

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 benign 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	4.3	3.7	2.6	2.1	1.6
East Asia	4.3	4.2	2.9	2.4	1.7
Southeast Asia	7.8	7.1	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 4.3% in 2003, whereas 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 FDI 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 signifi-

cantly 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 signif-

icant 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/Resourses/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, Republic of Korea (hereafter 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.

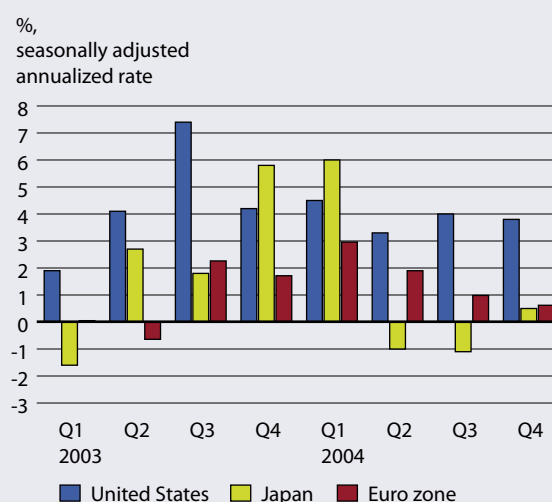
Prospects for the world economy in 2005–2007

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 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

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 31 March 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/gdemenua.html>, downloaded 14 March 2005.

consumption and business capital spending. With 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.

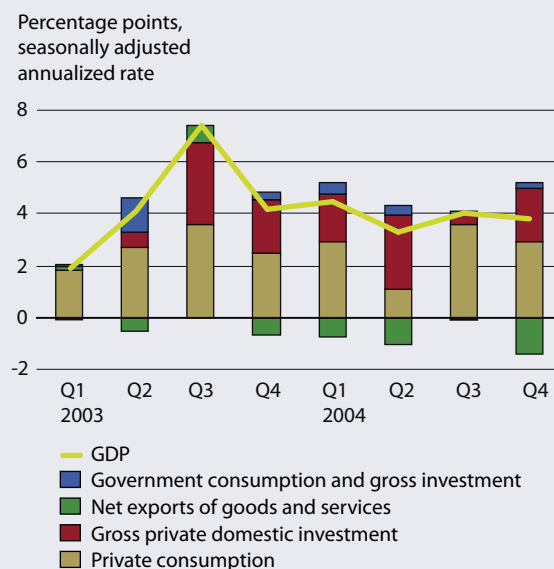
Overall, the economies of industrial countries are projected to grow at 2.5% in 2005 and 2006 (Table 1.2 above), lower than the robust performance of 3.5% last year, but still considerably higher than the average growth rate during the 1990s. Nevertheless, there are signs that a gradual deceleration 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.

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

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 31 March 2005.

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 15.7% 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 10.3% 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.

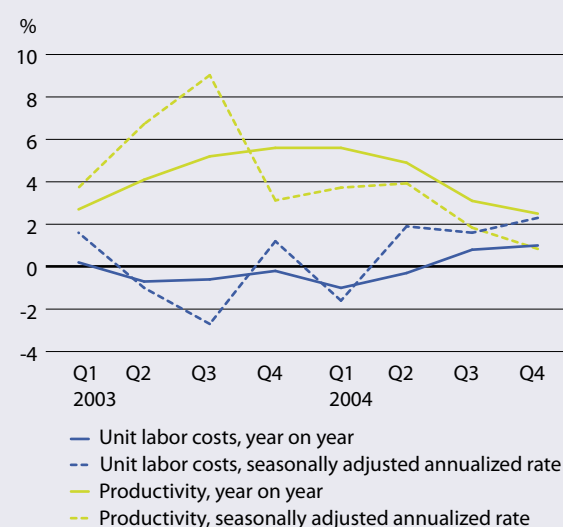
The labor market is making slow, but steady, progress. Nonfarm payroll employment gained a total of 2.2 million during 2004, lowering the overall unemployment rate to an average of 5.5% in 2004 from 6.0% in 2003. Reflecting the improvement in the job market, hourly compensation in the business sector 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

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.

growth, suggest dwindling profit margins, which may induce many companies to pass on such increased costs to customers.

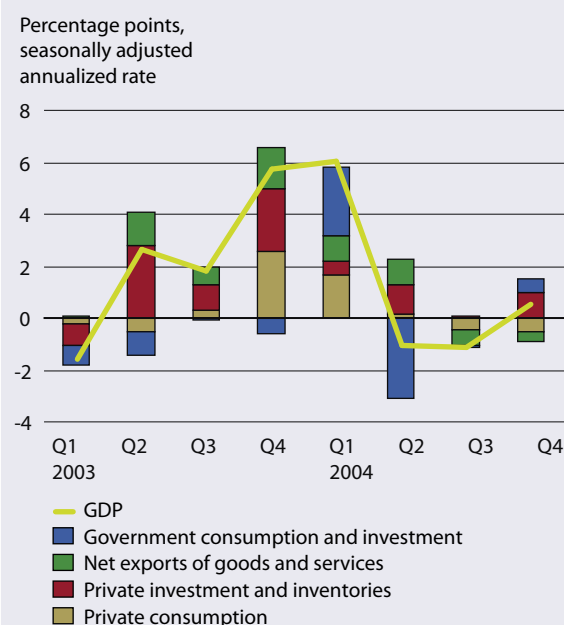
With inflationary pressures building, US interest rates could move significantly higher in 2005. Unlike 2004 when the Fed started raising interest rates from a historically low base of 1.0%, the US economy will begin to feel tightening effects as the Fed continues its rate increases this year. As of 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

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

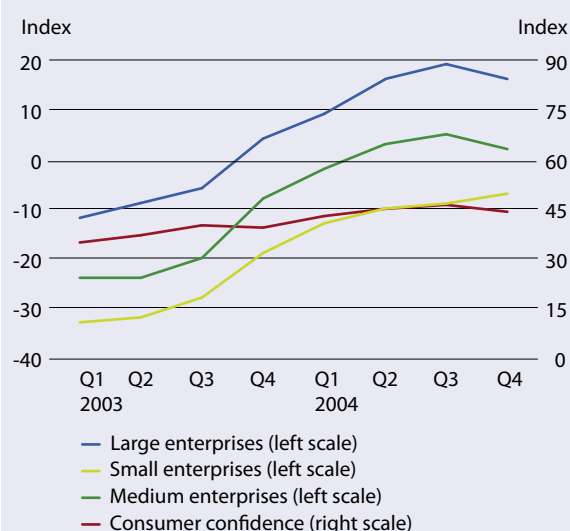


Source of original data: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/en/sna/qe044-2/gdemenua.html, downloaded 14 March 2005.

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.

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

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/0412shouhie.html; Datastream, downloaded 26 January 2005.

the contribution of net exports to growth turned negative in the last 2 quarters.

A tentative recovery in domestic demand 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% and 1.0% (saar) 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% 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.

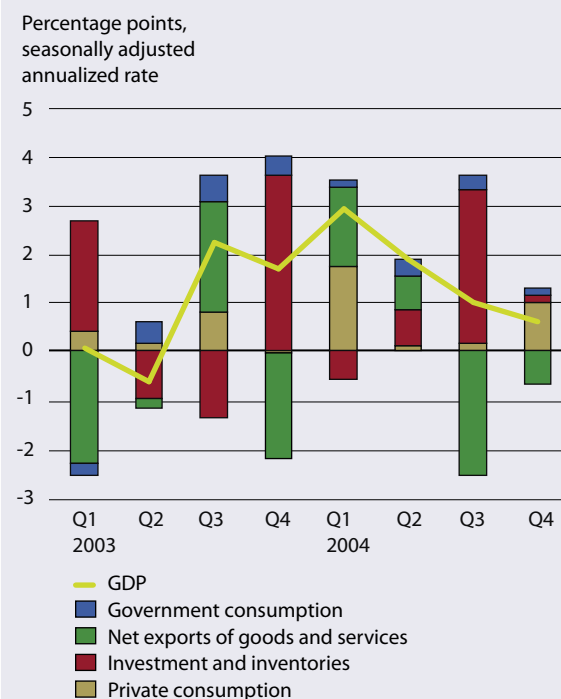
Euro zone

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 1.7% (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

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.

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 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 2.4% (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 8.8% in 2004. In Germany, the unemployment rate surged to 12.4% in February 2005, while France reported 10.1% the same month. 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 rela-

tively 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 3.1% 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 slowdown 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.

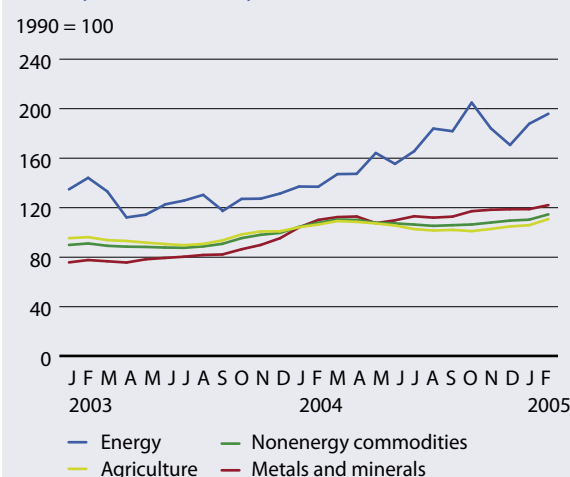
Oil prices surged and remained high at above \$40 per barrel for most of the second part of 2004. The price of benchmark Brent crude

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.

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/EXTDECPROSPPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>, downloaded 4 March 2005.

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%.

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). 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.

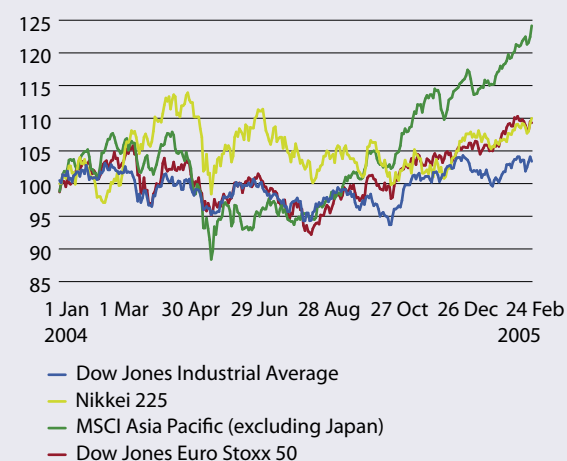
A healthy growth outlook for the PRC in 2005 is positive for the prices of raw materials, particularly metals and minerals. The prices of agricultural raw materials will likely remain strong, although increasing at a much more subdued rate of 1.0–2.0% in 2005, as they will benefit from resilient industrial 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 stabilization 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

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.

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, 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.

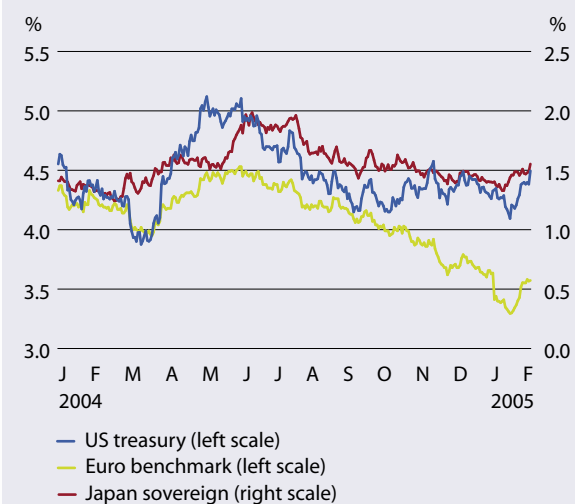
The gradual increase in optimism regarding the global economic outlook and the pace of ongoing rate movements in the US helped lift investors' risk appetite, which had retrenched significantly during the heavy sell-off of risk assets between April and May prior to the initial Fed decision to raise interest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

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



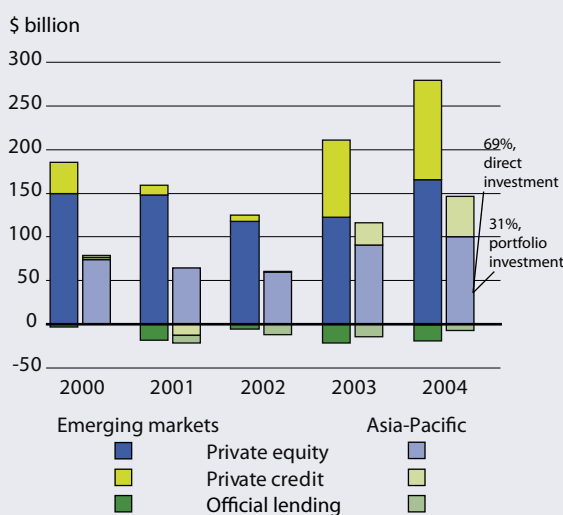
Source: Bloomberg, downloaded 1 March 2005.

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 \$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 FDI 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

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.

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.

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 FDI 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.

Developing Asia: Subregional trends and prospects

In the aftermath of the tsunami disaster that struck some parts of developing Asia on 26 December 2004, the new year began on a somber note. While the human dimensions of the disaster were tragic, recovery is expected to be rapid, with minimal downside effects at the macroeconomic level (Box 1.1).

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 foreign direct investment (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 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.

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



Source: Datastream, downloaded 1 March 2005.

Box 1.1 The impact on poverty of the tsunami

The 26 December Indian Ocean tsunami killed more than 200,000 people. Despite the huge scale of loss of human life, homelessness, and displaced populations, the macroeconomic impact of the disaster appears limited. This is mainly because the damage is largely confined to rural areas rather than key economic and densely populated urban centers and industrial hubs. Nonetheless, the economic impact will be felt severely at the local and community levels, dragging a significant number of already poor people into deeper poverty. The disconnection between the human costs and the limited macroeconomic impact is considerable with this particular disaster.

Immediate impact on poverty

The poor often subsist in flimsily constructed houses, which are susceptible to destruction by natural disasters. The sudden loss of housing and any other assets, and of jobs, paralyzes their daily activities. The extent and length of recovery depend on the sector affected, and how the recovery process is managed. Incoming aid flows help reconstruct housing and infrastructure. However, the restoration of eroded and salinized fields may take several years. Worse, it can take years for communities to replace the skills lost in a disaster such as a tsunami.

