ADO 2011—Highlights

Developing Asia, having shown resilience throughout the global recession, is now consolidating its recovery. The region is forecast to grow by 7.8% in 2011 and 7.7% in 2012.

It faces two critical challenges to maintain inclusive growth in the years ahead. The most immediate is responding to swelling inflation pressures, which can be complicated by subsequent capital inflows. Policy makers will need to maintain a coherent policy mix to ensure success here.

Further ahead, the region must explore and then foster new sources of growth. The strengthening of ties with developing countries, both in the region and beyond, has much potential, but so far these links have been mainly used for final goods exports to major industrial countries.

To fully tap the potential of these developing-country markets as new sources of growth, policy makers must remove barriers to “South–South” trade and investment, which are still higher than those with the industrial world.

Key messages

- Developing Asia's recovery is firming. Its high growth is expected to continue despite the modest recovery in the major industrial economies. The region is forecast to grow by 7.8% in 2011 and 7.7% in 2012. In order to maintain sustainable and inclusive growth, however, Asia must confront two important challenges.

- First, on the immediate horizon, is coping with rising inflation pressures. Developing Asia's swift turnaround from the crisis provided the impetus for rising consumer prices. Tensions in the Middle East and the nuclear anxieties in Japan have further lifted market expectations of higher oil prices. Consumer price inflation in the region is forecast to rise to 5.3% in 2011, and some economies are showing signs of potential overheating.

- Although inflation is generally still low, regional policy makers need to make preemptive management of inflation a top priority. Developing Asia is home to two-thirds of the world's poor, and it is they who are the most vulnerable to its effects. Maintaining a coherent policy mix is key to success since monetary tightening to curb inflation pressures is likely to invite an increase in foreign capital inflows, which would compound the problems of managing inflation.

- More flexible exchange rates may be a better policy for countries with persistent current account imbalances and misalignment between their exchange rate and fundamentals. For countries without such symptoms, relying more on temporary policies, such as capital controls, may be an option if they are carried out in an internationally coordinated manner.

- The second challenge is to find and contribute to new sources of sustainable global growth. Industrial countries are unlikely to drive global growth any time soon and the economies of the South—developing Asia, Africa, Latin America, and the Middle East—should take up the slack.

- It is encouraging that South–South economic links are strengthening and contributing to the recovery of the world's economy. South–South trade has expanded fast in the past two decades, from about 7% of nonfuel world merchandise trade in 1990 to 17% in 2009. Foreign direct investment (FDI) links have also increased hugely as high-saving Southern economies have become new sources of outward FDI.

- This strengthening does not, however, guarantee sustainable growth for Asia. Much of it was the result of the rise of "factory Asia," where developing Asia sourced intermediate goods and parts from within Asia to assemble them into final goods to be exported to affluent markets in the North. Hence growing South–South links do not necessarily translate into greater economic independence from the North.

- Strengthening South–South links through recycling savings to finance investment (rather than holding them in safe assets) could enhance the growth potential of the South and contribute to the stability of the global economy by promoting global rebalancing. To do that, the South has to work hard to reduce internal trade and investment barriers—still higher than those with the North—and continue to promote global and regional integration.

Muted Industrial-country Upswing

- **Recovery is progressing modestly in the major industrial economies.** In 2010, the gross domestic product (GDP) of the United States, eurozone, and Japan together expanded by a respectable 2.6% (partly due to the effect of the lower base from the downturn). Yet it is still unclear whether private demand can sustain growth once authorities start to normalize fiscal and monetary policies. Consequently, their GDP is forecast to expand at a somewhat slower pace than the initial rebound: 2.1% in both 2011 and 2012. Despite rising global commodity prices and accommodative monetary policy, industrial-country inflation remains low due to their slower growth prospects.

