ASIA IN THE UNEVEN GLOBAL RECOVERY

1

Asia in the uneven global recovery

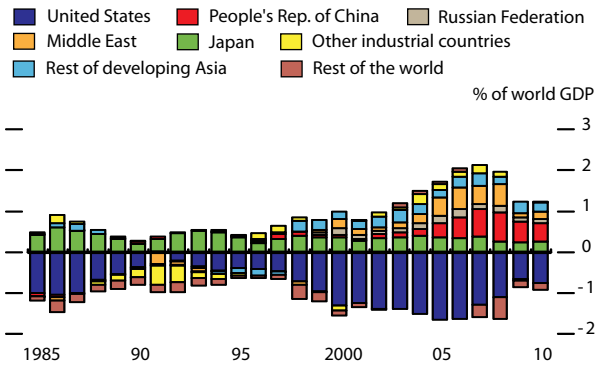
The world has come out of its deepest downturn since the Great Depression, in a recovery marked by an interesting bifurcation: the developing world has made a rapid return to its precrisis growth path while major industrial countries continue to struggle. The asymmetric nature of the crisis—a financial crisis in the United States (US) and Europe and a trade shock elsewhere—helps to explain this dual outcome, as the output effects of a financial crisis tend to persist.

Developing Asia will continue to spearhead the global recovery. Private demand is sustaining growth even as monetary and fiscal policies are normalized. The region's growth in 2011 will remain vigorous, albeit somewhat slower than in 2010. Inflation pressures are building, however, and overheating is an emerging threat in some economies. The resurgence in global oil and food prices complicates the challenge of managing inflation.

In the medium term, sustaining growth requires the global imbalances that built before the crisis to be unwound. These imbalances narrowed significantly during the crisis and remain well below their peaks (Figure 1.1.1). This positive trend will be temporary, though, unless surplus and deficit countries make the necessary structural adjustments to ensure more balanced growth.

For developing Asia, that means exploring and fostering new sources of growth. Intensifying efforts toward greater regional integration will be an important part of that story. Yet there is huge potential beyond the region's boundaries. Developing countries in Africa, Latin America, and the Middle East—together with developing Asia, the so-called South—also rebounded rapidly from the worst effects of the global slump. At a time of modest growth in industrial countries, improved South–South relations may well become an important new driver for global growth.

1.1.1 World current account balance



Note: 2010 data are estimates.

Source: International Monetary Fund. 2010. World Economic Outlook database. October. http://www.imf.org (accessed 1 March 2011).

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This chapter was written by Donghyun Park, Arief Ramayandi, Cindy Castillejos-Petalcorin, Gemma Estrada, Benno Ferrarini, Nedelyn Magtibay-Ramos, Aleli Rosario, and Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila. Background materials from Jeff Brown, Arpitha Bykere, Peter Morgan, Elisa Parisi-Capone, and Paul Vandenberg are gratefully acknowledged.

Twin-track global growth

The major industrial countries have stepped back from the brink of further global turmoil. Gross domestic product (GDP) in the US, eurozone, and Japan together grew by a respectable 2.6% in 2010. While the risk of another recession is receding, it is unclear whether private demand can sustain itself without continued policy stimulus. As a result, the combined GDP in 2011–2012 will expand at a somewhat slower pace than it did during the initial rebound (Table 1.1.1). Global trade will continue to expand at a healthy pace during this period, although somewhat less strongly than in the postcrisis rebound of 2010.

While forecasts indicate that the major industrial economies will continue to recover from the recent downturn, authorities must carefully maneuver around their own particular obstacles: soft labor and housing markets in the US, vulnerable sovereign debt positions in the eurozone, and the aftermath of natural disaster in Japan pose critical risks to growth. Upward-trending commodity prices add to the uncertainty.

Developing Asia's robust growth has provided the major industrial economies—and developing economies outside Asia—some much-needed support during the downturn and recovery. But it is unclear how far the region can extend this role without a firmer industrial-country recovery.

1.1.1 Baseline assumptions for external conditions

	2009 Actual	2010 Actual	2011 *ADO 2011* projection	2012 *ADO 2011* projection
GDP growth (%)				
Major industrial economies[a]	-3.8	2.6	2.1	2.1
United States	-2.6	2.9	2.8	2.6
Eurozone	-4.1	1.7	1.6	1.6
Japan	-6.3	3.9	1.5	1.8
World trade (% change)				
Merchandise exports	-12.2	13.5	7.5	8.5
Prices and inflation				
Brent crude spot prices (average, US$ per barrel)	61.7	79.6	104.0	112.0
Energy price index (% change)	-36.8	25.9	17.8	5.2
Food and beverage price index (% change)	-13.1	11.8	15.0	1.0
Inflation (major industrial-economy average, %)	-0.2	1.2	1.3	1.8
Interest rates				
United States Federal funds rate (average, %)	0.2	0.2	0.3	0.6
European Union refinancing rate (average, %)	1.3	1.0	1.0	1.0
Japan interest rate (average, %)	0.1	0.1	0.2	0.4
US$ Libor[b] (%)	0.3	0.3	0.5	1.0

[a] Average growth rates are weighted by gross national income, Atlas method (current US dollars).
[b] Average interbank quotations on 1-month loans.

Sources: US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp; World Trade Organization, http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary Fund, Primary Commodity Prices, http://www.imf.org; World Bank, Global Commodity Markets, http://www.worldbank.org; ADB estimates.

Even with welcome signs of strength in the global environment, several risks underline the need for the region's policy makers to stay vigilant.

One major global development has been a surge of commodity prices. High and volatile oil and food prices will in particular reverberate through the world economy, and they are likely to stay that way in 2011–2012. They will thus be a significant source of global inflation, especially in developing countries where recovery is firmly under way.

Outlook for industrial countries

United States: Soft labor and housing markets

The rise in economic activity continued apace in the US. Industrial production has picked up gradually (Figure 1.1.2) from the trough in early 2009, but remains below its precrisis level. Consumer confidence and retail sales have been on the rise, although the occasional wobble reflects household uncertainty in the strength of the recovery.

Reflecting this increased activity, US GDP expanded in all 4 quarters of 2010, the bulk of this coming from a recovery of private consumption and investment (including changes in inventories) (Figure 1.1.3). The revival of private demand is promising, but it is unclear that private demand can sustain itself beyond the recently extended fiscal and monetary expansion.

Private consumption in particular will stay weighed down by the sluggish housing market and persistently high unemployment rate. Households increasing their saving to bolster their net worth (which was hammered by the crisis) will damp consumption in the medium term. Self-sustaining growth based on robust private consumption will require concrete progress in both labor and housing markets, and a rebound in households' net worth.

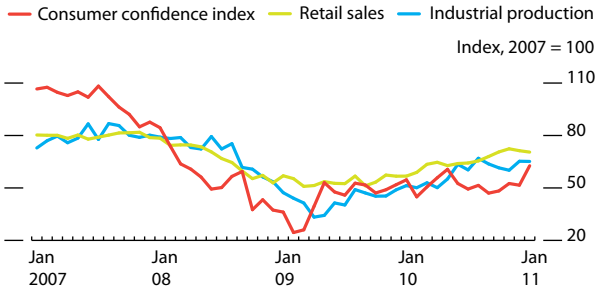
The recent outcomes for private investment suggest that business owners are still tentative about the future. Inventory restocking (to replenish recession-depleted stocks) made up a large part of investment growth, rather than increased corporate spending on new plant and equipment. But even here, a rundown in inventories in the fourth quarter became a drag on growth.