Clearly, the economic recovery does not only depend on supply-side factors such as access to facilities and boats, which is the focus of reconstruction efforts. It also depends on people's recovery from the psychological impact of broken and displaced households, poverty, and health problems. This of course is extremely hard to measure. Assessing the full extent of the loss of life and other effects, therefore, is complex.

This box does two things. First,

it assesses the immediate poverty impact of the tsunami by estimating the numbers of poor people who fell below the poverty line as a result of the disaster. Second, it describes two scenarios of recovery—fast and slow—based on a benchmark case of no tsunami.

Box table 1 shows the immediate poverty impact of the tsunami among five of the most affected countries.

In Indonesia, which suffered the highest number of deaths, the poverty impact is geographically

287,000, raising the national HCR by 1.4 percentage points.

In the Maldives, while the loss of life was fortunately low, the tsunami caused widespread damage to infrastructure. About one third of the country's population of some 300,000 was directly affected. Tourism and fisheries were hard hit. The national HCR of 22% in 2004 is estimated to have risen sharply to 35%, reflecting an increase in the number of poor of about 39,000.

The number of poor in India is estimated to have increased

Box table 1 Poverty indicators and poverty impacts of the tsunami

Country	Base year	Total population (000)	Number of poor (000)	National HCR (%)	Additional number of poor (000)	New national HCR (%)
Indonesia	2002	212,000	38,584	18.2	1,035	18.7
Sri Lanka	1995	17,280	4,355	25.2	287	26.6
Maldives	2004	300	66	22.0	39	35.0
India	1999	1,001,000	261,261	26.1	644	26.2
Thailand	2002	63,430	6,216	9.8	24	9.8

HCR = head count ratio.

Source: Figures are based on the national poverty lines and ADB staff estimates.

concentrated in Aceh and North Sumatra and sectorally in agriculture and fisheries. The disaster has displaced at least 475,000 people, and by taking into account other indirect effects, the number of poor people is estimated to have increased by more than 1 million, adding 0.5 percentage point to the national head count ratio (HCR)—the ratio of the number of poor people to the total population.

In Sri Lanka the disaster hit fishing communities and small-scale traders and other enterprises close to the shore. The associated job losses are significant, especially in the fisheries sector, which accounts for more than 80% of all job losses. The devastating effects of the catastrophe are estimated to have increased the number of poor by around

by 644,000 in the affected states of Andhra Pradesh, Kerala, Pondicherry, and Tamil Nadu, and the islands of Andaman and Nicobar. This substantial number does not significantly change the national HCR because of India's very large population.

In Thailand, the likely additional number of poor people as a result of the tsunami is estimated at around 24,000.

The tsunami also has an impact on people in affected areas who were below the poverty line before the disaster struck. Many of them have sunk deeper into poverty because essential goods as well as basic services, such as sanitation and health, are in shorter supply. It will now take an even greater effort to lift these people above the poverty line.

Box 1.1 (continued)***Recovery process and its impact on poverty***

Over the next 3 years in these five countries, the extent of the poverty impact is estimated on two recovery scenarios, fast and slow, based on a time frame of recovery used in a Citigroup study (Citigroup 2005). The recovery speed and its poverty impact depend on several factors such as the extent of the damage, sectors affected, responses of governments, and other aspects including political stability and macroeconomic management. For example, the scenarios assume that Thailand, where damage is concentrated in part of the tourism sector, recovers faster than other countries. India, Maldives, and Sri Lanka could take longer to recover, and Indonesia even longer.

Box table 2 describes the total number of poor in the fast and slow recovery scenarios and the benchmark case of no tsunami. The scenario analysis suggests that if recovery is fast, the additional poverty due to the tsunami would be eliminated by 2007 in all of the countries except Indonesia, where the additional number of poor would still be around 345,000 compared with the benchmark number. If the recovery process is delayed, the

additional poverty in the affected countries would still be 1.1 million in 2007. Of this number, 621,000 would be in Indonesia, 322,000 in India, 144,000 in Sri Lanka, 20,000 in Maldives, and 8,000 in Thailand.

An economy-wide impact would be felt in the Maldives, where the additional poor in the slow recovery scenario in 2007 is still about 44% above the benchmark level. For other countries, the national impacts are relatively smaller, yet the impact in the affected regions would be substantial.

Effective and quick responses are crucial to minimize the poverty impact of a natural disaster of this magnitude. Central and local governments as well as the international community need to work together to overcome immediate and longer-term problems. At the macro level, governments should commit to sound macroeconomic management in an attempt to produce a V-shaped recovery since the longer the recovery process, the worse will be the effect on the poor. At the sectoral level, local participation in decision making will help identify and prioritize the most needed programs. Also, efforts to establish independent authorities to ensure transparent

use of recovery funds—such as the Specific Authority Board for Aceh Reconstruction in Indonesia—can speed recovery because they enable better implementation of programs, despite time lost initially.

Well-targeted programs by governments are needed to achieve, among other things, employment generation and provision of schools and health centers. Employment generation through public works programs, for example, can provide income, build socially useful infrastructure, and resume the growth process.

More broadly, the inflow of aid and the engagement of governments in tsunami-affected countries in the planning and implementation of rehabilitation programs provide an opportunity to reinvigorate a general push to build infrastructure, to develop regional cooperation on an early warning system on earthquakes and tsunamis, and to pull out of poverty not only those who were made poor by the 26 December disaster, but also those who were already poor.

Sources: Asian Development Bank staff; Citigroup. 2005. "Economic Impact of the Tsunami," available: http://www.asia.citibank.com/asia/index/hm_index/1,3800,5~5-en-genCont-345-7365,00.html. January.

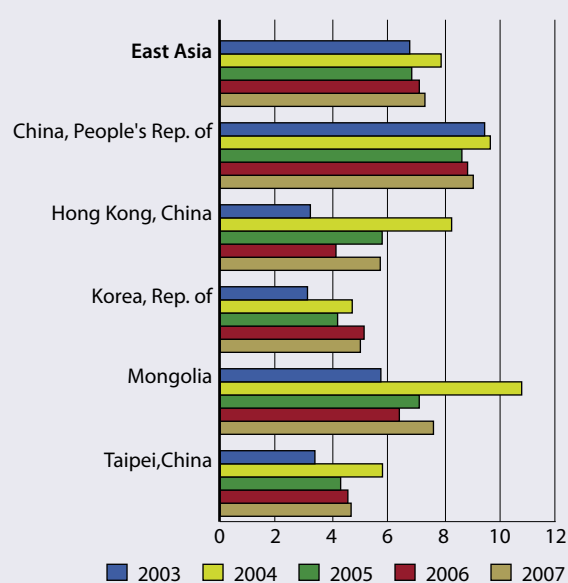
Box table 2 Number of poor (000)

Country	Benchmark (without tsunami)			Fast recovery scenario			Slow recovery scenario			Additional poor people due to tsunami, 2007	
	2005	2006	2007	2005	2006	2007	2005	2006	2007	Fast recovery	Slow recovery
Indonesia	37,777	37,508	37,239	38,812	38,198	37,584	38,812	38,336	37,860	345	621
India	175,837	161,600	147,363	176,481	161,922	147,363	176,481	162,083	147,685	0	322
Sri Lanka	4,248	4,236	4,224	4,535	4,380	4,224	4,535	4,452	4,368	0	144
Maldives	65	55	45	104	74	45	104	84	65	0	20
Thailand	6,011	5,943	5,875	6,035	5,943	5,875	6,035	5,959	5,883	0	8
Total	223,938	209,342	194,746	225,967	210,517	195,091	225,967	210,914	195,861	345	1,115

Note: The fast recovery assumes that the recovery process in Thailand is 1 year, India and Sri Lanka 2 years, and Indonesia 3 years; similarly, for the slow scenario 3 years in Thailand, 4 years in India and Sri Lanka, and 5 years in Indonesia. As for the Maldives, which is not available in the Citigroup report, it is assumed to follow Sri Lanka and India given the extent of damage and sectors affected.

Sources: ADB staff estimates; Citigroup 2005.

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



Sources: Asian Development Outlook database; staff estimates.

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 information technology 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.

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 elsewhere 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 2.0 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 economic growth could slow more sharply than expected 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 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 4.2% 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.

Southeast Asia

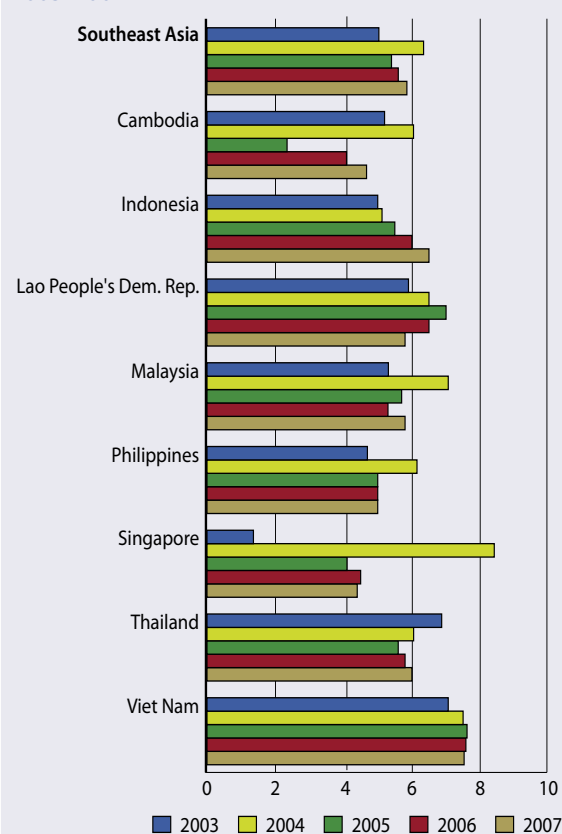
The economies of Southeast Asia expanded on aggregate by 6.3% in 2004, with Malaysia, Singapore, and Viet Nam the fastest growing (Figure 1.14). In spite of some improvement, Indonesia, the third most populous country in Asia, continued to perform well below potential, a matter of concern. Based on their 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 20.2%, compared with a 12.8% rise in 2003. The outcome was well above the expecta-

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



Sources: Asian Development Outlook database; staff estimates.

tions 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 23.6%, up from 12.1% growth in 2003. With the exception of the Philippines and Singapore, net exports subtracted from

growth. Developments in the external sector also helped lower the aggregate current account surplus, to 7.1% of GDP in 2004 from 7.8% 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 several 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 Multifibre Arrangement (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 rates of 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 degree, 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 infrastructure development plan, which focuses 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 presaged in many countries over the last quarter of 2004. Export growth is projected at around 7.9–9.1% over the next 3 years, down from 20.2% in 2004 and 12.8% in 2003. 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, while 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, which is forecast to be 10.6% in 2005, less than half the rate of 2004, and about 10% in the following 2 years. Southeast Asia will continue to exhibit a sizable—albeit reduced—current account surplus of about 6.2% of GDP in 2005 and about 5% on average in 2006–2007.

The need for fiscal consolidation in most subregional economies has been noted in recent ADOs. 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 goods and services tax 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 (Box 1.2). 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 led 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.

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.

Indian 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.

Box 1.2 Oil subsidies as fiscal liabilities

Oil subsidies are widespread. Government price controls, which hold prices below the economic cost of supply, remain the most common means of providing subsidies for equity purposes. Rising oil prices in recent years, however, have prompted several developing countries that grant heavy subsidies to reduce the size of the subsidies. Still, as oil prices remain high, the fiscal costs and associated opportunity costs continue to soar. This box illustrates the different forms of subsidies for petroleum products implemented in India, Indonesia, Malaysia, and Thailand.

Government intervention for redistributive and environmental reasons is justifiable only when the social gain or the environmental improvement exceeds the economic cost. Nonetheless, the existing practices in these four countries appear ineffective since the subsidies are poorly targeted and often distort resource allocation. Further, the distorted pricing encourages an excessive use of oil products, and the resulting deadweight costs can be substantial. Efficient use of oil products requires correct price signals. Aligning the underpriced markets with international prices would lead to more efficient use of oil, force productivity improvements, and increase competitiveness over time. The message that emerges is that continued oil subsidies can be justified neither on equity nor efficiency grounds.

In Indonesia, except for unregulated liquefied petroleum gas (LPG), the Government sets the price ranges for refined oil products, which are far below the production costs at Pertamina, the state-owned oil and gas company. Although all prices, except for

household kerosene, were finally increased substantially by 29% in February 2005, the after-subsidy prices of oil products have been set at only 20–60% of their internationally traded prices.

Consequently, the rise in international oil prices over the past year compelled the Government to quadruple the oil subsidy budget to about \$6.8 billion in 2004, or 3% of GDP. Despite the recent price increase, the subsidy might balloon again in 2005 because of high world oil prices. Any future move to eliminate subsidies may be frustrated by a constitutional court decision in December 2004, which supported price controls on goods sold to the poor.

Similarly, the Malaysian Government has, since 1993, controlled prices of petroleum products under the “managed market approach” by setting ceiling prices or manufacturer list prices. The production cost above the controlled prices is subsidized or given tax exemptions. A total of \$1.3 billion or about 4% of total budget expenditure was used in 2004 to keep retail petroleum prices low. With the rising pressure on the budget, the Government finally took the first step in reducing the subsidies in March of this year by increasing the diesel price, which accounts for almost 70% of total subsidies. Yet \$0.8 billion is still allocated in the 2005 budget, as the scaling back of subsidies is expected to move only gradually.

In India and Thailand, subsidies on oil products, with a focus on specific products such as diesel, LPG, and kerosene, are also fairly common, and are mainly for social welfare purposes. These subsidies are characterized by off-budget

expenditure in principle, but may incur fiscal liabilities in practice.