- **Global uncertainties pose risks to maintaining their growth momentum, however.**

  - The recent surge in oil prices could undermine the global recovery, and geopolitical and other factors have heightened uncertainty about future prices. Political instability in the Middle East raises questions about oil supplies, while Japan's nuclear energy woes have heightened concerns about this alternative energy source. Food prices hit records in February 2011. While core inflation remains low in industrial countries, oil and food price pressures can fuel inflation in developing countries where recovery is well under way.
  - Despite the mild recovery that is forecast (2.8% in 2011 and 2.6% in 2012), the United States economy is beset by stubbornly high unemployment and weak housing markets. These undermine the strength of the economy, and thus the global outlook.
  - Sovereign debt problems in the eurozone periphery still await a fundamental resolution, which could jeopardize the 1.6% growth forecast for both 2011 and 2012. Further problems may precipitate financial instability within the eurozone—which could even spread globally. Inflation and global geopolitical uncertainty can increase borrowing costs, further aggravating the fiscal problems in the single-currency bloc.
  - Japan's economy is slowing after its rebound from the recession, and it must now face the challenges arising from one of the most destructive natural disasters in its history. The short-run economic impacts from the supply disruptions and power shortages could be substantial, but the long-run prognosis is less dire. Through reconstruction efforts and the return of productive activity, the economy is forecast to grow by 1.5% in 2011 and 1.8% in 2012.

Developing Asia's Outlook

- **Developing Asia's recovery is firming.** The region is projected to grow by 7.8% in 2011 and 7.7% in 2012. The moderation from 9.0% in 2010 stems from slower growth of the major industrial economies and world trade as well as normalization of fiscal and monetary policy. The exceptional performance of 2010 was partly due to the base effect, as the region bounced back from the impact of the global downturn. The moderation marks a welcome return to growth rates that can be sustained without stoking inflation.

- **Developing Asia's robust growth provided timely support during the crisis and recovery.** The region's resilience has contributed to the recovery of both industrial economies and non-Asian developing countries, primarily via the trade channel. Even as global trade collapsed, developing Asia's imports continued to grow. Rapid growth in the region's two giants—the People's Republic of China (PRC) and India—will continue to lift regional and global growth. The medium-term outlook for both is good, although finance sector risks in the PRC and the fiscal consolidation in India need to be addressed.

- **The current account surplus is falling and projected to decline further.** Rising commodity prices, especially for oil, and the region's strong GDP growth are raising its imports. The current account surplus fell from 4.7% of GDP in 2009 to 4.1% in 2010. Under the forecasts for even higher oil prices with continued strong growth, the region's current account balance is forecast to fall further to 3.3% of GDP in 2011 and 3.0% in 2012. Yet this should not be interpreted as an unwinding of the structural global imbalances.

- **Inflation pressures are building, and preemptive measures may well be needed to avoid overheating.** Inflation has risen more sharply in the region than in the major industrial countries. Consumer prices rose by 4.4% in 2010, accelerating from 1.2% in 2009, on a combination of external factors (global oil and food price shocks) and the robust domestic recovery. Although many central banks have already taken action, inflation is expected to accelerate further to 5.3% in 2011 before tapering off to 4.6% in 2012.

- **Rising oil and food prices could shake developing Asia's macroeconomic stability.** Model simulations show that a 30% increase in both oil and food prices over their 2010 levels could shave 0.7 percentage points from the region's forecast growth and add 1.7 percentage points to its inflation rate. An oil price shock has the bigger impact on macroeconomic stability, but rising food prices disproportionately affect the poor.

- **The need to take preemptive action on inflation is building in developing Asia.**

  » Demand pressure in some Asian economies is more intense than in the advanced countries. Growing demand pressures can put strains on the labor market, potentially inducing a wage–inflation spiral.

  » Inflation undermines the promotion of inclusive growth through its effects on poverty and inequality. Its impact, particularly if driven by food prices, increases the number of poor since the region's consumption baskets tend to have larger shares of food than those in the advanced economies. This widens income inequality and could potentially lead to social tensions.

  » Authorities have started responding to inflation, but some may be behind the curve. So far, Asian economies have either allowed their currencies to appreciate or have imposed tariff-relief measures to curb imported inflation (with varying results). They have also tightened monetary policy to manage the growing demand pressures, but some countries are still showing signs of overheating.

- **Managing inflation pressure is not easy.** The policy mix needs to be coherent.

  » Increasing benchmark policy rates would prompt wider interest differentials, and so attract more volatile capital inflows.

  » Letting currencies appreciate more flexibly is one option, but may not be appealing for those who favor maintaining international competitiveness. Intervening in the foreign exchange markets is not an alternative, however. The intervention may not be globally acceptable and could be self-defeating as it potentially worsens domestic inflation pressures.

  » Imposing selective and carefully designed temporary capital control measures on inflows might be another option. To be effective, however, such measures require high degrees of administrative capacity to implement and should only be exercised temporarily.