External demand for US goods picked up in 2010. Exports grew by 11.7%, after declining by 9.5% in 2009. But the export rise was more than offset by imports, which grew by 12.6% after declining the previous 2 years.

Growth moderated from a high of 5.0% (quarter on quarter) in the fourth quarter of 2009 to 3.1% in the same quarter of 2010. This was natural since growth in the fourth quarter of 2009 stemmed from the very low base around the trough of the recession. Growth for all 2010 reached 2.9%, recovering much of the ground lost in 2009 when GDP contracted by 2.6%.

Overall consumer price inflation remains low, even with the energy price spike in 2010. Increases in international commodity prices

1.1.2 Business activities and consumer confidence indicators, United States



Source: CEIC Data Company (accessed 11 March 2011).

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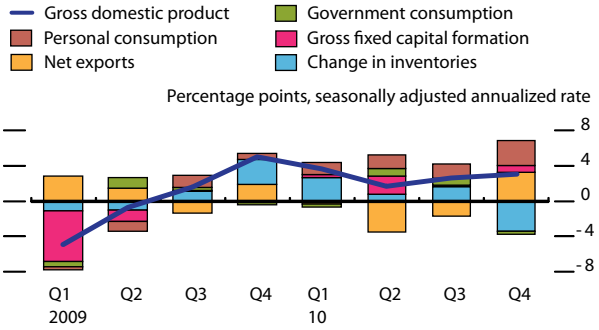
1.1.3 Contributions to GDP growth, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 11 March 2011).

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accounted for most of 2010's rise in inflation, with core inflation staying below 1% (Figure 1.1.4) and supporting the Federal Reserve's decision to maintain its expansionary monetary policy.

Despite the recovery in GDP, two important segments of the economy are still weak—labor and housing. Although the pickup in business activity supported some job creation, the labor market remains soft. Unemployment has only crept down from its peak of 9.8% in April 2010 to 8.9% in February 2011 (Figure 1.1.5), and long-term unemployment remains high.

In the 5 years before the crisis (2003–2007), the long-term unemployed made up about 20% of the total and the median duration of unemployment was less than 10 weeks. As of February 2011, the share of the long-term unemployed was 44% while the median duration was just under 21 weeks. The economy needs to grow much faster to bring these indicators back to their precrisis levels.

So, too, with housing. Prices have continued to slip, and residential construction has followed suit (Figure 1.1.6). This weakness persists, even with low mortgage rates. The low and still falling median price for housing is heavily affected by the overhang of vacant and foreclosed properties. Concerns over possible further declines in home values may have kept potential homebuyers from looking for mortgages, despite the recent low borrowing rates.

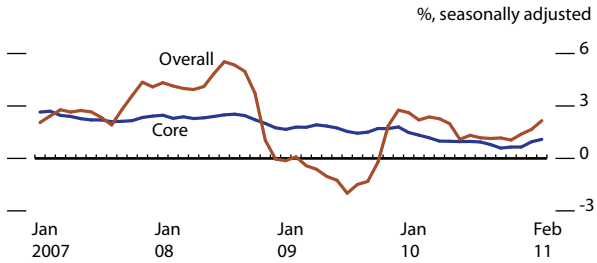
With continued low inflation and lingering high unemployment, monetary policy is expected to remain expansionary in 2011. The Federal Reserve will likely maintain the policy interest rate—the Federal funds rate—at near-zero levels to midyear as it completes its second round of purchases of longer-term Treasury securities (so-called quantitative easing). Some move toward less expansionary monetary policy may begin toward the end of the year, depending on the strength of the recovery and consumer price movements.

Fiscal policy will also remain expansionary in 2011. The temporary tax cuts enacted in 2001 have been extended through 2012, and the extended period of eligibility for unemployment benefits will continue through end-2011, which should help to support demand. Some tightening of other expenditure, though, is expected. As incomes recover and the labor market improves, revenue will increase and unemployment spending will decline. The fiscal position is expected to become less expansionary in 2012.

Growth in 2011 will be close to its 2010 level, and may well offer a positive surprise. If the policy stimulus contributes to faster than expected recovery of the labor and housing markets, improved business and consumer confidence may lift 2011's growth above the current projection of 2.8%. On the downside, households rebuilding their balance sheets will continue to handicap consumption, particularly if housing and labor markets stay soft.

While the fiscal stimulus is a recovery driver, the lack of a credible medium-term plan to bring the fast-rising public debt is a growing risk.

1.1.4 Inflation, United States



Source: CEIC Data Company (accessed 17 March 2011).
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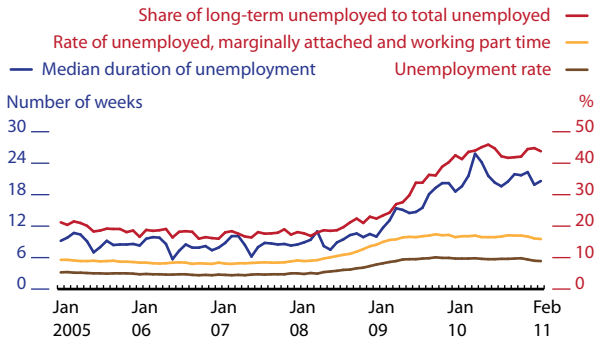
1.1.5 Unemployment, United States



Source: CEIC Data Company (accessed 22 March 2011).
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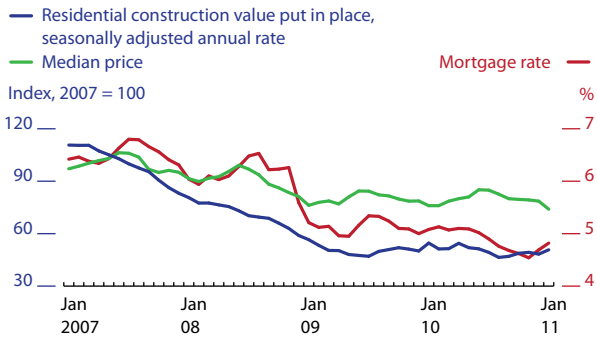
1.1.6 Housing indicators, United States



Source: CEIC Data Company (accessed 11 March 2011).
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As the effects of the stimulus fade and concerns over fiscal sustainability mount, the outlook for 2012 becomes more uncertain. Growth is forecast to slow somewhat to 2.6%.

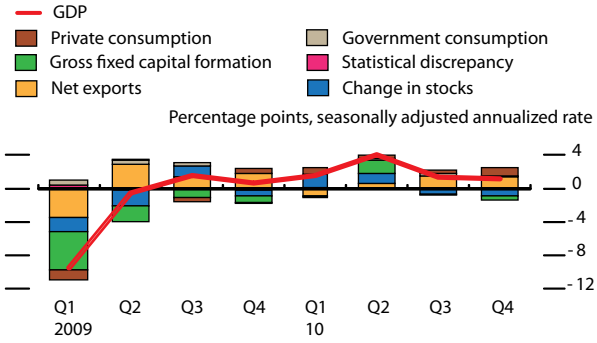
Eurozone: Sovereign debt vulnerabilities

The eurozone economy picked up from the third quarter of 2009, but after a strong performance in the first half of 2010 it slowed to 0.3% quarter on quarter in both the third and fourth quarters. For the whole of 2010, growth came in at 1.7%.

Uncertainty remains high, however, with many downside risks clouding the outlook. Externally they relate to shocks that could dent the current global recovery, while internally most are associated with a possible disruption from disorderly debt workouts in one or more of the eurozone's peripheral economies. Some internal risks reflect the damping effect on growth of fiscal austerity packages (and restrictive monetary policies to stem inflation).