In India, the Government has historically maintained heavy subsidies through the public distribution system on the two principal household fuels, LPG and kerosene. Rising oil prices have severely dented the profitability of public sector oil-marketing companies as the retail prices have not increased in line with international prices. Consequently, subsidy spending of over \$3 billion was estimated for FY2004. The scheme would ultimately create a fiscal liability once the public sector oil-marketing companies no longer prove viable. Several remedies adopted in FY2004 include requiring profit-making upstream companies to share the burden, and reducing customs duties on petroleum and excise taxes on diesel and LPG. However, as such remedies are palliative and temporary, the Finance Ministry’s declaration in December 2004 that these subsidies would end in 3 years is a welcome move. Accordingly, during FY2005, the subsidy will be reduced to 33% of the previous year’s level.

Thailand utilized its Oil Stabilization Fund on gasoline and diesel to maintain the stability of domestic commodity prices and transportation costs. As tax revenues on oil products finance the Oil Stabilization Fund, the fund is in principle not a subsidy. However, as the fund’s deficit continued to increase to B40 billion, or about \$1.0 billion, in October 2004, the stabilization scheme began to signal a possible fiscal liability. The Government responded by removing the price cap on gasoline in October 2004 so that gasoline’s tax revenues generate revenue for the fund. As

Box 1.2 (continued)

for diesel, which accounted for 47% of petroleum consumption in 2004, the subsidy remains. Although the subsidy has been reduced gradually in the first quarter of this year, the cost of the diesel subsidy will continue to put pressure on the Oil Stabilization Fund as the international price of diesel is expected to stay high in 2005.

All the recent measures taken by the four governments will lessen some of the pressures on their budgets; however, it should be remembered that increasing the prices to another level will not solve the distorted market incentives. The appropriateness of the subsidies should be measured by assessing their impact on economic efficiency and equity as well as their economic costs, i.e., the fiscal costs. However, convincing evidence for environmental and equity improvements, or for and dampened price fluctuations—the very objectives of subsidies—hardly exists.

Past studies suggest that, in many instances, overall social welfare would be higher without subsidies (von Moltke et al. 2004) and oil subsidies are not associated with less volatile price movements (Terada-Hagiwara and Pardo 2004). In India, where subsidies on LPG and kerosene are meant to help the poor, the United Nations Develop-

ment Programme and World Bank (2004) find that the use of these products by the poor is limited. As for the impact on the environment, it may not always be negative as the subsidies on kerosene and LPG discourage the use of firewood for cooking and lighting needs to some extent. However, the more pressing environmental cost relates to the health impact of air pollution, as in the case of India and Indonesia.

The opportunity costs of the subsidies are substantial—mispricing of oil products discourages efficient use of the products and delays investments in cost-effective energy. Moreover, such a cost would include the spending forgone that could have been directed to other social welfare programs, such as direct income-support payments for the poor. Thus, scaling back the existing subsidies to reflect rising oil costs is critical, while efficiency and equity should be improved through better targeted and practical subsidy programs.

Examples might include temporary support for new renewable and energy-efficient technologies to overcome market barriers, and measures to improve poor or rural households' access to modern commercial forms of energy. Limited duration, preferably set at the outset, is important—among other

reasons so that consumers and producers do not take the subsidies for granted, and the cost of the program does not spiral out of control.

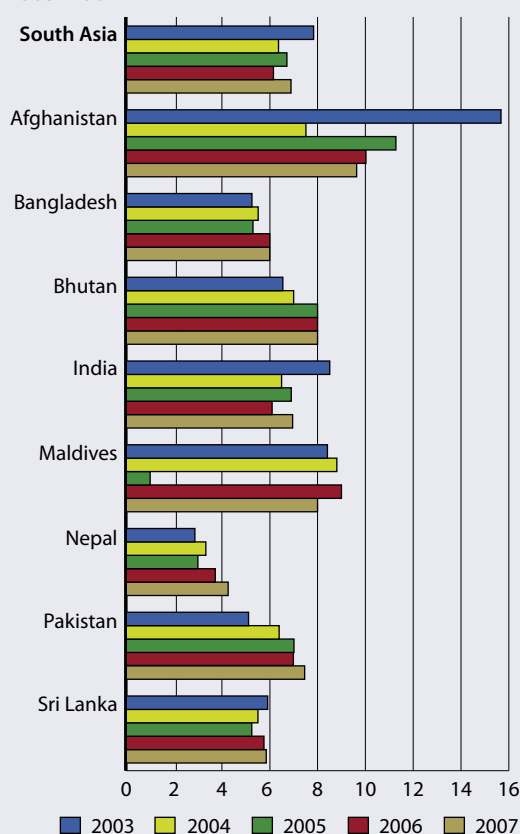
In practice, public resistance to removing subsidies can be very strong, particularly during times of volatile oil prices, as seen in Indonesia. While great attention should be paid to mitigating a reform's excessive negative impacts on the poor who may initially bear the brunt of the change, current market conditions should be taken as an excellent reason to push through with reform, as the fiscal costs rise and as the escalation in the oil price may be more than just transitory.

Sources. This box draws heavily on *Energy Subsidies: Lessons Learned in Assessing their Impact and Designing Policy Reforms*, edited by Anja von Moltke, Colin McKee, and Trevor Morgan, published in 2004 by the United Nations Environment Programme and Greenleaf Publishing, Sheffield, United Kingdom. Other sources are: Terada-Hagiwara, Akiko and Aludia Z. Pardo. 2004. "Are Petroleum Products Priced Right?—Case of the Selected Asia." Asian Development Bank; and United Nations Development Programme and World Bank. 2004. "Access of the Poor to Clean Household Fuels in India," available: [http://lnweb18.worldbank.org/SAR/sa.nsf/Attachments/InHHFuel-full/\\$File/Access+of+the+Poor+to+Clean+Household+Fuels+in+India.pdf](http://lnweb18.worldbank.org/SAR/sa.nsf/Attachments/InHHFuel-full/$File/Access+of+the+Poor+to+Clean+Household+Fuels+in+India.pdf).

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 lowered cereal production 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 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 cease-fire. 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 awaits determination of a new direction. The year ended in tragedy with the tsunami.

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



Sources: Asian Development Outlook database; staff estimates.

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 hydropower 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 situation 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 continued and that downside pressures associated with a loss of MFA quotas and current confrontational domestic politics be 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 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 the insurgency. 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 policies 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 steep rise in export prices. Kazakhstan now accounts for about 60% of aggregate CAR exports.

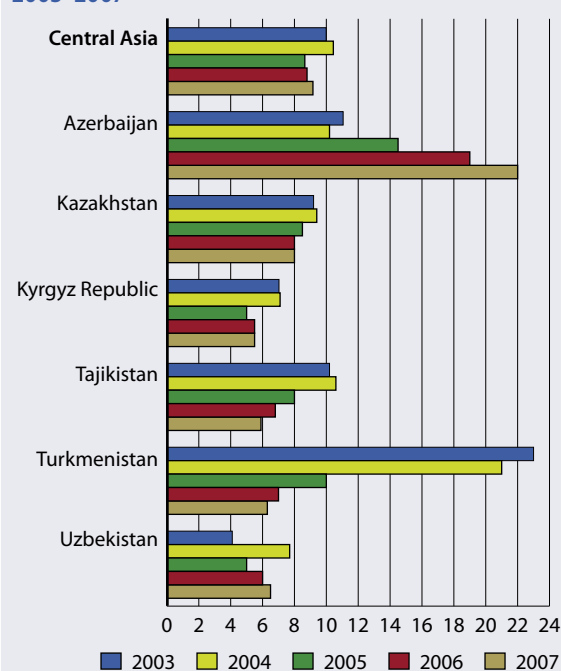
An upturn in domestic consumption demand as well as continued investment boosted the CARs' imports at essentially a matching pace of 38.1%, again well above the 2003 expansion (19.0%). Consequently, as a group, the CARs' current account deficit at 1.9% of GDP was only slightly improved from a year earlier. 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 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.

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 6.3% in 2007.

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



Sources: Asian Development Outlook database; staff estimates.

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

following 2 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 than what would be determined by the operation of fully free market forces. Implementation of more effective monetary policies 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 (per capita GNP of \$1,780) and Azerbaijan (per capita GNP of \$810) 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 (per capita GNP of \$330) and Tajikistan (per capita GNP of \$190) have developed medium-term poverty reduction and growth strategies supported by International Monetary Fund 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.

Recently, Uzbekistan (per capita GNP of \$420) 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 (per capita GNP of \$1,120) 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.

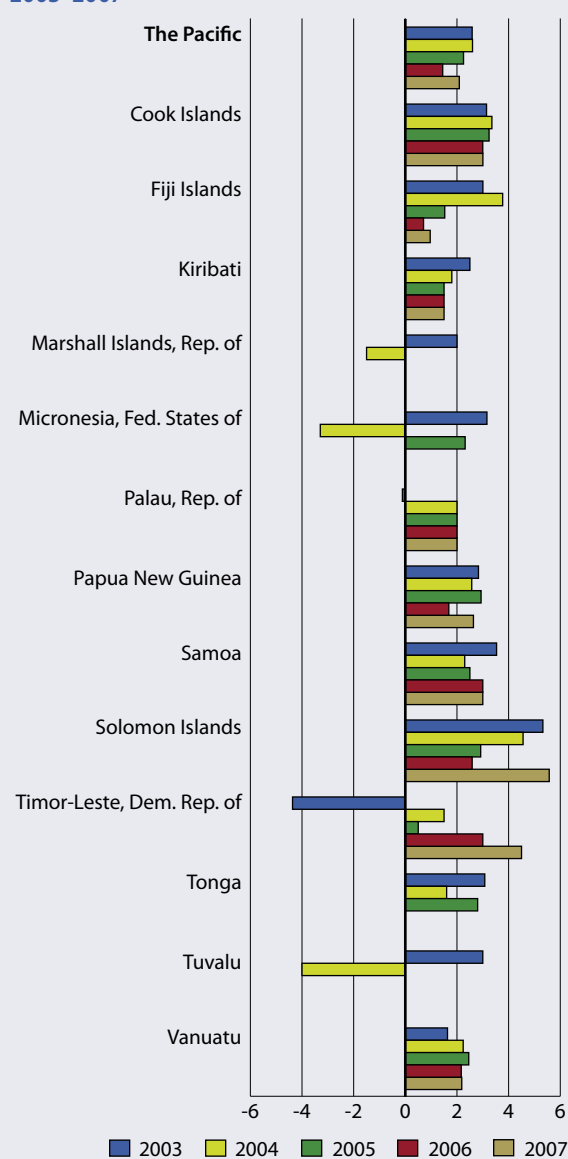
The Pacific

Aggregate GDP growth of the Pacific DMCs was unchanged at an estimated 2.6% in 2004 (Figure 1.17). Increases in GDP ranged from 1.5% (Timor-Leste) 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,

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



Sources: Asian Development Outlook database; staff estimates.

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 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.

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. Rela-

tively 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 mineral 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.

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 (Box 1.1 above) 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 its contribution 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 reserves 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 previous 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 year. 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 SARS 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 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 continues to be 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 (Box 1.2 above). 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 the following: creating a positive investment climate for enhancing competitiveness (see *ADO 2003*, Part 3: "Competitiveness in developing Asia"); generating sustainable increases in domestic demand across the region; and further strengthening regional economic cooperation to improve the region's resilience against adverse external conditions. The following points 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 coop-

eration within the region as well as broaden its economic linkage to the rest of the world.

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.

Export or domestic demand-led growth in developing Asia?

In recent years, some developing Asian countries claim to have started shifting emphasis from export-led to domestic demand-led growth policies with a view to achieving a more balanced growth strategy. This part of ADO 2005 evaluates empirically how far this shift has gone. The evaluation—based on an analysis of five countries—finds no evidence that the last decade has been marked by such a shift at the expense of a decline in net exports. It also finds that periods of expansionary domestic demand and deteriorating net exports signaled an ensuing crisis.

Introduction

Since the Asian financial crisis erupted in 1997, countries in the Asia-Pacific region have been immersed in a search to identify what policies led to the crisis and subsequent recession, and what alternative set of policies would lead them back to a path of sustained and higher growth (Felipe 2003). The majority view has been that the crisis was the consequence of a fundamental flaw in precrisis financial policies, which led to currency overvaluation, overborrowing, and overlending for the domestic economy, and speculative bubbles in the nontradable sectors that eventually burst (for an overview see Jomo 1998, Seguino 2000, and Lim 2004).

As part of the “package of solutions” to revitalize these economies, a number of policy makers in the region (some of them more openly, e.g., in Thailand, and some others less so, e.g., in Malaysia) proposed shifting to a “new development paradigm” based on *domestic demand-led growth*. This way, it is argued, the Asian countries hit by the crisis are making efforts at diversifying their economic base away from overreliance on external trade, the basis of the so-called *export-led growth model*. During the last 4 years, articles in the press have analyzed and followed this alleged shift.¹ Thailand’s Prime Minister Thaksin Shinawatra, for example, announced upon taking

the helm of government in January 2001 that he was determined to move the country away from mass manufacturing for exports into domestic demand-led growth through a series of policies. The country’s policy makers are making big efforts toward shifting economic policy in an attempt to reduce the country’s overdependence on external demand and foreign capital. The high growth rates achieved by Thailand in recent years seem to vindicate the new approach. However, Mr. Thaksin’s approach is not, strictly speaking, just a transformation from export-led growth into domestic demand-led growth, if by the latter a series of policies to boost domestic demand is meant (this will be properly defined in the section “Definition of domestic demand- and export-led strategies,” below).

His policies are based on what has been referred to as a “dual-track” strategy (Lian 2004) of relying on external demand (first track) and simultaneously developing domestic demand and supporting domestic enterprises (second track). Though it is true that his policies emphasize private consumption, they try to boost the demand of domestically produced goods and services (Box 1.3).

Since becoming prime minister in 2001, Mr. Thaksin’s objective has been to alter Thailand’s production structure with a view to reducing the country’s dependence upon exports. The key is to create demand among households and businesses

Box 1.3 What is *Thaksinomics*?