- **Appropriate policies to deal with inflation and capital inflows depend on the specific problem.** More flexible exchange rates may be a better policy for countries with persistent current account imbalances and misalignment between the exchange rate and fundamentals. For countries without such symptoms, relying more on temporary policies, such as capital controls, can be an option if executed in an internationally coordinated manner. G20's recent efforts to establish practical indicative guidelines for assessing countries' current account imbalances and principles for capital controls could provide useful tools.

Outlook by Subregion

- **East Asia will grow most rapidly in developing Asia.** Led by the PRC, aggregate subregional GDP growth will moderate somewhat from its 9.6% recovery pace in 2010 to 8.4% in 2011 and 8.1% in 2012. Slower investment (from the winding down of policy stimulus) and less-heated export growth will temper GDP expansion in the PRC—from the 10.3% recovery to 9.6% in 2011 and 9.2% in 2012. Hong Kong, China; the Republic of Korea; and Taipei,China will settle back to more sustainable growth of around 5% after their sharp 2010 rebound. Most East Asian economies are moving toward a tighter monetary stance as their production levels reach their potential and rising commodity prices add pressure. Inflation in the subregion is forecast to pick up in 2011 to 4.3% (from 3.1% in 2010) before easing back to 3.9% in 2012.

- **Southeast Asia's expansion will moderate after its exceptionally strong recovery.** Growth is expected to step down in light of the higher 2010 base (from 7.8% growth that year), a slowing in export growth, and policy tightening by governments. GDP will expand by 5.5% in 2011 and 5.7% in 2012. This moderation is most notable in Malaysia, the Philippines, Singapore, and Thailand, which grew rapidly during the recovery. The region is also playing its part in rebalancing growth toward private domestic demand, as seen in the increased investment rate in Indonesia. Inflation in Southeast Asia is accelerating from its moderate rate of 4.0% in 2010 to 5.1% in 2011. Inflation pressures have been more tenacious in some countries—Viet Nam, for example, is expected to hit double digits. With appropriate policy responses, Southeast Asia's average inflation is expected to come down to 4.2% in 2012.

- **South Asia's GDP is expanding steadily.** After growing by 7.9% in 2010 in line with the global recovery, growth will continue steadily, at 7.5% in 2011 and 8.1% in 2012. Leading the subregion, India's 2010 expansion was robust and broad-based (8.6%)—even in the face of fiscal consolidation and substantial monetary tightening—and is set to remain strong at 8.2% in 2011 and 8.8% in 2012. Pakistan's floods weighed on its growth in 2011, but Sri Lanka's peace dividend continues to support its expansion. Food price pressures in India pushed inflation in South Asia to 9.3% in 2010, although that country's sharp monetary tightening should help bring the subregional average inflation rate down to 8.7% in 2011 and 7.3% in 2012.

- **Central Asia is benefiting from higher international commodity prices.** Much higher prices for the region's key exports (oil and gas, metals, cotton, and gold) supported the recovery (6.6% in 2010) and will stay important drivers. Growth is set to rise slightly to 6.7% in 2011 and 6.9% in 2012. Following its V-shaped recovery, Kazakhstan will slow somewhat from the higher base as it winds down its anticrisis measures. The non-oil economies strengthened with the economic revival in the Russian Federation (their main source of remittances, trade, and finance). Inflation across the subregion is expected to average 8.2% in 2011, up from 7.1% in 2010, driven by higher food prices in all countries and higher energy prices in the oil importers. Moderation in food prices in 2012 will provide some relief, and inflation should ease to 6.6%.

- **Resource-rich economies will drive growth in the Pacific.** Most of the 6.3% growth forecast in 2011 is attributable to the resource-rich economies of Papua New Guinea, Timor-Leste, and Solomon Islands, which are benefiting from higher global commodity prices, new investment, and higher government revenue from resources. While income from tourism and remittances generally picked up in step with the global recovery, most small Pacific economies are projected to grow only slowly (2% or less). Growth for the subregion should settle back to 5.4% in 2012. Inflation is also picking up alongside global commodity prices as these import-dependent countries cope with rising world food and oil prices. Inflation is forecast to rise from its 2010 rate of 5.9% to hit 6.5% in 2011, before falling to 5.6% in 2012.