Net exports and, to a lesser extent, private consumption were the main contributors to eurozone growth in the third and fourth quarters of 2010 (Figure 1.1.7). They had this role against the backdrop of dwindling government spending (as postcrisis support measures petered out), a drag on GDP from fixed capital investment and inventories, and an exceptionally harsh winter. Pulled by the global recovery and by growing external demand from, especially, the US, the People's Republic of China (PRC), and Brazil, eurozone exports to the rest of the world rose by 2.2% in the third quarter and by 1.8% in the fourth (quarter on quarter). In terms of net exports, the trade surplus rose, primarily with the US, benefiting from the recovery there.

1.1.7 Contributions to GDP growth, eurozone



Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 4 March 2011).

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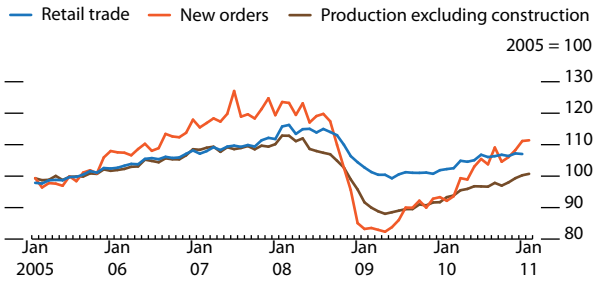
Germany continued to drive export performance—and overall eurozone economic expansion. The country further consolidated its trade surplus and powered ahead with 4.0% growth (year on year) in the last quarter of 2010. Far less impressive fourth-quarter growth rates were recorded by France (1.5%) and Italy (1.3%), and particularly the troubled peripheral states, where Spain did best with 0.6% growth, against Greece's huge 6.6% contraction.

Private consumption remained subdued during the whole of 2010, although edging up somewhat in the last quarter, spurred by the holiday season and firming consumer confidence. Retail trade trended upward by 5% (year on year) on average in the 6 months from July 2010. Consumer confidence was supported by a slight improvement in unemployment, which in January 2011 fell back to 9.9%, after hovering around 10% throughout 2010. As with growth, eurozone data mask considerable disparity among its members: Spain's unemployment is above 20%, almost five times that in the Netherlands or Austria, and more than three times Germany's.

1.1.8 Industry and services indicators, eurozone



Note: Since May 2010 data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev2) causing a potential break in series at this date.

Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 23 March 2011).

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Industrial output (except construction) continued its slow, upward postcrisis crawl. It was pulled up by accelerating new industrial orders in the fourth quarter of 2010, largely reflecting external export demand for capital goods (Figure 1.1.8). Continuing impetus from strong industrial new orders, reflected also in the upward-trending

industrial confidence indicator (Figure 1.1.9), is expected to drive up gross fixed capital investment and domestic demand in the first half of 2011, from their subdued levels in the fourth quarter of 2010.

Consumer price inflation is on the rise. It reached 2.4% in February 2011 (Figure 1.1.10), up from 2.3% a month earlier and from an average of 1.6% in 2010. The most recent upward pressures reflect the global rise in energy and commodity prices, which some parts of the eurozone saw reinforced by their higher exposure to the fallout from the unrest in North Africa and the Middle East. Pushed by external factors, inflation is projected at 2.3% in 2011, but is expected to fall back to 1.9% in 2012. This deceleration assumes the return of a more favorable external environment, and reflects still moderate upward pressures on wages, as the output gap narrows and a more restrictive monetary policy takes effect.

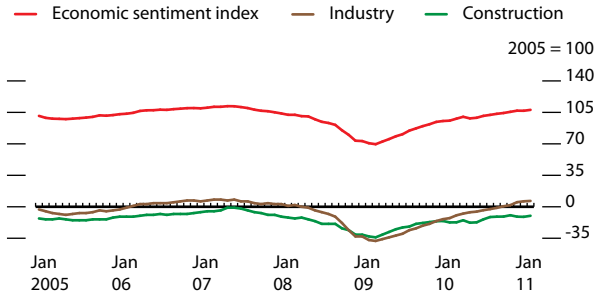
Policy interest rates are poised to rise. In early March, the European Central Bank hinted for the first time at an imminent increase in its reference rates, up from the 1% mark it has maintained during the entire postcrisis recovery. Worries remain that rate hikes in the months ahead could add to the difficulties not only of the eurozone's most troubled countries, primarily Greece, Ireland, and Portugal, but also of its larger economies, such as Italy and Spain, both of which have embarked on stringent fiscal austerity packages. To avoid weakening the eurozone's already fragile growth prospects, the central bank is likely to favor a gradual and soft approach rather than aggressive tightening.

The bloc is expected to continue expanding at about 1.6% in both 2011 and 2012, supported by the global recovery—particularly in the US and emerging markets—and by vigorous domestic demand on the back of growing consumer and manufacturing confidence.

Continued finance sector recovery and banks' expanded access to money markets will be key to sustaining the momentum. Weaknesses remain, however, as banks' balance sheets are still constrained, and lending to households has been very slow to pick up. In sovereign bonds, market confidence improved temporarily in November last year, coinciding with the €67.5 billion bailout of Ireland. Such emergency funding by the European Union (EU) and the International Monetary Fund (IMF) to Ireland, and to Greece earlier in 2010, will keep these countries from having to access the markets for 2 or more years.

Against the backdrop of soaring 10-year government bond credit default swaps for Greece, Ireland, and Portugal (Figure 1.1.11), EU leaders agreed to increase the lending capacity of the eurozone's bailout fund at EU summits held on 11 and 24–25 March. The commitments were to increase the fund to €440 billion (up from its current €250 billion), by increasing guarantees or paid-up capital. EU leaders did not, however, agree on how to raise those funds, and left open details on how

1.1.9 Economic sentiment index and subindexes, eurozone



Note: From February 2011, business surveys are presented exclusively in accordance with the NACE rev. 2 classification. In previous months, a combination of NACE rev. 1 and rev. 2 are used.

Source: Directorate General for Economic and Financial Affairs. http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm (accessed 23 March 2011).

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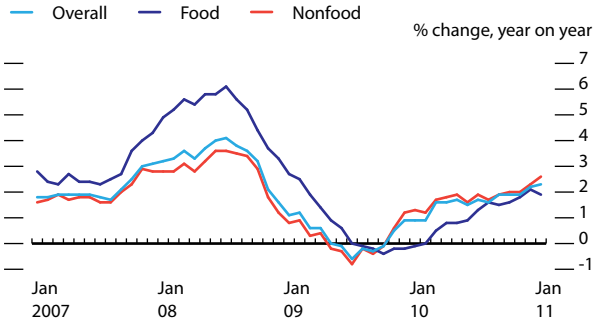
1.1.10 Harmonized indexes of consumer price inflation, eurozone



Note: Starting January 2011, a new methodology defines how seasonal products are to be treated, affecting the all-items index in the euro area by a reduction of 0.1 percentage points for January 2011.

Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 4 March 2011).

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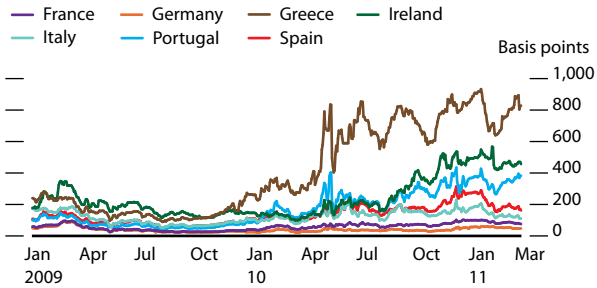
1.1.11 10-year euro-denominated government bond credit default swaps, selected eurozone countries



Source: Datastream (accessed 16 March 2011).