In August 2004, the Government of Thailand published a white paper entitled “Facing the Challenge: Economic Policy and Strategy.” This explains clearly the economic agenda that Prime Minister Thaksin has been trying to implement since January 2001. The message is that his policies try to balance past excessive dependence on external demand, urban-based mass manufacturing, and unproductive asset-building, with structural development in domestic demand, traditional sectors (e.g., agriculture, small and medium enterprises, and rural households) and entrepreneurs, and improvement in the pricing power of Thai goods and services. Thus, Mr. Thaksin intends to revive domestic demand (by boosting private consumption and by developing the traditional sectors), in addition to exports. This is what has been referred to as a dual-track strategy, as opposed to the single-track model followed by many countries in the region, namely, production for export. Mr. Thaksin’s dual-track strategy is five-pronged:

- *Revitalizing growth at the*

grassroots level. The key policy initiatives are embodied in the following programs: “one *tambon* [village] one product,” SME and entrepreneur promotion, farmers’ debt suspension, Village and Urban Community Revolving Fund, the People’s Bank of the Government Savings Bank, SME loans, venture capital, and asset capitalization.

- *Jump-starting key sectors.* The paper contains ideas for the key sectors of the economy. With regard to agriculture, for example, it argues that it is crucial to identify new demand for Thai agricultural products both domestically and abroad. For manufacturing, the Government has set up a new Entrepreneurs Promotion Board to create 50,000 new SME businesses. In tourism, the policy sets out to promote Thailand aggressively and to capture the upper middle classes of Chinese, Indians, and Europeans. In terms of real estate, the Government has disregarded the standard prescriptions of “fire sales” and driving asset prices to their true bottom. Instead, it has promoted asset

reflation. Finally, in the financial sector, the Government has put in place a financial sector master plan to create a more efficient and competitive financial system.

- *Enhancing economic efficiency and long-term competitiveness.* The Government has identified a series of industries to promote, namely automobiles, tourism, software, food, fashion, health care services, hospitality, rubber, and furniture.
- *Providing a stable and supportive macroeconomic environment to facilitate growth while maintaining overall policy discipline.* The Government has raised tax revenues, consolidated spending, balanced the budget, and retired public foreign debt.
- *Promoting the external sector through market expansion and fostering financial stability through regional and global cooperation.* Under the dual-track strategy, the external sector is as important as the domestic. Thus, exports remain a cornerstone of the strategy.

Source: Asian Development Bank staff.

without creating another bubble (i.e., to avoid a household-led spending boom fueled by borrowing such as in the US). Moreover, Mr. Thaksin’s strategies aim at boosting domestic demand and strengthening local enterprises as well as developing indigenously owned production capacity.²

Malaysia is also making an effort at diversifying its economic base. The Republic of Korea is reported to have gone into a debt-led consumption binge after the Asian financial crisis, which led to the 2003 crisis of credit card defaults and weak consumption demand that is the cause of low growth.

It is therefore important to analyze whether

the empirical evidence indicates that a shift from export-led growth to domestic demand-led growth is indeed taking place across Asia, and the consequences of this shift. In particular, do the data appear to confirm this move toward a domestic demand-led growth strategy? More precisely, this part of *ADO 2005* attempts to answer the following three questions:

- Does the evidence indicate that countries are switching from export-led growth to domestic demand-driven growth?
- Did the export-led strategies partly contribute to the Asian financial crisis?

- (iii) What lessons can be drawn from the different country experiences?

Structure

In order to address the three questions, this part of *ADO 2005* analyzes growth from the point of view of the aggregate demand components. The approach is very simple, based on the analysis of the information provided by the basic demand-side macroeconomic accounting identity, according to which output equals the sum of consumption, investment (i.e., domestic demand), and net exports.

The section after this, “Export-led growth strategy,” offers a summary and discussion of the strategy as well as a summary of some recent critiques of it. These have led (at least in the view of some authors) to the theoretical rationale for the alleged need to shift to a domestic demand-led growth approach. The next section, “Definition of domestic demand- and export-led strategies” defines the two types of growth strategies for purposes of the subsequent discussion.

The empirical work is carried out in the form of three complementary analyses (the sections “Demand-side growth-accounting exercise,” “Decomposition analysis,” and “Comparing expenditure shares”). Since the objective of this part is limited to an *ex post*, factual, and descriptive analysis of whether a shift to domestic demand-led growth is taking place, the methodology used is very simple. Output (GDP) from the demand side is looked at. This way, the latter is made up of the domestic demand components—consumption and investment—and net exports (exports less imports); and this is seen from the point of view of an accounting identity, i.e., there is no attempt at *modeling* in the sense of understanding *ex ante*, *causal*, or *behavioral* relationships. The first of these three sections, “Demand-side growth-accounting exercise” presents the results of such an exercise performed on the aggregate demand components of a selected group of Asian countries, namely, People’s Republic of China (PRC), India, Korea, Philippines, and Thailand. Growth accounting apportioned overall GDP growth to the contribution of each component of demand. Thus, overall growth of output is the sum of the growth rate of each component multiplied by its share in GDP. For

example, the contribution of private consumption growth to overall GDP growth is calculated as the product of the growth rate of consumption times the share of consumption in GDP. Expressed as a percentage of the overall growth rate, it is the ratio of this product to the growth rate of GDP. The exercise provides a long-run view of these five countries in terms of the contribution of growth in domestic demand components and net exports to overall growth.

The second of these three sections, “Decomposition analysis of stances in the private, government, and trade sectors,” broadens the analysis of the five countries by looking at the expansionary versus nonexpansionary (or even contractionary) stances or positions of the private sector, government or fiscal sector, and external trade sector over the last 20 years, in terms of aggregate demand “injections” (private investment, government spending, and exports) versus “leakages” (private savings, taxes, and imports) of the three sectors. Over the last three decades, there have been substantial changes in demand-side parameters, such as import coefficients, tax efforts, and savings rates, along with jumps in flows such as annual exports, investments, and government spending. The analysis in this section looks at how output has responded to these shifts, using a simple decomposition of demand injections versus leakages. The discussion helps identify whether the component of demand in question has an expansionary or nonexpansionary contribution to aggregate demand (naturally, *ex post*, total injections must equal total leakages).

It should be pointed out that, while the growth-accounting exercise provides a long-run picture over three decades (1973–1983, 1983–1993, and 1993–2003) in terms of the growth contribution of each demand component to overall growth, the stances provide an annual graphical picture over 20 years of the different phases of growth of the five countries by identifying expansionary and nonexpansionary factors (private, government, and external sectors) in effective demand.

The last of these three sections, “Comparing expenditure shares,” completes the empirical analysis with a comparison of the shares of aggregate demand components for a large number of Asia-Pacific countries—classified according to

three income groups—with the shares of a group of small open European economies. Since it is impossible to carry out the growth-accounting and stance analyses for all Asia-Pacific countries, the analysis of the demand shares provides an overall picture.

The last section of this part of *ADO 2005* provides a summary and some conclusions.

Methodology

Some words on methodology are important. First, the demand-side growth-accounting and stance exercises are not, strictly speaking, an economic model in itself (nor based on a model), so no causal inferences should be drawn. The former is simply a device to split and apportion, *ex post*, the growth of output from the demand side. The latter also provides an *ex post* classification of how the private, government, and trade sectors contribute to expansions or contractions in output, where, by definition, the sum of the three is zero. Second, the analysis does not take into account any supply-side considerations (e.g., the relationship between exports and technology upgrading, often brought up in the discussions of the benefits of export-led growth). Third, although the analysis is an exercise in positive economics, it leads naturally to the normative observation that the problem being considered should not be an either/or choice between domestic demand-led growth and export-led growth, but a need to actually give both domestic demand growth and net export growth due importance and proper balance. This is especially crucial since developing countries need precious foreign exchange for their economic development, which net export earnings provide. Finally, it is virtually impossible to clearly discern a structural change from export-led growth into domestic demand-led growth with 3-year data. If this is happening, it will take years, perhaps a decade, for the data to show. Hence, the analysis covers three decades and unveil episodes of the two strategies mentioned.

Synopsis of conclusions

The analysis leads to the conclusion that the more successful phase of development of the selected countries has been associated with significant investment increases and capital accumulation, as well as with significant export growth that

brought about trade surpluses or reductions in trade deficits. For the countries badly hit by the Asian crisis in 1997–98, the instabilities were preceded by unbalanced growth in demand components, with domestic demand highly expansionary, and increasing trade deficits. This was the result of currency overvaluations, overborrowing and overlending in the domestic private sector, and rise of speculative bubbles that most economists agree triggered the loss of confidence, substantial currency depreciation, and capital flight during the crisis. The harsh adjustments during the crisis resulted in the collapse of domestic demand (especially investments) as net exports recovered sharply. Thus, it was not the export-led strategy that contributed to the crisis—it was the promotion of debt-financed domestic demand growth at the expense of net exports that precipitated it.

The analysis suggests that the best periods seem to be those when both domestic demand and net exports exhibit significant and continuous growth or improvements, as in the case of the PRC and India today, or in postcrisis Thailand. This was also the case of the post-Plaza Accord period of the second half of the 1980s in Korea and Thailand, when the reputation of the “Asian miracle” reached its peak. Periods when domestic demand was highly expansionary at the same time that net exports deteriorated signaled an ensuing crisis, as the experiences of Korea, Philippines, and Thailand show.

The comparisons between the upper-medium and low-income Asia-Pacific countries show that, during the last decade, 1993–2003, the high-performing Asian countries outpaced the European countries in terms of growth in both exports and net exports. The Asia-Pacific middle-level and low-income countries, on average, improved their trade deficits during the last decade. However, the low-income countries still have very high trade deficits that need to be reduced (or, alternatively, the gap between aggregate domestic demand and domestic production has to be narrowed). But there is no evidence that countries in the Asia-Pacific region have recently been exhibiting growing domestic demand shares at the expense of net exports.

Inasmuch as the analysis suggests that healthy growth for developing countries should be the

result of growth in both domestic demand and net exports, the last section includes a general discussion about how the international trade system should be more responsive to the needs of poorer countries with a view to allowing them to benefit from international trade. It is proposed that, to provide developing countries with the proper environment in which to achieve improvements in their net exports, the international trade system should provide them with mechanisms to reduce their large trade deficits. This requires (i) a more open international trade system—richer and trade-surplus countries can contribute by opening up their agriculture, industry, and services markets to the developing world; and (ii) use of price and non-price mechanisms by poorer and deficit-ridden countries to improve their productivity and competitiveness in the world market.

Export-led growth strategy

Overview

Export-led growth is a term used loosely to refer to a strategy comprising the encouragement of and support for production for exports. The rationale lies in the belief of many economists that trade is the engine of growth, in the sense that it can contribute to a more efficient allocation of resources within countries as well as transmit growth across countries and regions. Exports, and export policies in particular, are regarded as crucial growth stimulators. Exporting is an efficient means of introducing new technologies, both to the exporting firms in particular and to the rest of the economy, and exports are a channel for learning and technological advancement. Moreover, the growth of exports plays a major part in the growth process by stimulating demand and encouraging savings and capital accumulation, and, because exports increase the supply potential of the economy, by raising the capacity to import.

Mercantilist economists believed that the wealth of a country should be measured by the extent of the accumulation of precious metals and placed a great emphasis on achieving trade surpluses. Classical economists, on the other hand, argued that trade was welfare improving because it led to an efficient use of resources in each country, in the sense that countries would

produce and export the products in which they have a comparative advantage, and import the products in which they have a comparative disadvantage. It could even be said that the purpose of trade, from a classical point of view, is imports. Exports are simply the way to pay for imports. In this sense, there is also an emphasis on the importance of exports, although of different nature.

As a development strategy, the classical belief was that development could be transmitted through trade. Classical economists justified the benefits of exports with the traditional argument of comparative advantage. Accordingly, opening up a country's market to the international markets allows a country more efficient production and allocation of resources as the country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. Thus, world trade markets allow producers and consumers of the participating countries to benefit from lower prices, higher-quality products, more diverse supply of goods, and higher growth. The export-led growth model seemed initially to have been vindicated with the success of Asia's miracle countries, which achieved extraordinarily high growth between the 1970s and mid-1990s, supposedly through export promotion. Since the eruption of the Asian crisis, however, some sectors have expressed increasing doubts as to the feasibility of export-led growth for many developing countries (Felipe 2003).

Recent decades have brought about other important justifications for export promotion. Some of these are:

- Participating in trade, especially export production and promotion, exposes a country to the latest and most advanced production and marketing techniques, and a "learning-by-doing" process that brings about dynamic innovation and technological diffusion into the economy. It also drives a country to higher production and to economies of scale, which lead to increasing returns (Felipe 2003).
- Many development economists use the "two-gap or three-gap" models of Taylor (1993) to justify the need to earn foreign exchange via exports. According to these models, the investment-savings gap and the foreign exchange gap are major obstacles to the

growth and development of many developing countries. Since countries need precious foreign exchange for their development needs (capital goods, industrial raw materials, oil, and food), export earnings are a more efficient means to finance these needs than foreign debt since the latter is vulnerable to adverse exogenous shocks and currency risks that may lead to debt defaults.

- A similar argument (McCombie and Thirlwall 1994) claims that large balance-of-payment deficits, spurred by large import propensities or elasticities, may be a hindrance to growth for many developing countries. Thus, moderate trade deficits, or trade surpluses, are more desired. This, of course, implies that export growth should be in pace with, or ahead of, import growth.
- Felipe (2003) also argues that export-led strategies allow an expansion of aggregate demand without much inflationary pressure and without the danger of a wage-price spiral, compared with strong domestic demand injections. This partly stems from the real appreciation of the currency that results from large export earnings, which tame inflation and allow real wages to rise.

A rationale for domestic demand-led growth?

It is important to mention that while the literature on growth and development considers the export-led growth strategy, the “domestic demand-led growth strategy” is not a term defined and used (hence it has to be defined here, in particular for purposes of empirical implementation—see “Definition of domestic demand- and export-led strategies,” below).³ Therefore, it is not straightforward to place the “debate” between export-led and domestic demand-led growth strategies in a theoretical context.

In recent years, however, a series of economists have hypothesized that, the Asian crisis had very different roots and that after several decades of being presented as the optimal growth strategy, the export-led growth model that the Asian countries followed ultimately gave in and even harmed the growth prospects of developing countries. These economists have put together a critique of the export-led growth model and proposed a shift toward domestic demand-led growth.