Special Theme: South–South Economic Links

Growing importance of South–South links

- **The share of the South in world GDP rose from about 25% in 1980 to 45% in 2010, of which developing Asia alone contributed two-thirds.** The South has burnished its economic credentials on the world stage by leading the way out of the global economic crisis, developing Asia in front. Concomitantly, it has raised its profile in international governance. The emergence of the G20 summit reflects a belated response to this reality.

- **Concurrent with high growth, South–South links have proliferated.** Trade and financial integration in the South have intensified in tandem with its rising global economic role. Greater integration allows the economies of the South to share experiences and to learn from each other. As there is no single model for development, it is imperative for countries to diversify sources of knowledge and share development experiences. As well as North–South knowledge exchanges, South–South knowledge sharing is becoming a reality.

- **South–South links are creating new potential drivers of aggregate demand.** Given their reversals in the recent crisis, industrial economies are unlikely to drive demand in the world economy any time soon. With their strong prospects for growth, the economies of the South should take up the slack. Potentially, the rising consumption of emerging economies and the new investment flows within the South can be new sources of growth for the world economy—but only if the economies of the South become more open to trade and capital flows.

Expanding South–South economic links through trade

- **South–South trade has shot up in the past two decades.** Trade among Southern countries rose from about 7% of world nonfuel merchandise trade in 1990 to 17% in 2009. Developing Asia now accounts for about three-quarters of South–South trade, and the PRC alone for roughly 40%.

- **The rise of factory Asia explains most of the rise of South–South trade.** Intermediate goods are sourced mainly within the region, including Japan, for assembly in the PRC, the regional hub. Final goods are then exported, predominantly to affluent markets in the North.

- **South–South trade has grown rapidly for Latin America, Africa, and the Middle East.** Although these regions' trade with the South is relatively small, at roughly one-quarter of South–South trade, it has been quickly expanding, particularly with Asia.

- **Tariff levels and other barriers to trade in the South have tumbled in the past two decades, but are still higher than with the North.** As a 2005–2008 average, applied tariffs in the South were 9.3%, compared with 3.2% in the North. Trade-related infrastructure and logistics performance, as measured by World Bank surveys, shows that the South lags far behind the North, although it has been closing the gap.

- **A gradual removal of these remaining bottlenecks would especially spur South–South trade, where they tend to hold back trade on both sides.** Simulation analysis suggests that lowering tariff barriers to South–South trade even to the levels prevailing in South–North trade could bring three-quarters of the gains to Southern countries of freeing all countries' goods trade. South–South trade would expand by 6 percentage points as a result. However, trade reforms supporting South–South trade must not undermine continuing global integration. In view of the proliferation of regional trade agreements in Asia and elsewhere, it is increasingly important that future agreements be made as inclusive as possible and ensure compatibility with provisions of the World Trade Organization.

Expanding South–South economic links through investment

- **In developing Asia, FDI is by far the most important source of capital from abroad.** Developing Asia received an average of $187 billion in FDI each year during the last two decades, which far exceeded the average annual combined flows of $126 billion in portfolio and bank investments. The importance of FDI is even clearer given its resilience to external shocks, hence serving as a stable source of financial resources to Southern economies.

- **Southern countries became sources of outward FDI in the 2000s.** Most FDI is among Northern countries, but the share of the South has grown fast. By 2009, about a quarter of global inward FDI stocks and about 13% for outward FDI stocks were in the South. Developing Asia accounts for more than 70% of developing countries' outward FDI stocks.

- **As part of the deepening of factory Asia production networks, Asian FDI has become more intraregional.** Over half the inflows to developing Asia are estimated to be regional. The concentration is especially high in East Asia and Southeast Asia, stimulated by regional integration efforts, expansion of production networks, and relocation of production to lower-cost areas within the region.

Upgrading South–South links is key to Asian and global growth

- **South–South links can be a new source of global growth, but to maximize potential, structural weaknesses must be overcome.** Growing South–South relations at a time of modest growth in industrial economies could be a potential new driver of global growth. However, this trend does not guarantee sustainable growth for Asia and the global economy, since it stems from the rise of factory Asia. Growing South–South links do not therefore necessarily mean greater economic independence from the North.