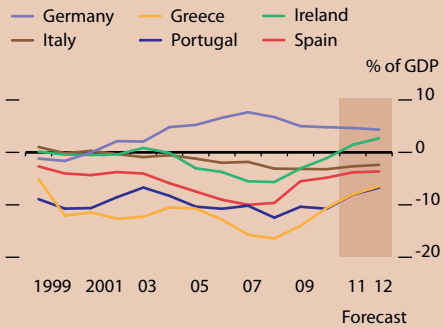
to replace the European Financial Stability Facility, which runs out in mid-2013, with a permanent European Stability Mechanism. This would be allowed to lend up to €500 billion to aid debt-distressed eurozone members.

At a more fundamental level, resolving the eurozone debt crisis will require winding down the large internal and external imbalances that lie at its heart (Box 1.1.1). The political willingness of the region's surplus countries to pay for a debt-restructuring program will depend on a credible medium-term initiative for the region's deficit countries to reduce their imbalances.

1.1.1 Eurozone sovereign debt crisis: Causes and possible solutions

The question of cohesion of a monetary union rests on whether there is convergence or divergence of living standards and macro fundamentals among member countries. In the eurozone, the main manifestations of growing divergence were the emergence of sizable and persistent current account deficits in Greece, Portugal, and Spain (and to a lesser extent France and Italy), mirrored by high current account surpluses in northern eurozone countries, especially Germany and the Netherlands. Ireland shows a persistent trade surplus, but high factor income payments abroad had increasingly contributed to a current account deficit (Box figure 1).

1 Current account



Source: European Commission, Directorate General for Economic and Financial Affairs, Annual Macro-economic Database. http://ec.europa.eu/economy_finance/db_indicators/ameco (accessed 1 March 2011).

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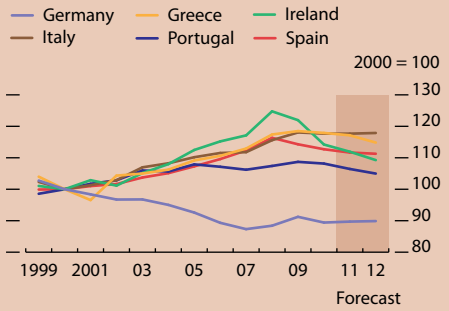
Further, the buildup of large current account deficits in peripheral countries was accompanied by a steady decline in competitiveness, as shown by relative unit labor costs (Box figure 2). These were driven by persistent price and wage differentials relative to underlying productivity trends.

Market data—wide sovereign bond spreads for example—suggest dim prospects for a quick resolution of the crisis. Revealingly, yields have not come down for the two countries receiving large bail-outs, namely Greece and Ireland. The markets are clearly awaiting more fundamental solutions.

So what might these be? Contagion to other eurozone countries can be prevented if governments in high-risk countries successfully deleverage in spite of the social and short-term economic pains of fiscal adjustment. Accommodative macro policies from surplus countries, resorting to bank recapitalization or insolvency regimes, and better risk sharing through a common eurobond, for example, could help to put the eurozone onto a path of rebalancing and fiscal sustainability.

2 Real effective exchange rate based on unit labor costs



Source: European Commission, Directorate General for Economic and Financial Affairs, Annual Macro-economic Database. http://ec.europa.eu/economy_finance/db_indicators/ameco (accessed 1 March 2011).

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A promising new development here is the pact for the euro, to which eurozone leaders agreed on the general principles in the March summits. The pact aims to increase competitiveness and tighten convergence among the countries of the eurozone. Under the pact, measurable yearly targets for key objectives would be enshrined in national legislation, to increase peer pressure and accountability. The pact also includes an agreement on a numerical debt-reduction benchmark.

With reform and fiscal discipline commitments by its debt-stressed members anchored in this way and the European Stability Mechanism coming into place as a permanent financial backstop facility, eurozone leaders hope to have found a response strong enough to assuage financial market sentiment now and to avert similar crises down the road. So far, market reactions have been muted.

Japan: Uncertainty compounded by disaster

GDP grew by 3.9% in 2010, after contracting by 6.3% in 2009. Rebounding exports, the low 2009 base, and a series of fiscal stimulus packages boosted growth. External demand contributed 1.8 percentage points of GDP growth, with domestic demand accounting for the rest.

Private consumption rose by 1.8% in 2010, largely due to fiscal stimulus packages on household appliances and passenger cars, making a 1.1 percentage point contribution to total growth. After that surge, however, consumption was flat in the fourth quarter (Figure 1.1.12). Growth in real exports, after a strong rebound in the first half, fell by 0.8% in the fourth quarter from the third.

A sluggish labor market continues to weigh on private consumption. Unemployment is high and job offers remain well below precrisis levels. Nominal wages grew strongly in the first half of 2010, mainly in manufacturing, before decelerating in the second, and with the labor market expected to improve only gradually, labor income is unlikely to make much headway in 2011.

Business fixed investment was generally weak in 2010, but has started to recover in recent months (Figure 1.1.13). Healthy corporate profits will add further momentum but lingering excess capacity will remain a drag. Housing investment has also started to recover. Inventory adjustment, along with lower mortgage rates and housing prices, boosted housing sales, mainly of owner-occupied houses and condominiums.

Prior to the earthquake and tsunami (Box 1.1.2), the overall outlook was mixed. The slower growth of global trade, fading effects of the fiscal stimulus, and labor market weakness all pointed to deceleration in the years ahead. The recent tragedy further clouds the immediate prospects for Japan as well as the global outlook.

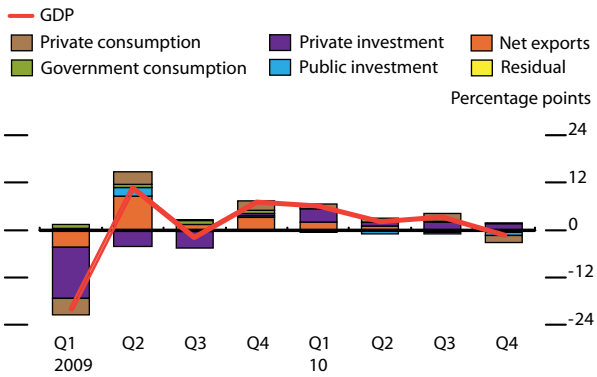
The one area where the earthquake may have a lasting and sizable impact is the global energy market. More precisely, to the extent that Japan's unfolding nuclear crisis raises long-term worldwide concerns about the safety of nuclear energy, it may precipitate a structural shift in the global energy mix.

Overall then, aside from energy, the regional and global impact of the Japanese earthquake is hard to quantify but likely to be temporary and limited.

Including the impact of the earthquake and tsunami, Japan's real GDP is projected to grow at 1.5% in 2011 and 1.8% in 2012 (2011 a shade lower than predisaster projections but 2012 a touch higher). This benign baseline scenario assumes no major aftershocks, extended power shortages, or massive radiation leaks from the Fukushima plant.

In looking over the performance of the major industrial economies, it is clear that—despite the severity of the recent crisis and the lingering uncertainties—they have returned to growth. Also that developing Asia's support arrived at a critical time.

1.1.12 Contributions to GDP growth, Japan



Source: Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 17 March 2011).