Palley (2002), for example, has argued that the emphasis on export-led growth of most Asian countries had a series of negative effects. First, it prevented the development of domestic market growth. Second, it put developing countries in a “race to the bottom” among themselves. Third, it placed workers in developing countries in conflict with workers in industrial countries. Fourth, there is a relationship between export-led growth and financial instability through the creation of overinvestment booms. Fifth, due to the emphasis placed on global goods and commodity markets, this model has aggravated the long-trend deterioration in developing-country terms of trade. And finally, and most important, export-led growth has reinforced the dependency of developing countries on industrial countries, thus rendering them vulnerable to slowdowns in industrial-country markets (e.g., as in the slowdown of the semiconductor world market in 1996–97 right before the Asian crisis). Export-oriented economies are dependent on foreign (mostly Western) demand. The problem is that recessions in Europe, US, or Japan translate into slow growth in the developing world. Summing up, Palley (2002) argued that the export-led growth model that the Asian countries followed for several decades is no longer an optimal strategy.

Blecker (2002, 2003) has also contended that the adoption of a development strategy that relied on high rates of growth of manufactured exports is the root cause of the problems that led to the crisis, for such a strategy led to growing excess capacity, intensified competitive pressures, and disappointing growth performance. In a similar vein, Kaplinsky (2000) and Erturk (2001–2002) have suggested the possibility of *immiserizing growth* as a result of the creation of excess capacity in export-oriented manufacturing industries. During the 1990s, too many developing countries entered the more advanced product categories, thus creating excess capacity and fostering falling prices.

Blecker (2002, 2003) has also argued that reliance on export growth suffers from a “fallacy of composition.” The reason is that, if too many countries try simultaneously to rely on export-led growth policies to stimulate growth in a given set of global demand conditions, the market for developing countries’ exports is limited by the

capacity of the industrial nations. If demand in the industrial countries stagnates, it translates into overinvestment and excess capacity in developing countries. As Asian countries plunged into the crisis, the first policy option they all considered as a means of resuming growth was the export-led strategy. However, the difficulty with this strategy is that the fallacy of composition problem has been exacerbated, since during the last decade the PRC has been added into the equation. Export-led growth operates through a hierarchical process with less-developed newcomers replacing more maturing export economies as their wages grow. The PRC poses an entirely different problem for it has a fairly large supply of labor so that it can keep wages very low and, seemingly, for a long time.

Blecker summarizes his views as follows: “the current emphasis on export-led growth in developing countries is not a viable basis on which all countries can grow together under present structural conditions and macroeconomic policies” (Blecker 2003). Palley (2002) has gone further and contends that the export-led growth model followed by many developing countries during the last few decades was part of the “Washington consensus” emphasis on trade liberalization.⁴ As a solution, Palley proposes a new development paradigm based on domestic demand-led growth.⁵

Definition of domestic demand- and export-led growth strategies

The analysis is performed in terms of the macro-economic accounting identity:

$$GDP \equiv Y \equiv C_p + C_g + I + X - M \quad (1)$$

where GDP stands for gross domestic product, C_p is private consumption, C_g is government consumption, I is gross domestic investments or gross domestic capital formation (GDCF), and X and M are exports and imports, respectively, of goods and services. An export-led growth strategy is referred to as one that results in:

high export growth, accompanied by high GDP and income growth;

and

improvement in net export growth, i.e., higher export growth than import growth.

Conversely, growth is *strictly speaking* domestic demand-led if domestic demand is growing, accompanied by GDP and income growth.

The share of each component in output is defined as: (C_p/Y) is the share of private consumption, (C_g/Y) is the share of government consumption, (I/Y) is the share of investment, and $((X-M)/Y)$ is the share of net exports.

A convenient way of categorizing the different possibilities for the two strategies is as follows. The first three terms on the right-hand side of identity (1)—consumption of the private and government sectors plus investments—are the domestic demand components, while $(X-M)$, or net exports, is the other component of aggregate demand. Thus, the following cases can arise:

- Domestic demand is growing and net exports are deteriorating (becoming a smaller positive number or larger negative number). If GDP growth is positive, then growth must be domestic demand-led. This is the only case where one can, *strictly speaking*, refer to domestic demand-led growth.
- Domestic demand and net exports are growing. Thus, growth is due to both domestic demand and net exports. Which one is contributing more to growth is simply an empirical issue. If domestic demand is growing faster, it can be said that growth is demand led, but *weakly speaking*.
- Domestic demand is deteriorating and net exports are increasing. If growth is positive (which is often not the case since domestic demand is usually a much larger component of GDP), growth must be net export led. If growth is negative, the recession is due to a decline in domestic demand.
- Both domestic demand and net exports are decreasing. Obviously, there is an economic recession and negative growth rates are due to declines in both domestic demand and net exports.

It must be pointed out that, as GDP is separated into the domestic demand and net export components, the share of domestic demand will be much larger than the net export share,

usually constituting more than 90% of GDP when net exports are positive. (When net exports are negative, the share of domestic demand will be more than 100%.) This is because much of the export earnings will go to import purchases, and since net exports track the difference between these two trade variables, the magnitude becomes quite low compared with domestic demand. This is true even in the most successful export-led growth cases where export growth is in double-digits.⁶

Demand-side growth-accounting exercise

In this section, a growth-accounting analysis on the components of demand is performed. As indicated above, the objective of this exercise is to apportion overall growth between domestic demand and net exports. Technical details are shown in Box 1.4.

The five countries chosen—PRC, India, Korea, Philippines, and Thailand—provide a relatively wide spectrum of experiences and results. The first two are the oft-touted Asian success stories of the most recent decade due to their opening up to international trade, and the latter three were countries affected by the Asian financial crisis in 1997–98. Table 1.3 gives the shares of the expenditure components of GDP at constant prices for the five countries. Table 1.4 shows the average annual growth rates of GDP and of demand components over the 10-year intervals of 1973–1983, 1983–1993, and 1993–2003. Table 1.5 provides the growth rates of the expenditure components weighted by their shares in GDP. This gives, in growth rate terms, the contribution of each component to the growth rate of GDP. Finally, Table 1.6 displays, as a percentage, the contribution of each aggregate demand component to overall GDP growth.

Box 1.4 Demand-side growth accounting

Real output from the demand side is given by the national income and product accounts as:

$$GDP \equiv Y \equiv C_p + C_g + I + X - M \quad (1)$$

where GDP stands for gross domestic product, C_p is private consumption, C_g is government consumption, I is gross domestic investments or GDCF, and X and M are exports and imports of goods and services, respectively.

In growth rate terms:

$$\begin{aligned} \hat{GDP} \equiv & (C_p/GDP) \times \hat{C}_p \\ & + (C_g/GDP) \times \hat{C}_g + (I/GDP) \times \hat{I} \\ & + (X/GDP) \times \hat{X} - (M/GDP) \times \hat{M} \end{aligned} \quad (2)$$

where the symbol $\hat{}$ denotes growth rate of the variable.

The above simply states that the growth rate of GDP is the sum of the products of the shares in GDP times the growth rates of private consumption, government consumption, gross domestic invest-

ments and exports, less the product of the share of imports and its growth rate.

Real values were derived for 1973, 1983, 1993, and 2002 using the United Nations Statistics Division data, which have a continuous series of expenditure component measures from 1973 to 2002 in constant 1990 prices. Data for 2003 were derived from the 2002 data above and the latest growth data from ADB's *Key Indicators 2004* or the latest IMF *International Financial Statistics*. For the Philippines, the United Nations Statistics Division has a complete continuous series from 1973 to 2003. India did not have data for 2003 at the time of writing (December 2004), so its data end in 2002.

Average annual growth rate of a variable, denoted \hat{x} , was derived, say, for 1973 to 1983, as:

$$\hat{x} = (((x_{1983} - x_{1973}) / x_{1973}) * 100) / 10 \quad (3)$$

For a continuously increasing positive x , the above method will yield a higher annual average growth rate than taking the 10 actual annual growth rates of x from 1973–74 up to 1982–83, and then averaging them.¹

The method employed here also uses the GDP estimate without taking into consideration the statistical discrepancy between the value-added GDP estimate and the expenditure GDP estimate. That is, the GDP in the denominators of the shares in equation (2) uses equation (1) exactly without including the statistical discrepancy. This allows the expenditure shares to sum up to exactly 100%, and for equation (2) to sum up exactly to the GDP growth rate.

¹ This is because the base year in (3) is always the value of 1973, while averaging the actual annual growth rates uses base years from 1973 up to 1982.

Source: Asian Development Bank staff.

Table 1.3 Shares of expenditure components in real GDP, 1990 prices, %

		Domestic demand (1)=(2)+(3)+(4)	Private consumption (2)	Government consumption (3)	Gross domestic fixed capital formation (4)	Net exports (5)=(6)-(7)	Exports of goods and services (6)	Imports of goods and services (7)
1973		99.1	55.7	9.4	34.1	0.9	5.0	4.1
1983		100.2	54.3	12.1	33.7	-0.2	13.2	13.4
1993	PRC	100.8	49.1	13.1	38.6	-0.8	18.6	19.3
2003		94.2	39.6	12.0	42.6	5.8	24.4	18.6
1973		101.6	70.8	9.1	21.7	-1.6	6.7	8.4
1983		103.1	71.8	10.3	21.0	-3.1	6.5	9.6
1993	India ^a	102.8	68.7	11.9	22.2	-2.8	8.6	11.5
2002		101.1	62.8	12.0	26.4	-1.1	16.7	17.9
1973		100.5	64.1	15.7	20.7	-0.5	16.4	16.9
1983		96.7	55.1	12.8	28.8	3.3	27.7	24.4
1993	Korea	100.2	52.3	10.5	37.4	-0.2	33.9	34.1
2003		94.3	52.9	12.2	29.2	5.7	45.7	40.0
1973		100.4	69.0	11.4	20.0	-0.4	19.0	19.5
1983		102.3	63.0	9.8	29.6	-2.3	21.9	24.2
1993	Philippines	107.2	74.8	10.0	22.4	-7.2	31.3	38.5
2003		105.7	73.8	9.2	22.7	-5.7	39.3	45.0
1973		114.4	68.7	10.0	35.7	-14.4	17.1	31.5
1983		109.5	63.5	13.1	33.0	-9.5	19.6	29.1
1993	Thailand	105.9	55.1	8.7	42.0	-5.9	39.6	45.5
2003		85.3	55.4	8.7	21.2	14.7	65.7	50.9

^a India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.4 Average growth rates of expenditure components based on constant 1990 prices, %

		Expenditure on GDP	Private consumption	Government consumption	Gross domestic fixed capital formation	Exports of goods and services	Imports of goods and services
1973–1983		9.0	8.6	14.7	8.8	40.6	52.3
1983–1993	PRC	16.1	13.6	18.0	19.8	26.7	27.7
1993–2003		14.2	9.5	12.2	16.7	21.8	13.3
1973–1983		5.0	5.2	6.9	4.5	4.4	7.2
1983–1993	India ^a	5.6	5.0	8.1	6.5	10.9	8.7
1993–2002		8.0	6.4	8.1	11.6	26.0	18.7
1973–1983		10.6	7.7	6.8	18.7	24.8	19.8
1983–1993	Korea	12.2	11.1	8.2	18.9	17.2	21.1
1993–2003		7.3	7.5	10.1	3.5	13.3	10.3
1973–1983		6.4	5.0	4.0	14.2	8.8	10.4
1983–1993	Philippines	1.5	3.6	1.8	-1.3	6.4	8.2
1993–2003		4.7	4.5	3.5	4.9	8.5	7.2
1973–1983		8.9	7.5	14.7	7.5	11.7	7.5
1983–1993	Thailand	13.3	10.2	5.6	19.7	37.0	26.4
1993–2003		3.6	3.7	3.6	-3.1	12.6	5.3

^a India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.5 Growth rates of expenditure components weighted by their share in GDP, %

		Expenditure on GDP (1)=(2)+(6) =(3)+(4)+(5) +(7)-(8)	Domestic demand (2)= (3)+(4)+(5)	Private consump- tion (3)	Gov- ernment consump- tion (4)	Gross domestic fixed capital formation (5)	Net exports (6)= (7)-(8)	Exports of goods and services (7)	Imports of goods and services (8)
1973–1983		9.0	9.2	4.8	1.4	3.0	-0.1	2.0	2.1
1983–1993	PRC	16.1	16.2	7.4	2.2	6.7	-0.2	3.5	3.7
1993–2003		14.2	12.7	4.7	1.6	6.4	1.5	4.0	2.6
1973–1983		5.0	5.3	3.7	0.6	1.0	-0.3	0.3	0.6
1983–1993	India ^a	5.6	5.8	3.6	0.8	1.4	-0.1	0.7	0.8
1993–2002		8.0	7.9	4.4	1.0	2.6	0.1	2.2	2.1
1973–1983		10.6	9.9	5.0	1.1	3.9	0.7	4.1	3.3
1983–1993	Korea	12.2	12.6	6.1	1.1	5.4	-0.4	4.8	5.1
1993–2003		7.3	6.3	3.9	1.1	1.3	1.0	4.5	3.5
1973–1983		6.4	6.7	3.4	0.5	2.8	-0.3	1.7	2.0
1983–1993	Philippines	1.5	2.1	2.3	0.2	-0.4	-0.6	1.4	2.0
1993–2003		4.7	4.8	3.4	0.3	1.1	-0.1	2.6	2.8
1973–1983		8.9	9.3	5.1	1.5	2.7	-0.4	2.0	2.4
1983–1993	Thailand	13.3	13.7	6.5	0.7	6.5	-0.4	7.3	7.7
1993–2003		3.6	1.0	2.0	0.3	-1.3	2.6	5.0	2.4

^a India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.6 Contribution of demand components to GDP growth, %

