer that a smaller number of goods (possibly a single good) be available in the marketplace. There are also some instances where production may be most efficiently pursued by a small number of producers (possibly just one). Competition policy must be applied in ways that take account of the technological characteristics of such markets.

To the extent that creating national champions substantially increases concentration in a domestic market, there may be a stronger case for implementing competition policy than otherwise. In general, tension between the objectives of competition policy and industrial policy is more apparent than real.

Most measures to protect domestic industries or firms create barriers to entry and can lead to high concentration in affected sectors.

Competition law can reinforce the effectiveness of cuts in trade barriers on growth-enhancing imports. Participating in international organizations such as WTO or the Organisation for Economic Co-operation and Development is an effective way to bring the pressures of international competition to bear on promoting rivalry in domestic markets.

During economic transition or reforms, the benefits of an open market economy cannot be fully realized unless restrictions on competition are removed. Opening markets is not enough by itself for countries to begin reaping the benefits of competition. Firms will still find incentives to engage in anticompetitive practices. Thus, the intended benefits of trade reform may not be realized without active enforcement of competition law. This highlights the importance of having faith in the benefits of competition from an early stage of economic growth and of incorporating competition policy into the broader economic policy framework.

Foreign direct investment has not always resulted in increased competition in host country markets. However, for foreign investors the existence of a competition policy indicates some commitment by the government to ensure a level playing field among domestic and foreign investors. And relaxing foreign participation requirements can be generally expected to contribute to increased competition in the domestic economy.

Competition policy is affordable. In most countries it will more than pay for itself. The savings on government purchases that result from less bid rigging alone are likely to easily offset any additional outlays needed to rigorously enforce national cartel laws. Even greater may be the increase in tax revenues resulting from greater competition-induced growth. At the same time, competition policy's implementation serves to reinforce the consumer rights and competition culture that help ensure that the benefits of competition will be realized.

Development of a competition culture can, in turn, ensure that competition is strengthened. In most developing countries, the interests of consumers are poorly represented and are much weaker than those of producers. Recognition of consumers' rights creates a potent force for ensuring the promotion of competition. In this regard, it can be crucial that the authority charged with promoting competition has independence from ministries or other agencies representing producers or producer groups.

Competition can help create a prosperous future. Preserving the ability of innovative firms to enter a market may well be contingent on the appropriate enforcement of competition laws. Intellectual property rights generally strengthen competition in an economy over the long run by providing incentives for the development of new products and production processes. Such technological progress is likely to contribute at least as much to social welfare in the long run as the elimination of allocative inefficiencies in the short run.

With regional and global integration accelerating, the pressures of international competition and their context have become increasingly palpable. However, competition policy is important in its own right for domestic reasons. Drawing on lessons from the experience of Japan and Korea, developing countries in Asia and the Pacific should start early and take a long-term view in implementing competition policy. The complementarity of competition and competition policy with industrial, trade, and FDI policies highlights the need for active competition advocacy. Too often, the advocacy functions of competition authorities are neglected at the expense of enforcement of competition law, only to create the need for even greater enforcement as other legislation is enacted without consideration of its implications for competition.

The general conclusion is that competition confers net benefits on an economy. Productivity rises, choice expands, and some (generally the bulk) of the increased benefits accrue to domestic consumers and factors of production. These benefits appear to be especially important in connecting the country to the global economy and in ensuring the international competitiveness of its firms as the country develops. At the same time, the discipline of participating in a globalizing economy reinforces the importance of competition. Of particular relevance is the fact that, while many countries are moving to implement or strengthen their competition policies, none appears to be moving toward repealing them.