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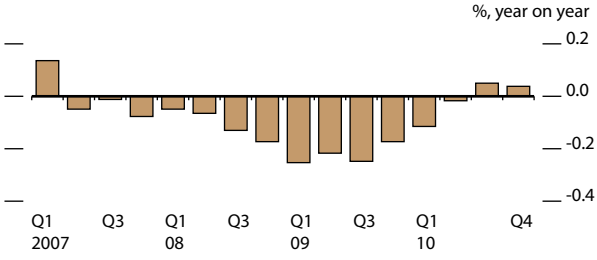
1.1.13 Fixed investment growth, Japan



Sources: Ministry of Finance, Japan. Policy Research Institute. http://www.mof.go.jp/english/pri/index.htm (accessed 23 March 2011).

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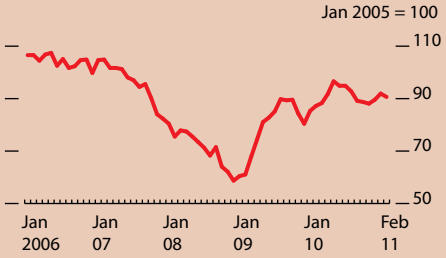
1.1.2 Economic effects of the Tohoku disaster on Japan

A Richter-scale 9.0 earthquake and a tsunami devastated the Tohoku region of Japan on 11 March (the January 1995 Kobe earthquake was 7.3). This region accounts for around 6% of Japan's GDP, 7% of its population, and 7% of the private sector capital stock.

How the disaster will affect 2011 GDP growth is hard to quantify since it is still unfolding. Economic activity in the Tohoku region will be severely hit in the short run due to extensive damage to production facilities, transport, and other infrastructure. The earthquake has also caused substantial power shortages related to the shutdown of three nuclear facilities in the area. Nuclear power supplies a third of Japan's electricity and power companies have already put into place a program of rolling blackouts.

Possible erosion of consumer and business confidence is an intangible factor. An improvement of consumer confidence after December 2008 had stalled from May 2010, reflecting the mixed outlook and overall uncertainty (Box figure). One huge short-term influence on confidence is how well the authorities contain the radiation leakage from Fukushima nuclear plant.

Consumer confidence, Japan



Source: Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 17 March 2011).

Click here for figure data

The earthquake will affect other key variables. For example, right after the disaster, the stock market plummeted while the yen rose to a post–Second World War high on expectations that Japanese firms would repatriate profits to bolster domestic balance sheets. G7 coordination has, though, stemmed the currency's rise, which would have dented confidence and prospects.

A rough parallel is the Kobe earthquake, whose impact on growth turned out to be modest. Many local macroeconomic indicators initially fell but quickly reverted to their predisaster levels. The recovery was spearheaded by government reconstruction spending, which paved the way for a robust rebound in private investment.

The magnitude of both damage and the funding for recovery are likely to be much larger than for Kobe. At that time, the damage to buildings, roads, and other infrastructure amounted to about 2% of GDP, and the fiscal outlays for reconstruction totaled little more than ¥3 trillion. Market estimates of the damage from the Tohoku earthquake are in the range of $150 billion–$200 billion, or 3%–4% of GDP.

Beyond the very short term, Japan's economic prospects are less dire, assuming that the nuclear crisis at Fukushima is brought under control. Private consumption and production are now falling but capital-stock rebuilding, largely financed by the government, will exert a positive effect in the longer run.

The one caveat to this optimistic longer-term view is that the fiscal demands of post-earthquake reconstruction will impose new burdens at a time when net public debt is over 120% of GDP. The lack of fiscal space may constrain the positive effect of the recovery-related government stimulus by requiring higher taxes. In addition, the funding demands of reconstruction may exacerbate financial market jitters about debt sustainability. Monetary policy, however, can afford to remain expansionary given near-zero inflation before the disaster, which should help to contain government borrowing costs.

Developing Asia's role in the global recovery

Developing Asia's prospects have long depended on the economic health of the major industrial countries, the main markets for the region's exports. When Indonesia, the Republic of Korea, Thailand, and other economies were hit by the late 1990s' Asian financial crisis, demand for their goods from the US and the rest of the world constituted the primary driver of recovery. Even now, the drop in industrial-country demand during the recent global downturn showed that developing Asia is not immune to a deep recession originating from outside.

But a notable shift is under way, one that accelerated during the crisis. The region itself is now exerting greater impact on the global economy. Increasingly, the region's own outlook will affect the prospects of the

rest of the world, including the major industrial countries. The rising economic influence of developing Asia is a result of its change into a major player in the global landscape. In fact, when developing Asia and Japan are considered together, they are one of three main hubs of the global economy, along with the US and EU. And the region is now the world's largest net exporter of capital.

The crisis in fact marks a significant milestone, proving that the region has evolved and can now withstand even a colossal external shock. When the financial crisis that originated in the US intensified and led to a collapse in output and trade, the region's surprising resilience had global benefits. When export demand elsewhere was drying up, developing Asia's unexpectedly strong demand provided some much-needed relief—but to what extent?

Quantifying developing Asia's role in the recovery

The relative importance of developing Asia and the PRC in trade has grown, pointing to their growing role as importers. For a group of eight countries, Figure 1.1.14 shows the share of the region (proxied by 10 developing Asian economies accounting for the bulk of the region's output and trade) in their exports, and Figure 1.1.15 the PRC's share. The eight economies are the four largest industrial economies and four of the largest developing economies. (South Africa is the biggest economy in Africa; Brazil and Mexico the two largest economies of Latin America; and Saudi Arabia the biggest in the Middle East.)

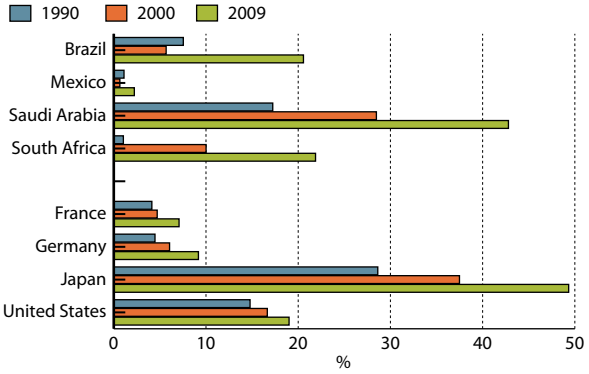
As a large and growing market for the world's goods, developing Asia contributed to the global recovery through trade (Figure 1.1.16). Germany, for example, exported $52 billion to the PRC and $103 billion to Asia-10 in 2009, when Brazil exported $19 billion to the PRC and $32 billion to Asia-10. Further, exports are growing rapidly, even for countries whose trade with the region is relatively limited. For example, South Africa's exports to Asia-10 shot up from $250 million in 1990 to $3.1 billion in 2000 and further to $12 billion in 2009.

In the depth of the crisis and the early recovery, continued strong export growth to developing Asia shows that the region was indeed providing much-needed demand, even while markets in the rest of the world contracted (Figure 1.1.17).

For both the industrial economies and the non-Asian developing countries, there is a marked difference between the growth of exports to Asia-10 and the rest of the world. In fact, for all eight economies, during the crisis the average growth rate of exports to Asia-10 exceeded export growth to the rest of the world. For the US, for instance, the average growth rate was 5.5% for the Asia-10 but a contraction of 0.4% for the rest of the world. Even more strikingly, for Brazil, the figures are 25.4% and a contraction of 0.9%.