		Expenditure on GDP (1)=(2)+(6) =(3)+(4)+(5) +(7)-(8)	Domestic demand (2)= (3)+(4)+(5)	Private consump- tion (3)	Gov- ernment consump- tion (4)	Gross domestic fixed capital formation (5)	Net exports (6)= (7)-(8)	Exports of goods and services (7)	Imports of goods and services (8)
1973–1983		100.0	101.4	52.9	15.2	33.3	-1.4	22.3	23.6
1983–1993	PRC	100.0	101.1	45.9	13.6	41.6	-1.1	21.9	23.1
1993–2003		100.0	89.6	32.9	11.3	45.4	10.4	28.6	18.1
1973–1983		100.0	106.1	73.9	12.7	19.6	-6.1	5.9	12.1
1983–1993	India ^a	100.0	102.3	63.2	14.8	24.4	-2.3	12.5	14.8
1993–2002		100.0	98.8	54.7	12.0	32.1	1.2	27.9	26.7
1973–1983		100.0	93.2	46.6	10.0	36.5	6.8	38.3	31.5
1983–1993	Korea	100.0	103.1	50.0	8.6	44.5	-3.1	39.0	42.1
1993–2003		100.0	86.3	53.7	14.6	18.0	13.7	61.9	48.1
1973–1983		100.0	105.3	53.6	7.2	44.5	-5.3	26.4	31.7
1983–1993	Philippines	100.0	140.4	154.5	11.8	-25.8	-40.4	94.6	135.0
1993–2003		100.0	102.4	71.7	7.4	23.3	-2.4	56.4	58.8
1973–1983		100.0	104.0	57.6	16.5	29.9	-4.0	22.5	26.5
1983–1993	Thailand	100.0	103.2	48.8	5.5	48.8	-3.2	54.7	57.9
1993–2003		100.0	28.6	56.0	8.6	-36.1	71.4	137.3	65.9

^a India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

People's Republic of China

The tables show that the PRC registered high domestic demand growth in the first two decades, 1973–1993, while its net export position deteriorated and was negative.⁷ This happened even as the growth of exports posted annual averages of more than 20% (since imports increased more than exports). The last decade, 1993–2003, however, saw not only continuing large growth in domestic demand components, but also a strong shift from negative net exports (or trade deficits) to high positive net export (or trade surplus) positions, as export growth accelerated and import growth decelerated. Thus, the PRC's growth experience during the last decade points to high growth in both the domestic demand components and in the net export component. Domestic demand contributed around 90% to the double-digit GDP growth of the PRC in 1993–2003, while net exports contributed around 10% (Table 1.6). It is also important to point out that, in all three decades, investment growth outpaced consumption growth (Table 1.4), so that the last decade saw a larger contribution of investment than consumption to GDP growth, an increase in the share of capital formation (to more than 40%), and a continuing decline of the share of private consumption. It must be emphasized that in the last decade the share of net exports in GDP grew substantially—reflecting the transition from a negative contributor to growth to a high positive contributor.

India

India registered positive average annual GDP growth during the three decades, but lower than the PRC. The first two decades (1973–1993) were marked by growth in domestic demand as net exports deteriorated. During the last decade, when India opened up to the international market, the country exhibited even higher growth, with higher growth in the domestic demand components, but now the trade deficits improved so that net exports contributed slightly to overall GDP growth. During this decade, the growth rates of exports and imports more than doubled, with exports outpacing imports, leading to the decline in the trade deficits (net exports became a smaller negative number). As in the PRC, investment increased more than consumption

in the last decade, with the consequence that the share of capital formation increased, while that of private consumption fell. But the high share of consumption still made this component of demand the largest contributor to growth in the last decade. Finally, the last decade saw an increase in the share of net exports to GDP (actually a decline of its negative share to GDP) and a slight decline in the share of domestic demand to GDP.

Korea

The high-growth decade for Korea was 1973–1983, when it started being touted as an “Asian tiger”. During this decade, the domestic demand components of GDP grew very fast. Export growth exceeded 20% annually and surpassed import growth such that the country registered net export growth. At the same time, there was strong domestic demand growth. The trade surplus position reversed during 1983–1993 as the country began exhibiting trade deficits in the early 1990s, even if exports continued growing at a very high rate. The very high GDP growth during this decade, therefore, was due to high growth of domestic demand, with net exports deteriorating and turning negative toward the 1990s. Trade deficits continued until the Asian crisis. The last decade, 1993–2003, reversed the trade deficits, and the country returned to positive net exports starting in 1998, at the height of the Asian crisis. Because of the significant contraction of the economy in 1998, the growth rate of the last decade was lower than those registered during the last two decades, though still respectable. The last decade saw a slower growth of consumption and investment than in the previous decades, with investment actually losing share of GDP (reflecting the investment collapse of 1998). Net exports contributed to GDP growth in this last decade, and increased its share in GDP, while the share of domestic demand fell.

Philippines

The Philippines exhibited respectable growth during 1973–1983, with domestic demand growing significantly. The decade 1983–1993 was a difficult period for the Philippines, marked by the economic collapse of 1984–85 and 1991–92. Average annual growth was low during this

decade, which saw a decline in investment and low growth in consumption. Trade deficits also worsened, contributing to the low growth. The decade, therefore, was characterized by stagnation, with net exports not improving by the end of the decade (1993). The last decade (1993–2003) saw an improvement in growth rates, but net exports continued to be negative and did not improve in absolute terms, though they did improve as a percentage of GDP. The Philippines, therefore, is the only case among the five countries analyzed where all three periods, including the last one, were marked by growth in domestic demand and deterioration in net exports, although there was an improvement in terms of the share of net exports to GDP (to a smaller negative number).

Thailand

Thailand registered very high growth in the first two decades, 1973–1983 and 1983–1993, with both investment and consumption growing very fast. This was accompanied by deteriorating net exports in the two decades.⁸ The deterioration of net exports during 1983–1993 was accompanied by spectacular growth rates in both exports and imports. The last decade saw a significant fall in the GDP growth rate, as a consequence of the Asian crisis, which hit Thailand in 1997–98, and resulted in steep GDP and investment declines. Because of this, investment fell during the decade while consumption grew slowly and net exports turned from negative to largely positive. Thailand's GDP growth in 1993–2003 stemmed largely from improvements in net exports, which contributed 71% of the country's overall growth.

Thus, Thailand's post-Asian crisis improvement in net exports was the main contributor to growth during the last decade, rather than domestic demand.

Summary of results

Table 1.7 summarizes the results of the growth-accounting exercise. The overall picture that emerges from the analysis of the selected countries indicates that during the first two decades, but more especially during the second, domestic demand was the main driver of growth, as net exports deteriorated. The last decade of 1993–2003, on the other hand, was accompanied by significant improvements in the net exports position of the selected group of countries (with the exception of the Philippines). This is true for countries experiencing continuous growth (PRC and India) and for the countries hit by the Asian crisis (Korea and Thailand). The PRC and India registered high domestic demand growth in the last decade, simultaneously with net export growth (and very high export growth). Korea and Thailand saw net exports swing from negative to highly positive and contribute significantly to growth, as the domestic demand components grew more slowly.

In the Asian tigers such as PRC, Korea, and Thailand, export growth actually decelerated in the last decade relative to the second decade, but export growth was still in double digits. On the other hand, the growth rate of imports decelerated more with the consequence that all three countries saw improvements in their net export positions.

Export growth accelerated very strongly in

Table 1.7 Phases of domestic demand- and net export-led growth in selected Asian countries: A summary

Period	PRC	India	Korea	Philippines	Thailand
1973–1983	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD increasing, NE positive and improving	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating
1983–1993	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD stagnant, NE negative and deteriorating	DD increasing, NE negative and deteriorating
1993–2003	DD increasing, NE positive and increasing	DD increasing, NE negative but improving	DD increase slows, NE positive and improving	DD growing moderately, NE negative and deteriorating	DD growing slowly, NE positive and improving

DD = domestic demand, NE = net exports.

Source: Asian Development Bank staff.

India during the last decade, much more than imports, leading to the reduction in the country's trade deficit. The Philippines had the slowest growth in exports in the last decade, and was the only country with deteriorating net exports.

The net export share to GDP improved in all five countries. Even countries with negative net exports (or trade deficits) improved their positions. India was able to reduce its trade deficit in terms of magnitude. Trade deficits increased in magnitude in the Philippines, but declined in terms of the share in GDP. Tables 1.3 and 1.6 show that the share of domestic demand and its contribution to growth decreased during the last decade. Conversely, the share of net exports and its contribution to growth increased.

The conclusion is that there is no evidence that the net export position of the selected countries deteriorated during the last decade. And as a consequence, there is no evidence that growth during the last decade was domestic demand-led and at the expense of the net export position.

Decomposition analysis of stances in the private, government, and trade sectors

In this section, the stances of the private sector, the government (fiscal) sector, and trade sector for the five selected countries are analyzed. (The technical details of the aggregate demand decomposition analysis are provided in Felipe and Lim, forthcoming.) The private sector stance, or direct "own" multiplier on output, is given by (I_p/s_p) where I_p denotes gross private investment and s_p is the savings rate out of GDP. If (I_p/s_p) is larger than GDP, then private investment is larger than private savings (or, alternatively, private disposable income is smaller than private spending, composed of private consumption and private investments). Under these circumstances, the private sector is exhibiting an "expansionary stance" on aggregate demand, i.e., demand injections are larger than demand leakages. The government or fiscal stance is (G/t) where G is government spending and t is the tax effort out of GDP. If (G/t) is larger than GDP, then government spending is larger than tax revenues, and the government exhibits an expansionary stance on aggregate demand, i.e., it exerts positive net injections on aggregate demand. Finally,

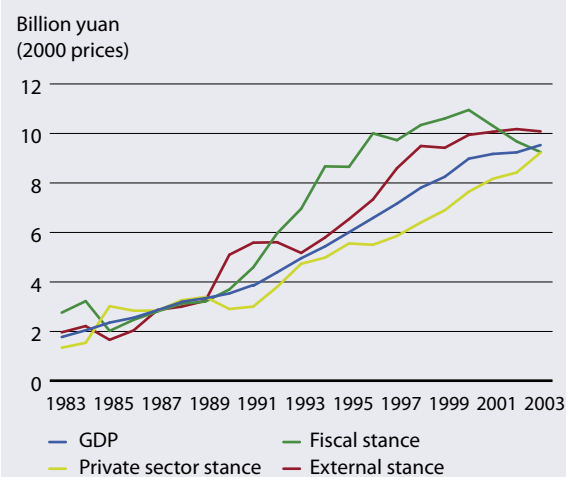
the external sector stance is (X/m) , where X denotes exports of goods and services and m is the propensity to import out of GDP. If (X/m) is larger than GDP, exports exceed imports, and the trade or external sector is exhibiting an expansionary stance on aggregate demand, i.e., export injections exceed import leakages. The period covered in this analysis is 1983–2003, using real values in the national income accounts for aggregate demand components.

The results are presented in Figures 1.18–1.22, which plot the stances of the three sectors vis-à-vis GDP.

People's Republic of China

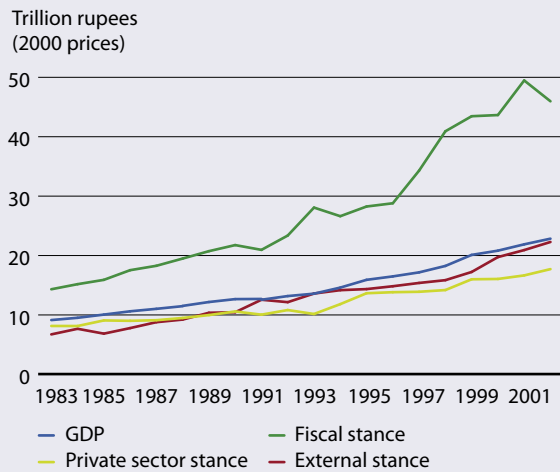
The PRC's slow transformation into a market economy and its participation in world trade has brought almost uninterrupted high growth to the country from the late 1970s until the present. The very high private savings rates (above 35%) have allowed the private sector "stance" to be nonexpansionary throughout most of the second and last decades, while maintaining a very high share, as well as growth, of GDCF (Figure 1.18). Since the early 1990s, the fiscal stance has been expansionary. The external stance became expansionary in 1990 and has remained positive until

Figure 1.18 Private sector, fiscal, external stances relative to real GDP, People's Republic of China, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.19 Private sector, fiscal, external stances relative to real GDP, India, 1983–2002



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

now. The major expansionary stances in the last decade came from the government and external sectors.

In recent years, the PRC Government has reduced the expansionary fiscal stance in an attempt to avoid overheating of the economy. This explains why the external sector has emerged as the leading expansionary sector in recent years.

India

As in the PRC, relatively high private savings rates for a low-income country have allowed a nonexpansionary private sector stance and, at the same time, have supported a GDCF of around 20–25% of GDP during most of the second and last decades. Figure 1.19 shows the consistent nonexpansionary stance of the private sector. This sector's stance falling below GDP seems to be widening in recent years as the private savings rate is close to 30% of GDP.

Imports have been increasing since the 1990s but at lower rates than in the other countries. Export growth, however, has outpaced import growth in recent years leading to smaller negative net exports and to a small nonexpansionary external stance.

The very low tax effort (below 10% of GDP during most of the 1983–2003 period) and high

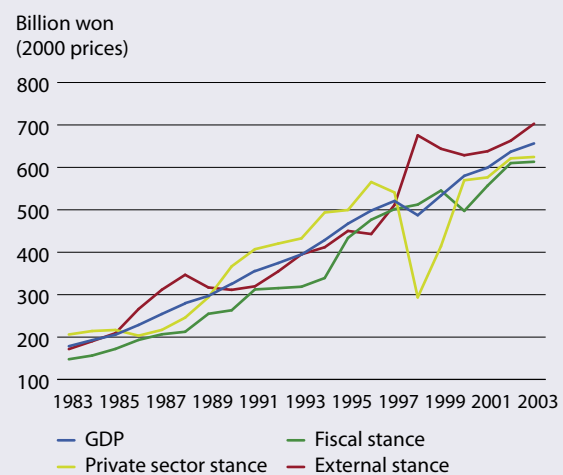
government spending have made the government the only sector with an expansionary stance. This impact of the fiscal expansionary stance on aggregate demand, though large and increasing in recent years, is moderated both by the growing gap between GDP and the private sector stance and by the improvement in the external stance.

Korea

Figure 1.20 shows that an expansionary private sector stance and nonexpansionary external stance during 1983–1985 were reversed in the second half of the 1980s. This shift to an expansionary external stance took place at the time the optimism about the Asian miracle was at its height. This high foreign exchange-earning capacity of the country was an important component of the country's success.