- **The potential for tighter South–South integration is strong.** The industrial migration associated with South–South FDI helps to enhance the growth potential and productive capacity of host Southern economies by filling investment gaps. Developing Asia could contribute to this if it were to recycle its saving to finance investment in the South (rather than hold it in safe assets). Such a move could contribute to the stability of the global economy by promoting rebalancing. It would also encourage regional financial-market deepening. But the South has to reduce its trade and investment barriers, which are still high relative to those with the North, to promote global and regional integration.

- **Signs of progress are positive in international cooperation for South–South links.** Cooperation at the bilateral, regional, and multilateral levels is broadening. It includes sharing knowledge on development experiences, labor migration, and macroeconomic policy coordination. Here, the role of multilateral development banks is crucial as a source of technical and financial assistance.

Table 1 Growth rate of GDP (% per year)

Subregion/Economy	2008	2009	2010	2011	2012
Central Asia	**6.1**	**3.2**	**6.6**	**6.7**	**6.9**
Azerbaijan	10.8	9.3	5.0	5.8	5.8
Kazakhstan	3.3	1.2	7.0	6.5	6.8
East Asia	**7.3**	**6.8**	**9.6**	**8.4**	**8.1**
China, People's Rep. of	9.6	9.2	10.3	9.6	9.2
Hong Kong, China	2.3	-2.7	6.8	5.0	4.7
Korea, Rep. of	2.3	0.2	6.1	4.6	4.6
Taipei,China	0.7	-1.9	10.8	4.8	5.0
South Asia	**6.3**	**7.1**	**7.9**	**7.5**	**8.1**
Bangladesh	6.2	5.7	5.8	6.3	6.7
India	6.7	8.0	8.6	8.2	8.8
Pakistan	3.7	1.2	4.1	2.5	3.7
Sri Lanka	6.0	3.5	7.6	8.0	8.0
Southeast Asia	**4.2**	**1.2**	**7.8**	**5.5**	**5.7**
Indonesia	6.0	4.6	6.1	6.4	6.7
Malaysia	4.7	-1.7	7.2	5.3	5.3
Philippines	3.7	1.1	7.3	5.0	5.3
Singapore	1.5	-0.8	14.5	5.5	4.8
Thailand	2.5	-2.3	7.8	4.5	4.8
Viet Nam	6.3	5.3	6.8	6.1	6.7
The Pacific	**5.3**	**4.2**	**5.2**	**6.3**	**5.4**
Fiji	0.2	-3.0	0.1	0.5	0.8
Papua New Guinea	6.6	5.5	7.1	8.5	6.5
Developing Asia	**6.7**	**5.9**	**9.0**	**7.8**	**7.7**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

Table 2 Inflation (% per year)

Subregion/Economy	2008	2009	2010	2011	2012
Central Asia	**16.5**	**5.9**	**7.1**	**8.2**	**6.6**
Azerbaijan	20.8	1.5	5.7	7.5	7.0
Kazakhstan	17.3	7.3	7.1	8.5	6.0
East Asia	**5.5**	**-0.1**	**3.1**	**4.3**	**3.9**
China, People's Rep. of	5.9	-0.7	3.3	4.6	4.2
Hong Kong, China	4.3	0.5	2.4	4.5	3.3
Korea, Rep. of	4.7	2.8	2.9	3.5	3.0
Taipei,China	3.5	-0.9	1.0	2.8	2.9
South Asia	**9.5**	**4.3**	**9.3**	**8.7**	**7.3**
Bangladesh	9.9	6.7	7.3	8.0	8.5
India	8.7	2.1	9.2	7.8	6.5
Pakistan	12.0	20.8	11.7	16.0	13.0
Sri Lanka	22.6	3.4	5.9	8.0	7.5
Southeast Asia	**8.6**	**2.5**	**4.0**	**5.1**	**4.2**
Indonesia	9.8	4.8	5.1	6.3	5.8
Malaysia	5.4	0.6	1.7	3.0	3.0
Philippines	9.3	3.2	3.8	4.9	4.3
Singapore	6.6	0.6	2.8	3.2	2.0
Thailand	5.4	-0.9	3.2	3.5	3.0
Viet Nam	23.0	6.9	9.2	13.3	6.8
The Pacific	**9.8**	**5.0**	**5.9**	**6.5**	**5.6**
Fiji	7.8	3.7	7.8	4.0	3.0
Papua New Guinea	10.8	6.9	6.0	8.0	7.5
Developing Asia	**6.9**	**1.2**	**4.4**	**5.3**	**4.6**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.