Of particular interest is the role of the PRC. Its robust demand for imports held up well in the downturn because of

1.1.14 Share of exports to Asia-10 in total exports, eight economies

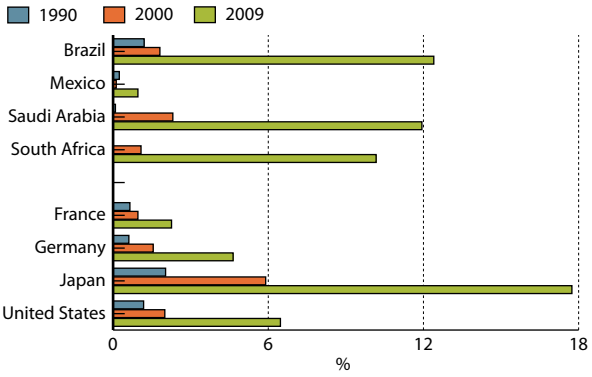


Note: Asia-10 are China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand.

Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

Click here for figure data

1.1.15 Share of exports to the PRC in total exports, eight economies



Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

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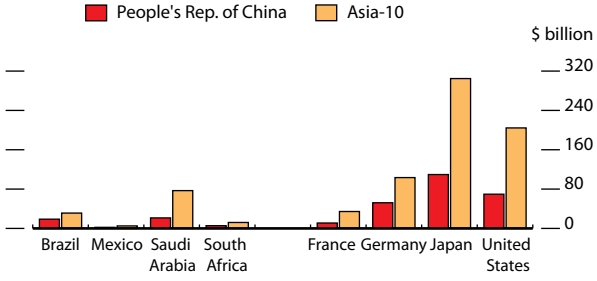
1.1.16 Total exports to the PRC and Asia-10, 2009



Sources: International Monetary Fund. 2011. Direction of Trade Statistics. February; CEIC Data Company (accessed 15 March 2011).

Click here for figure data

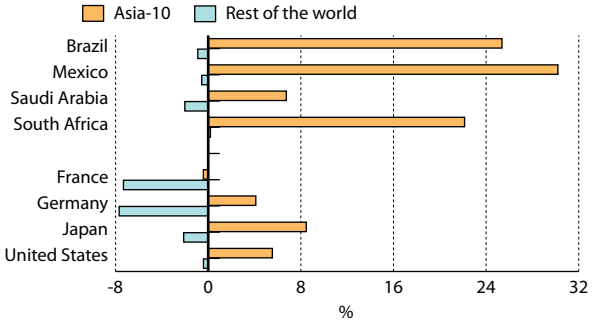
its slightly slower (but still very high) growth throughout the crisis. As with exports to Asia-10, exports to the PRC from the eight economies outpaced exports to the rest of the world (Figure 1.1.18). For example, for the US, the average growth rate was 10.9% for the PRC but flat for the rest of the world. For Brazil, the corresponding figures are a staggering 34.0% and 0.2%.

To sum up, developing Asia—the PRC in particular—provided much-needed support to the global recovery as a major market for the world's products around the crisis. Demand in the region had itself been supported by the unprecedented fiscal stimulus that authorities rolled out in the face of collapsing external demand and weak private demand. The PRC's 11% of GDP, 2009–2010 stimulus program attracted much attention but across the region governments aggressively boosted public spending and cut taxes. Although fiscal expansions were motivated by domestic needs, the demand support in developing Asia had positive global spillovers.

Although trade was the most important, there were other channels. Purchases of US, EU, and Japanese sovereign bonds by regional governments provided support during the recovery. Those purchases kept down the cost of borrowing for the industrial-country governments, thus facilitating their countercyclical fiscal expansion, and helping to stave off a deeper recession. This approach will, however, need to be unwound as recovery progresses to avoid the reemergence of the unsustainable global imbalances that were a contributing factor to the recent financial turmoil.

Developing Asia's strength has been a rare shaft of light in an otherwise gloomy environment. And as the major industrial countries face their own internal challenges to recovery, the return of higher global oil and food prices presents further complications for the region.

1.1.17 Average quarterly growth rate of exports to Asia-10, eight economies, Q3 2008–Q3 2010 (year on year)



Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

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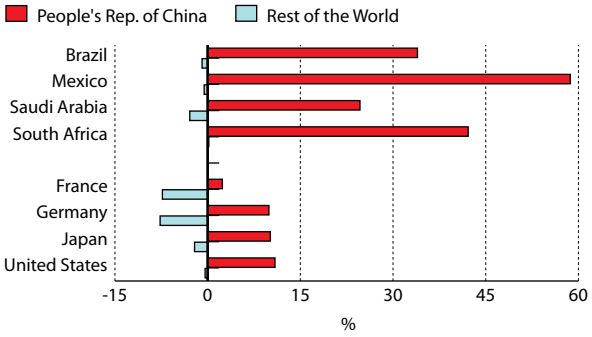
1.1.18 Average quarterly growth rate of exports to the PRC, eight economies, Q3 2008–Q3 2010 (year-on-year)



Note: Rest of the world excludes the other Asia-10.

Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

Click here for figure data

Resurgence of global oil and food prices

The sharp rises in global commodity prices—before and after the crisis—have substantial repercussions on developing Asia's economy. Immediately before the global crisis, oil prices leaped to around $150 in July 2008 and the price of food and other commodities also jumped. As the world economy went into a deep recession and global trade collapsed, global commodity prices also tumbled.

They subsequently rebounded on the back of the global recovery, accelerating in the second half of 2010, so much so that nonenergy commodity prices—agricultural products, metals and minerals, and raw materials—have reached record highs. Two commodities—oil and food—are especially important for developing Asia.

Global oil price trends and prospects

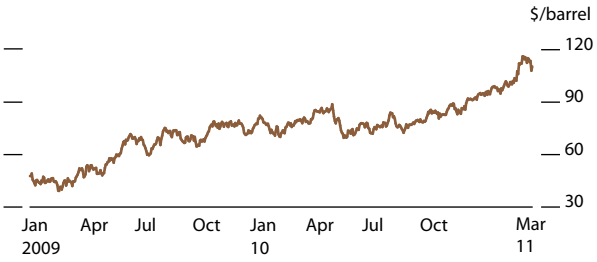
During the first 8 months of 2010, oil prices remained relatively stable, oscillating within a limited range of $75–$85 a barrel. Despite robust

global demand growth, particularly in Asia, persistently high inventory levels capped price escalation, as did lingering uncertainty over the recovery of industrial countries.

Since September, however, prices have shown a sustained increase (Figure 1.1.19). Brent crude climbed from $77 a barrel on 1 September to $96 at end-year and was nearly $120 by mid-March.

Both demand- and supply-side factors explain the rise. Growing market perceptions of firmer industrial-country recovery lifted demand, as did the exceptionally cold winter in Asia and Europe. Disruption of supply from Libya, which normally exports around 1.3 million barrels per day (mbd) pushed up prices. The indirect effect from Libya has been much bigger, triggering broader geopolitical concerns about Middle East supply.

1.1.19 Price of Brent crude



Source: Bloomberg (accessed 16 March 2011).

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Global oil demand strengthened steadily during 2010, from 86.5 mbd in the first quarter to 88.9 mbd in the fourth. For the year as a whole, global demand averaged 87.7 mbd. Year on year, global oil demand rose by 3.2% relative to 2009, the strong growth partly reflecting a rebound from weak demand. Demand from countries in the Organisation for Economic Co-operation and Development (OECD) grew by 1.4% and demand from non-OECD economies by 5.2%, reflecting the two-speed global recovery. Within the non-OECD group, Asian demand climbed by 5.7%, fueled by the PRC's oil-demand growth of 12.6%.

Global oil demand will remain robust in the short run as the world recovery continues. Demand growth is projected at a shade under 2% in 2011, mirroring projected global growth and its twin-track pattern—OECD demand flat in 2011 but non-OECD demand to rise by around 4%.