The appreciation of the won, high short-term capital inflows, speculative bubbles, and the fixed exchange rate regime of the 1990s, however, brought back an expansionary private sector despite the country's very high private savings rates. This was accompanied by a reversal to a nonexpansionary (and at times contractionary) external stance between 1990 and 1997. This contributed to a loss in confidence in Korea in the period right before the Asian crisis.

Figure 1.20 Private sector, fiscal, external stances relative to real GDP, Korea, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

As Korea became enmeshed in the crisis, the deep recession and sharp currency depreciations in late 1997 and throughout 1998 effected a sharp reversal, with the private sector stance shifting sharply from expansionary to highly contractionary, and vice versa in the case of the external stance. This situation continues, though is quite subdued compared with the situation in 1998–1999. In recent years, Korea has experienced difficulties in increasing its GDP growth rate due to weak consumption demand. The fiscal stance has historically been nonexpansionary except in 1998–1999 as a result of the Asian crisis. Therefore, the only expansionary sector in Korea in the post-Asian crisis period has been the external sector, as net exports remain significantly positive.

Philippines

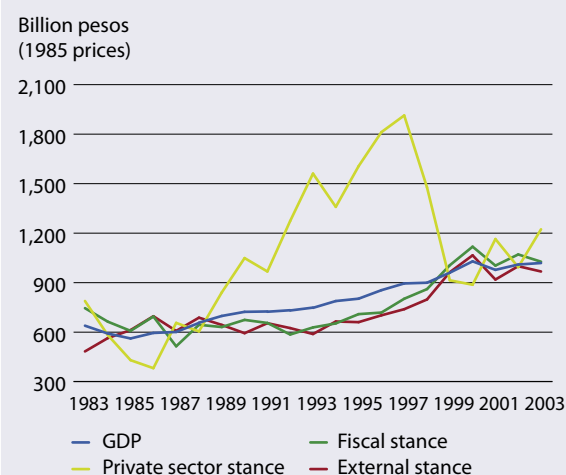
The Philippines' economic history since the 1980s has been marked by alternate periods of growth and recession. The sharp recession and crisis in the mid-1980s caused a sharp reversal in the private sector stance from highly expansionary in 1983 to highly contractionary. Correspondingly, the contractionary external stance in 1983 turned expansionary in 1985–1988.

Economic recovery in the late 1980s brought the private sector increasingly back to very positive territory in the 1990s, even though 1990–1993 were years of stagnation. The most expansionary period of the private sector was 1993–1997. Accompanying the high expansionary stance of the private sector were increasingly negative net exports, which returned in 1989 and rapidly increased in the 1990s (reaching more than 10% of GDP).

The Philippines was also hit by the Asian crisis in the second half of 1997 and throughout 1998. The sharp currency depreciation, initial high interest rates, and a slight recession tamed the high expansionary stance of the private sector (making it briefly contractionary in 1999 and 2000) and brought net exports to positive territory in 1999 and 2000.

The ensuing economic recovery (though weak and slow) returned the private sector to expansionary territory and the external sector to a contractionary position in recent years (2001 to 2003), but at much lower levels than before the Asian crisis.

Figure 1.21 Private sector, fiscal, external stances relative to real GDP, Philippines, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

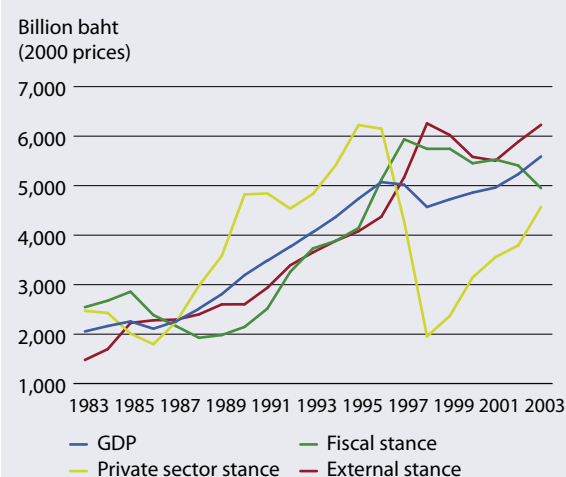
High government injections and deficits in the mid-1980s were met with fiscal austerity in 1987–1992 due to debt overhang as the country joined the decade-long debt crisis that afflicted most Latin American countries during 1982–1992. Philippine fiscal deficits remained high in 1987–1992, but this is not reflected in Figure 1.21 because much of the government spending was due to debt payments, and net lending and bailouts of government corporations. Fiscal surpluses were attained in 1994–1997 but these were reversed in 1998 due to the crisis. The Philippines now faces another fiscal crisis as the tax effort has continued its decline since the crisis, and as debt payments and failing government corporations (especially the National Power Corporation) are absorbing much government spending. The fiscal stance turned expansionary in 1999, but weakly so for the reasons given just above.

Summing up, recent years in the Philippines have been marked by an expansionary stance in the private and fiscal sectors, and a contractionary one in the external sector—but even then, these levels are much lower than before the Asian crisis.

Thailand

Like Korea, Thailand's private sector stance

Figure 1.22 Private sector, fiscal, external stances relative to real GDP, Thailand, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

moved from expansionary to nonexpansionary in 1985–1987, and its net exports turned from negative into positive in 1986–1987 (Figure 1.22). Net exports turned slightly negative in 1988–1989. Thus, like Korea, Thailand was at its most “miraculous” during the second half of the 1980s, when its net exports were either positive or in slightly negative territory, and its private sector was not too expansionary.

Also like Korea, currency overvaluation, high short-term capital inflows, speculative bubbles, overlending and overborrowing, and a fixed exchange rate regime made the private sector’s stance significantly expansionary from 1989, which continuously strengthened during 1990–1996. Correspondingly, its external stance was significantly contractionary throughout the 1990s, especially in the few years before 1997, the year of the outbreak of the Asian crisis (which, of course, originated in Thailand).

The fiscal stance was largely nonexpansionary during 1987–1995. More so than in Korea, there were very severe private sector and trade sector adjustments during the Asian crisis and its aftermath. The private sector became very highly contractionary, especially in 1999 and 2000, and it remains significantly negative. The external stance

turned very highly expansionary, especially in 1998 and 1999, and has remained that way.

The fiscal stance was expansionary (with fiscal deficits) during 1997–2000 because of a decline in the tax effort and social and economic spending due to the Asian crisis. These were restrained in 2002 and 2003 as tax efforts improved (unlike in the Philippines, where the tax effort has continued to decline).

Thailand has shown a continuous and increasing import propensity from the mid-1980s to the present, with a short respite in 1998 (because of the Asian crisis), but since then export growth has outpaced import growth. Thus, as in Korea, 2002 and 2003 saw the trade sector as the only one providing a significant expansionary stance to aggregate demand. Nevertheless, the reduction in the nonexpansionary stance of the private sector during the last few years is, to some extent, the result of Prime Minister Thaksin’s policies. For the time being, the private sector stance is still nonexpansionary. However, if it becomes overexpansionary, then the authorities must be cautious that the situation does not revert to that of the precrisis period, that is, a highly expansionary private sector stance leading to significant trade deficits financed by large foreign borrowings (making the economy very vulnerable to interest and exchange rate shocks).

Therefore, despite the attempts of the prime minister at switching from export-led to domestic demand-led growth, net exports still provide a key ingredient to Thai growth, while the private sector and fiscal stances—the domestic demand sectors—have actually been nonexpansionary in recent years. If anything, Mr. Thaksin’s policies must be seen as an attempt at increasing aggregate output vis-à-vis aggregate demand (domestic absorption). If one thinks of net exports ($X-M$) equivalently (through the national accounts) as the difference between aggregate output (GDP) and domestic absorption (the sum of consumption plus investment and plus government expenditures), it seems that the Government’s five-pronged strategy (Box 1.3) aims to boost the former rather than the latter.

Summary

The three questions posed at the beginning of this part of *ADO 2005* can now be answered.

(i) *Does the evidence indicate that countries are switching from export-led growth to domestic demand-driven growth?*

The answer to this question is a clear “No.”

The external sector is the one with the strongest expansionary stance in recent years in three out of the five countries studied, namely, PRC, Korea, and Thailand. For Korea and Thailand, it is the only sector providing an expansionary stance. For the PRC, the Government is very consciously reducing its expansionary stance to avoid overheating. Since its private sector has historically exhibited a nonexpansionary stance (due to the country's high savings rate), the trade sector provides a major force in the expansion of aggregate demand.⁹

In India, the high fiscal expansionary stance is growing, but growing nonexpansionary and offsetting pressures from the private sector and improving net exports (though still negative) are reducing this expansionary domestic demand pressure on aggregate demand.

In the Philippines, the post-Asian crisis years saw a return to expansionary stances in the private and fiscal sectors, and negative net exports, though the expansionary stance of the private sector and negative net exports are substantially lower than before the Asian crisis.

(ii) *Did the export-led strategies partly contribute to the Asian financial crisis?*

Again, the answer to this question is a clear “No.”

Korea, Philippines, and Thailand followed a growth strategy characterized by a bias against exports during the years before the Asian crisis. This bias has been well documented and consisted of overvaluation of the currency, overlending and overborrowing in the domestic private sector, and creation of speculative bubbles in the nontradable sectors. This resulted in highly negative net export positions, and the exaggerated expansionary stance of the private domestic sector. For Korea and Thailand, this hurt the strong Asian miracle image they had achieved in the second half of the 1980s. The Asian crisis and its aftermath have

been a painful reversal of the earlier situation in these three countries.

These results directly contradict the arguments of Palley (2002) presented earlier—namely that the export-led growth strategy was partly to blame for the Asian crisis and led to biases against the domestic demand sector. In fact, the above simple analysis has shown that it was an overexpansionary stance in the private sector and growing trade deficits that marked the immediate period before the Asian crisis for Korea, Philippines, and Thailand.

(iii) *What lessons can be drawn from the different country experiences?*

The most obvious result coming out of the above analysis is that the “best” periods for the selected countries have been those when both domestic demand and net exports exhibited impressive growth. This corroborates the earlier justifications for export-led growth, especially the argument that developing countries need precious foreign exchange to finance their import needs. It must be pointed out that this corresponds to the definition of domestic demand-led growth weakly speaking (both domestic demand and net exports are increasing). The PRC has demonstrated that this kind of growth can be sustained for long periods. India adopted this type of strategy in the late 1990s, and as a result its high domestic demand growth is accompanied by impressive export growth and improvements in its trade deficits. Thailand and Korea followed this strategy in the second half of the 1980s, when their reputation as Asian tigers was at a peak. A deviation from this strategy seemed to have led them toward the Asian crisis. The above analysis indicates that they actually have reverted to the earlier strategy of promoting both domestic demand and net export components of the economy during this postcrisis period.

Comparison of expenditure shares of open European countries and selected countries in the Asia-Pacific region

For comparison purposes, the expenditure shares of a group of small open developed economies in Western Europe (Belgium, Denmark, Nether-

lands, Sweden, and Switzerland) are analyzed and compared with those of the developing countries of Asia-Pacific.

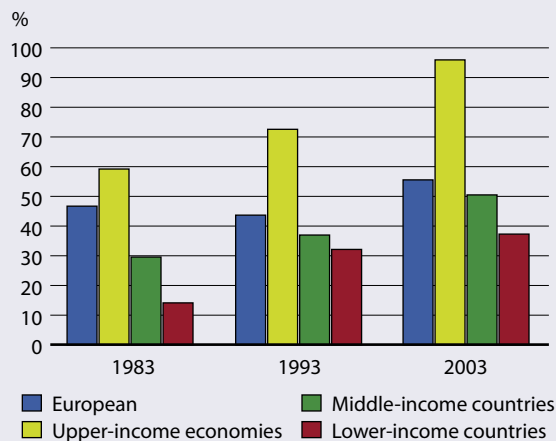
The Asia-Pacific countries are divided into three groups: upper-income economies (UA), middle-income countries (MA), and low-income countries (LA). The LA group coincides with the World Bank's latest categorization of low-income countries.¹⁰ The MA group coincides with the World Bank's countries in Asia-Pacific that are categorized as lower-middle-income countries. The UA group comprises those economies in Asia-Pacific that are above the income brackets for the lower-middle-income countries as categorized by the World Bank.¹¹

Figures 1.23 and 1.24 show the average shares of exports and imports, respectively, in GDP for the European countries, UA economies, MA countries, and LA countries.

Figure 1.23 indicates that the European and UA economies have significantly higher shares of exports in GDP than the MA and LA countries. The UA economies have by far the highest share of exports among all countries and their export share increased the most between 1983 and 2003. For all categories of countries, the shares of exports and imports grew fast between 1983 and 2003.

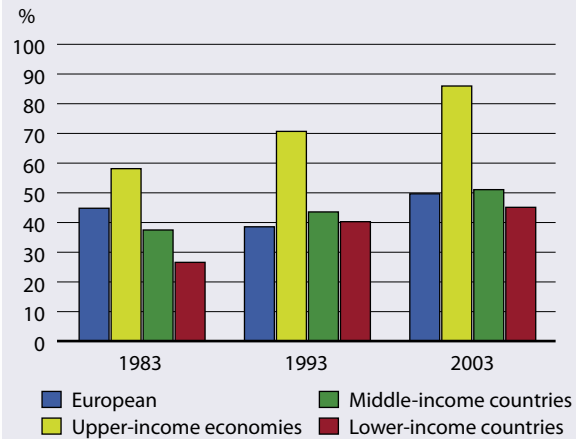
Changes in the import share are quite

Figure 1.23 Average share of exports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.24 Average share of imports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

different (Figure 1.24). The European countries had higher import shares than the MA and LA countries in 1983, but in 1993 both the MA and LA countries had exceeded the import share of the European countries. In 2003, the MA countries' import share still exceeded that of the European countries, but the share of the LA countries fell again below that of the European countries. The UA economies again have had the highest share of imports since 1983, and their import share is also growing the fastest.

Figure 1.25 indicates that net exports (exports less imports) as a share of GDP are positive and growing for the European and UA economies. On the other hand, net exports are negative for both the MA and LA countries in three periods analyzed. But the net export position of the MA countries had clearly improved in 2003 (almost zero on average). The LA countries still had large negative net exports in 2003, of around 8% of GDP on average.