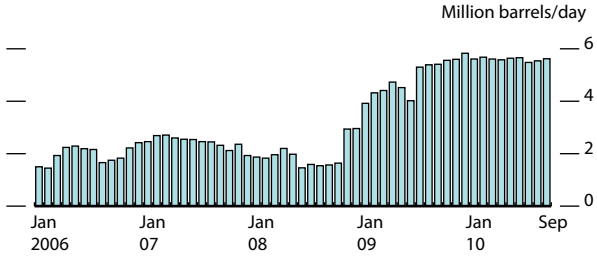
Healthy inventory levels and adequate spare capacity will, though, contain price pressures. Global oil supply is set to rise by around 2 mbd in 2011, with members of the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries each contributing about half the projected growth.

A supply-side development with major longer-term ramifications is the recovery of Iraqi output, which may rise by as much as 700,000 barrels in 2011. The restoration of political stability and security in Iraq, which has vast reserves, has led to a substantial increase in investment and production. Outside OPEC, Brazilian output is likely to be ramped up substantially in 2011, due to recently developed offshore fields.

The relatively benign global supply outlook has contributed to substantial spare OPEC capacity (Figure 1.1.20). This cushion is unlikely to shrink noticeably in the short term and will guard against sharp price surges.

The high inventories maintained by OECD countries are another limiter of price spikes (Figure 1.1.21). The inventory levels declined somewhat in the fourth quarter of 2010 and the decline is set to fall further in the first quarter of 2011 but overall supply and demand factors make a sharp fall in inventories unlikely.

1.1.20 OPEC effective spare capacity



Source: JP Morgan Energy Strategy.

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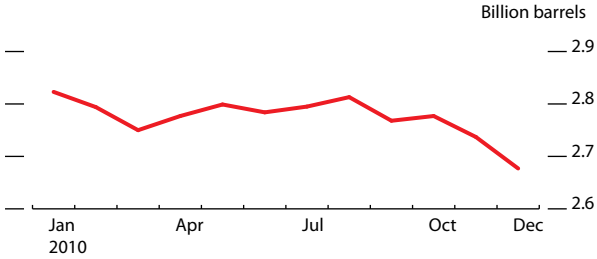
1.1.21 OECD oil inventories



Source: JP Morgan Energy Strategy.

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The civil conflict in Libya, which erupted in February 2011, has the potential to be very disruptive to oil supplies. Libya is an OPEC member and ranks among the top 15 exporters. It usually pumps around 1.6 mbd but output may have fallen by more than half.

Prices will be higher in both 2011 and 2012 due to the Libya factor, and there has been a significant increase in market expectations for oil prices since the outbreak of the fighting there (Figure 1.1.22). Those same expectations suggest, however, that the Libya effect will be limited, as evident in the decline in medium-term forward prices between 21 February and 16 March. The broader implication is that market perceptions of supply and demand fundamentals remain unchanged. Libya is likely to be a temporary shock unless instability threatens the entire Middle East.

The baseline medium-term outlook is still grounded on adequate spare capacity, bolstered by expansion of global output until the middle of this decade. The risk in that period of a sharp escalation is modest. Japan's disaster may, however, have medium-term ramifications if it leads to a significant shift of global energy demand from nuclear power to oil.

Global food price trends and prospects

Global food prices are set to remain high in 2011.[1] They have climbed sharply since bottoming in early 2009 and accelerated fast in the second half of 2010, as part of a broader surge in commodity prices enveloping oil and energy, metals, nonenergy, and agriculture (Figure 1.1.23).

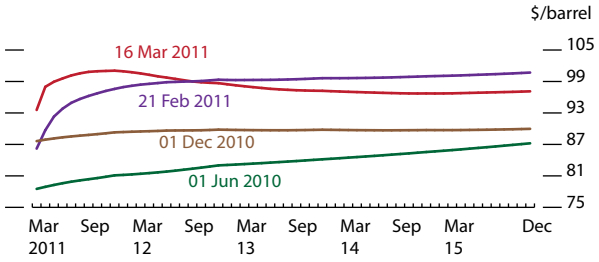
The world witnessed a similar commodity boom immediately before the global crisis. After commodity prices reverted to their historic trend levels in late 2008 as a result of the global slump, it was widely believed that they would rise at a moderate speed in the medium term. The events of the last few months have realigned expectations. In fact, while oil remains well below its peak of July 2008, many food and other nonenergy commodities have reached new highs.

In February 2011, for example, the benchmark index for food prices of the Food and Agriculture Organization of the United Nations reached the highest level (nominal and real) since its inception in January 1990. The index went up by 34.2% relative to a year earlier, driven by cereals, edible oils, and dairy products (Figure 1.1.24).

Fortunately, though, the price of rice—along with wheat one of the two staple cereals produced and consumed in Asia—moved up less rapidly in June 2010–February 2011, by 17% (Figure 1.1.25). A key difference with the food-price crisis of 2007–2008, this rise was moderate partly because Thailand and Viet Nam released ample supplies from their rice stocks to mitigate rising price pressures. The price of wheat, however, almost doubled in the same period.

Domestic rice and wheat prices in many developing Asian

1.1.22 NYMEX futures price, West Texas Intermediate



Source: Bloomberg (accessed 16 March 2011).

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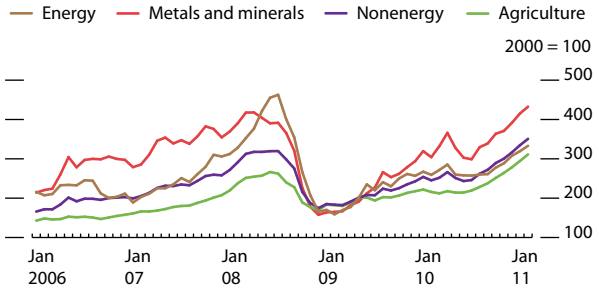
1.1.23 Commodity price indexes



Source: World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 4 March 2011).

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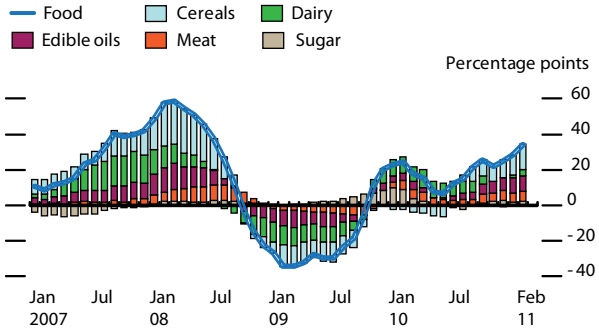
1.1.24 Sources of food price increases



Source: ADB calculations based on data from Food and Agriculture Organization of the United Nations. Food Price Index. http://www.fao.org/worldfoodsituation/en (accessed 4 March 2011).

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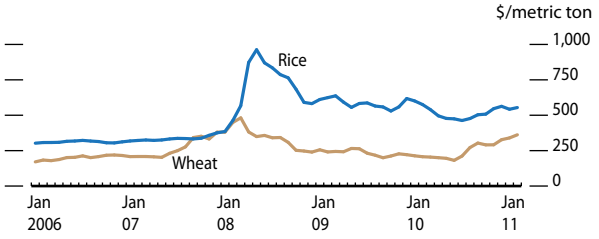
1.1.25 International rice and wheat prices



Source: Food and Agriculture Organization of the United Nations. Global Food Price Monitor. http://www.fao.org/giews/english/index.htm (accessed 1 March 2011).