It must be stressed that the UA economies improved their net export share considerably between 1993 and 2003. In 2003, it was almost twice as large as the net export share of the European countries.

Domestic demand—defined as consumption (private and government) plus GDCF—and net exports sum to GDP. Thus, Figure 1.25 also

indicates that the share of domestic demand has been decreasing significantly in the European, UA, and MA economies.

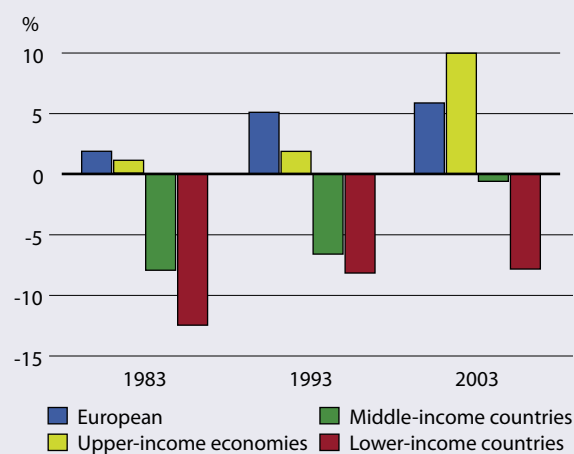
The above analysis shows that the UA and MA economies—where most of the emerging markets in the Asia-Pacific region are categorized—on average improved their net export position between 1993 and 2003, and that the UA and MA economies' share of domestic demand also declined. The UA economies even outperformed the European countries in terms of exports and net export shares.

The decreasing share of the domestic demand components in the UA and MA economies is borne out in Figures 1.26 and 1.27, which graph the average shares of consumption (private plus government) and GDCF (or gross domestic investments), respectively, in GDP.

Figure 1.26 indicates that consumption shares fell in all groups of countries between 1983 and 2003. It is clear that, although the MA and LA countries have higher consumption shares than the European and UA economies, the shares are decreasing more quickly over time in the first two groups of countries. The UA economies have the smallest share of consumption, even lower than that of the European countries.

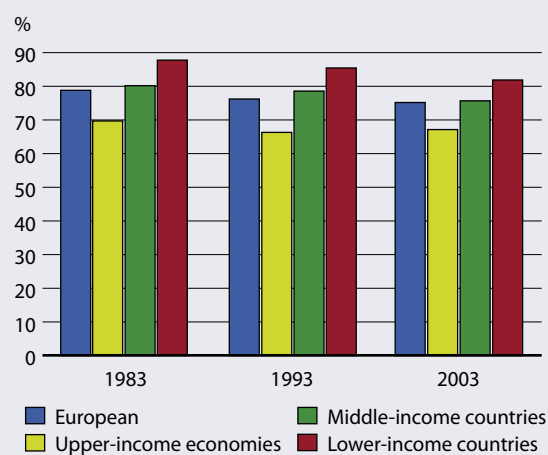
For GDCF, Figure 1.27 shows that all of the

Figure 1.25 Average share of net exports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.26 Average share of consumption in nominal GDP: 1983, 1993, 2003



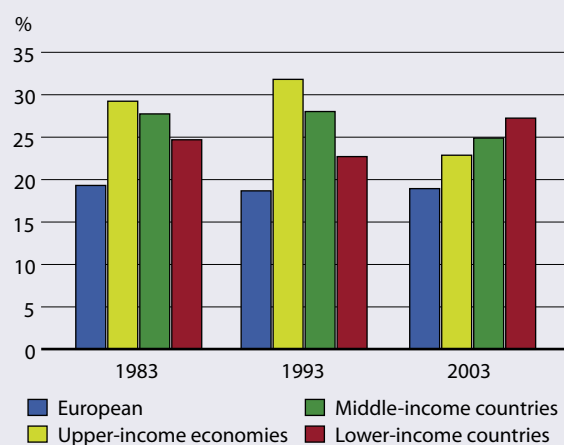
Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

categories of Asian countries have had, since the early 1980s, higher shares of investment to GDP than the European countries. The latter have very stable gross investment shares of between 18% and 19% of GDP. The UA economies had the highest investment share in 1983 and 1993. But this share, as well as that of the MA countries, fell during the 1993–2003 decade, with the UA economies' investment share losing almost 10 percentage points. The LA countries, on the other hand, increased their investment share in this decade.

Thus, on average, there is no indication that strong domestic demand-led growth or consumption-led growth has been taking place in the developing countries of Asia-Pacific during the last decade. The shares of consumption and GDCF declined during the last decade in the UA and MA economies (i.e., the share of domestic demand declined, which means that the net exports share improved). The LA countries' consumption share also fell, but their GDCF share increased. This is a positive indication that the lower-income countries, which are capital scarce, are accumulating capital at a faster rate than the other groups.

The outstanding performance of the UA economies in terms of exports and net exports reinforces the general perception that these four

Figure 1.27 Average share of gross domestic capital formation in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

economies are some of the strongest export performers in the world.

What is worrisome is the very large negative net exports still plaguing the low-income Asia-Pacific developing economies. This is discussed further in the following section.

Summary and conclusions

In brief, the main conclusions of the growth-accounting and stance analyses are as follows:

(i) There is no evidence that the 1993–2003 decade was marked by domestic demand-led growth at the expense of net exports. On the contrary, the countries hit by the Asian financial crisis, such as Korea and Thailand, lessened domestic demand expansion and strengthened net export growth. Domestic demand and net exports have been growing in countries not hit by the crisis, such as the PRC and India.

(ii) In general, the Asia-Pacific countries were able to reduce their trade deficits during the 1993–2003 decade, so that the share of net exports increased vis-à-vis that of domestic demand.

(iii) There is no evidence that the export-led strategy contributed to the Asian crisis. On the contrary, the export-led strategy, as defined in this discussion, was not implemented during

the period right before the crisis. This period was marked more by overexpansion in domestic demand, and deterioration of net exports.

(iv) Periods when domestic demand was highly expansionary at the same time that net exports deteriorated signaled an ensuing crisis. The periods when the countries analyzed performed the best were those when both domestic demand and net exports exhibited impressive growth. This corresponds to what was defined above as domestic demand-led growth weakly speaking.

Two more conclusions, of a normative nature, may be added.

(v) There should be no conflict between growth in exports and in domestic demand: successful and sustained growth requires growth in both domestic demand and net exports.

The demand-side growth-accounting exercise and the decomposition analysis of stances from the private, government, and trade sectors provide some useful lessons for appraising the discussion of domestic demand-led versus export-led growth.

Growth of successful countries such as the PRC, and to a lesser extent India, is based on a combination of both domestic demand components—especially GDCF—and exports. It is clear that developing countries should have adequate investment levels in order to grow and develop. There also has to be appropriate growth in consumption so that the population's welfare improves. These can be achieved at the same time that the country succeeds in developing and improving its export sector. In fact, in terms of technology deepening and “learning by doing,” growth in both sectors will be complementary and mutually reinforcing.

It is when one strategy is overemphasized at the expense of the other that the growth strategy becomes unstable. Clearly, the growth strategies of Korea, Philippines, and Thailand in the 1990s (before the Asian crisis) overemphasized expansionary tendencies in domestic private sector demand at the expense of net exports. This is reflected in the frequently discussed roots of the Asian crisis: currency overvaluation as well as overlending or overborrowing—spurred by inflows of short-term speculative capital—that

brought high growth to the domestic and nontradable sectors, and deterioration in the net export positions.

Conversely, the harsh adjustments undertaken by the three countries during and after the Asian crisis saw recessions and a collapse of gross investment as net export positions improved. There are prominent economists (e.g., Stiglitz 2002) who believe that the adjustments and policies imposed on the Asian countries hit by the crisis were overly harsh, especially on domestic demand, and contractionary. Whatever side one takes, it is clear that the sacrificed growth and resulting decline in the growth of productive capacity in the crisis-affected countries constitute a harmful consequence of the strategy that they followed (currency overvaluation, overlending, and overborrowing), which reversed the healthy balance and the desirable progression that both domestic demand (and the capital goods sector) and the tradable sectors achieved during the second half of the 1980s.

(vi) Countries with high trade deficits, mostly low-income countries, will benefit from a more open international trading system, and from promotion of their exports through price and non-price competitiveness.

Now, finally, is addressed the question posed by Palley (2002), Blecker (2002, 2003), and those who contend that not all developing countries can achieve successful export-led growth, inasmuch as positive net exports and trade surpluses correspond to trade deficits in other countries, and as the markets of the weaker countries (mostly in industrial countries) are gobbled up by the richer, high-performance countries.

It must be pointed out that Figure 1.25 shows that even if the LA countries had high negative net exports in 2003, this position had not, on average, deteriorated from that in 1993, despite the high export growth of countries such as the PRC, India, and other large countries that strengthened their export sectors in the 1990s. This is one encouraging sign, at least in the Asia-Pacific region. It must be added, however, that the net export position of many countries may not have deteriorated very much due to the very large and growing trade deficits of the US. Expected

adjustments, especially through the depreciating US dollar, may correct this situation in the medium term.

There are some other encouraging signs. The fast growth and expansion of the PRC has quickly opened up a potentially large export market for other developing economies. This will benefit many Asian economies, and has already benefited Korea; Malaysia; Taipei, China; and Thailand. The task now is to extend the benefits to the middle- and low-income countries in Asia-Pacific. India is another country that has been growing fast in the last decade. Its opening up to the world trade market has also opened a large export market.

The conclusion is that, for an export-led development strategy to cover as many countries as possible, a more balanced and equitable growth in exports and imports across the world is required.¹² This in turn requires the following two main “pushes”:

- all countries, including richer and trade-surplus nations, must open up their markets to poorer countries; and
- the poorer and latecomer countries need to make extra efforts both to promote their export sector via price and non-price competition, and to develop the necessary technological, physical, and human infrastructure to be competitive.

The first obviously requires the cooperation and participation of rich and trade-surplus countries so that developing countries can access the large world markets and reduce their trade deficits with the surplus countries. Trade liberalization of poor and trade-deficit countries alone (without the opening of the markets of the first group of countries) will obviously lead to perverse results. The second requires twin growth in the domestic demand and tradable sectors inasmuch as a high level of this infrastructure building will be part of domestic demand.

A more balanced and equitable international arrangement in world trade should therefore lead to smaller trade surpluses and smaller trade deficits across countries in the world, since more developing countries will be able to share in the benefits of international trade.

Endnotes

- ¹ See, for example, Patrick Smith. 2002. "From Exports to Domestic Demand-Led Growth: A New Model of Economic Growth?" *International Herald Tribune*. 8 November; and articles in *The Economist* (5–11 February 2005), "Heading back" (p. 9) and "Thaksin's way" (pp. 22–24).
- ² In fact, this is part of a very ambitious agenda (stimulus package) laid out by the prime minister, which includes lowering the cost of medical care; debt relief and microcredits for farmers; and the "local enterprise initiative" e.g., the encouragement of the production of wine out of exotic fruits.
- ³ What the literature discusses is the import-substitution strategy, often presented as the "opposite" of the export-led growth strategy (Felipe 2003).
- ⁴ The term "Washington consensus" was coined by Williamson (1990). In its original formulation, the idea encompassed fiscal discipline, reorientation of public expenditures, tax reform, interest rate liberalization, unified and competitive exchange rates, trade liberalization, openness to FDI, privatization, deregulation, and securing of property rights.
- ⁵ Palley certainly acknowledges that developing countries need to export. What he argues is that "the global trading system must be made the servant of domestic development, and domestic development must not be forgone for the sake of international competitive advantage" (Palley 2002, p. 4). For him, domestic demand growth rests on four pillars: improved income distribution, good governance, financial stability, and a fairly priced supply of development finance. The policies needed to put these pillars in place are labor and democratic rights; financial reform; and a combination of debt relief, increased foreign aid, and increased development assistance through the expansion of special drawing rights.
- ⁶ Another important point is that domestic demand is made up of consumption and investments. Growth dominated by consumption may have a very different impact and implications from growth led by investments. This topic is not tackled in this discussion.
- ⁷ Actually, the PRC's net exports turned positive in 1990. The negative net exports position in 1993 was an aberration, since it was the only year in the 1990s when the country registered a trade deficit.
- ⁸ In fact, Thailand's net exports improved in the second half of the 1980s, as will be shown in the next section, but deteriorated again in the 1990s.
- ⁹ It must be added that high GDCF growth also provides a strong force in expanding aggregate demand in the PRC, despite a nonexpansionary private sector stance.
- ¹⁰ Available: <http://www.worldbank.org/data/countrydata/countrydata.html>.
- ¹¹ The four UA economies are Hong Kong, China; Korea; Malaysia; and Taipei, China (Singapore was not included since it did not have separate data for exports and imports in the national income accounts). MA countries comprise People's Republic of China, Fiji Islands, Kazakhstan, Philippines, Sri Lanka, Thailand, and Vanuatu (Maldives was not included because it was such an outlier in some of the indicators that it distorted the averages). LA countries are Azerbaijan, Bangladesh, Bhutan, Cambodia, India, Indonesia, Kyrgyz Republic, Lao People's Democratic Republic (Lao PDR), Mongolia, Nepal, Pakistan, Papua New Guinea, Tajikistan, and Viet Nam. The World Bank categorizes the countries according to 2002 gross national income (GNI) per capita using the *World Bank Atlas* method. LA countries have GNI per capita of \$735 or less; MA countries have GNI per capita of \$736–2,935; and UA economies have more than \$2,935 GNI per capita. All the selected European countries fall into the World Bank's category of high-income countries, with \$9,076 GNI per capita or more. For the following countries, 2002 data were used due to lack of 2003 data: Bhutan, Fiji Islands, India, Lao PDR, Papua New Guinea, Tajikistan, and Vanuatu. Sources of data were ADB *Key Indicators*, IMF *International Financial Statistics*, United Nations Statistics Division, and World Bank country profiles.
- ¹² The breakdown of trade talks in Cancun, Mexico at the end of 2003 also points to the strong need to push for trade reforms in industrial countries to allow more agriculture, industry, and services sector imports from the developing world.

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