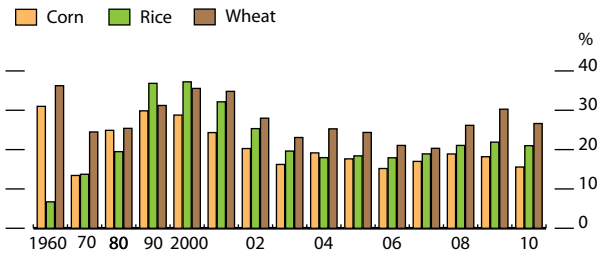
Click here for figure data

economies are following the rise in international grain prices. Domestic rice prices went up, for example, by 21.4% in Bangladesh, 21.6% in Indonesia, and 36.7% in Viet Nam from June 2010 to February 2011. But while international wheat prices rose by 99.6% in the 8 months to February 2011, domestic wheat price increases in the region in local currency terms generally did not exceed 70%.

The food price surge was triggered by weather-related production shortfalls and reinforced by cyclical factors. In the second half of 2010, crops failed in Australia, Europe, North America, and Argentina. In addition, the worst La Niña weather pattern in three decades led to widespread flooding in many food-producing countries. Corn, coffee, rice, wheat, and sugar output have all been hit. The strong economic recovery (boosting demand for food) and rising oil prices (raising input costs) also played a role.

Structural factors that are driving long-term demand trends also come into play in the current price surge. Such factors include a growing world population, strong income growth in emerging economies, and changing diets from staple foods toward increased consumption of meats. The supply–demand balance in global food markets has tightened, as reflected in a decline in stock-to-use ratios for corn, rice, and wheat since around 2000 (Figure 1.1.26).

1.1.26 Stock-to-use ratios of selected grains



Source: United States Department of Agriculture. Foreign Agricultural Service. http://www.usda.gov (accessed 4 February 2011).

Click here for figure data

Global food prices are likely to remain elevated and volatile in the short term. Grain stocks have been falling as production has been unable to meet demand. Production in 2011 will therefore be crucial in determining stability in global markets. Supply uncertainties are also rising on weather disturbances.

The international price of wheat is expected to remain high, exacerbated by the ongoing drought in the major wheat-producing belt in the PRC and extremely low global inventory stocks. The outlook for rice is more uncertain but upward pressures will persist if La Niña weather conditions continue to affect production.

Risks to the global outlook

Although the global recovery is showing signs of firming, it is still uneven and laden with risks. The risks to the outlook for the major industrial countries differ, but weakness in one could undermine recovery in the others—and have spillover effects globally. Developing countries are more susceptible to instability originating from rising commodity prices, and for those developing countries that have bounced back fastest from the recent downturn, overheating is a growing concern.

Persistent weakness of labor and housing markets in the United States

The health of the US economy has a strong impact on the global economy. The immediate prospects for the country have brightened somewhat with the support of monetary and fiscal stimulus, but it is still unclear whether private demand is strong enough to stand on its own. Persistent weakness of the labor and housing markets in particular are a drag on private consumption and investment.

Despite unemployment falling to 8.9% in February, without more

sustained progress, uncertainty over jobs will continue to damp consumer confidence and hold back consumption. A weak housing market inhibits households from repairing their balance sheets, and may also prevent workers from moving to more promising locations for jobs.

Sovereign debt risk in the eurozone

The sovereign debt problems pose a serious downside risk for international financial markets. The wide spreads between 10-year government-bond yields for Germany and for peripheral countries—Greece and Ireland in particular—show that the markets have real doubts about these two countries' fiscal sustainability. Although the EU and IMF averted a crisis in 2010, the risk of disorderly debt crisis remains.

These two economies are small, but crisis in either of them could jeopardize the financial stability of the eurozone, the EU, and beyond, given the substantial financial links between them and the eurozone's core economies. Such disruptions have the potential to spill over into global financial markets as well.

Uncertain aftermath of the disaster in Japan

It is premature to gauge the full economic impact of the huge earthquake and tsunami that hit Japan on 11 March 2011, either for Japan or the rest of the world. The effects of such natural disasters are typically large in the short run, when production is disrupted and private consumption suffers. Given the role of Japanese firms in global production networks, supply-chain disruptions could impede growth elsewhere, particularly where suitable replacements are not readily available. In the longer run, government reconstruction programs will help to revive private investment.

The benign baseline scenario of quick normalization assumes that there will be no major aftershocks, extended power shortages, or widespread radiation contamination (discussed further in Box 1.2.2 below).

Fiscal risks in industrial economies

Fiscal risks manifest themselves differently in the eurozone, US, and Japan. Those eurozone peripheral countries facing mounting concerns over their sovereign debt are pursuing austerity programs to improve their public finances. While such programs are necessary to avert default and bolster market confidence, they act as a drag on economic activity (as seen in Greece's shocking contraction). The slowdown of growth may then hit tax revenue and worsen the fiscal position in the short run.

In the US and Japan, fiscal risks stem from failure to develop medium-term consolidation plans. Both countries face a dilemma, because the fragility of their recoveries calls for a continued accommodative fiscal stance. In Japan, the dilemma is further heightened by the expected fiscal burden of disaster relief and recovery efforts stemming from the earthquake and tsunami. Given the escalation of public debt in both countries, such a failure could erode financial market confidence, which would push up borrowing costs, further exacerbating the problem.

High and volatile global commodity prices

The return of global growth, combined with lack of readily available spare production capacity, is driving demand for both oil and food. The narrowing of the gap between demand and potential global supply, along with the erratic recovery of the major industrial countries, will cause greater price volatility. The probability of a sustained surge of food prices in 2011 remains limited, however, because temporary supply factors were largely in play. Still, the short-term outlook for high and volatile commodity prices will add to inflation pressures, especially in high-growth developing countries.

Risk of overheating in fast-growing developing countries

Robust recovery and growth are giving rise to incipient overheating and inflation pressures in some developing countries. Risks here are notably evident in fast-growing developing Asia and are becoming apparent in other areas, such as parts of Latin America. Capital inflows and rising commodity prices may exacerbate asset and consumer price inflation. Any failure by policy makers to damp overheating pressures will jeopardize macroeconomic stability and growth. Given the current dependence of global growth on developing-country dynamism, this would cloud the global outlook.

The global recession may have ended, but its aftereffects linger. While advanced economies are struggling, the prospects for developing Asia are much more positive. Yet even there the risks are tilted toward the downside.

Firming recovery in developing Asia

Developing Asia is on a firm path of recovery. The policies that were put in place at the onset of the recent global turmoil set the stage for strong performance last year. Low inflation from the weak global demand allowed policy makers to respond aggressively with fiscal and monetary stimulus. Consequently, 2010 growth for most countries in the region surprised on the high side relative to the forecasts in the *Asian Development Outlook 2010*.

A year ago, the question facing policy makers was how to time the normalization of fiscal and monetary policies to avoid undermining the nascent rebound. At that time, the risk of overheating was much lower because of the soft global demand, hence erring on the side of continued stimulus made sense. Now that the region's growth is on a more solid footing, it is time to reevaluate that approach. Many of the stimulus measures are being wound down, but the fiscal and monetary stances are not yet back to their precrisis positions.

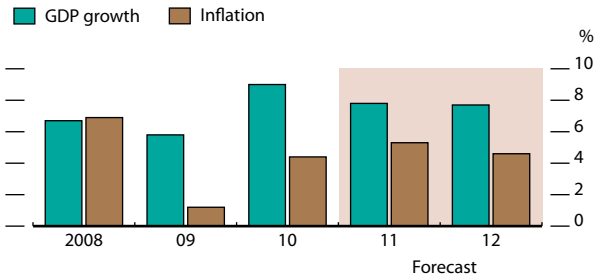
The region's continued rapid growth is far from guaranteed, and as discussed in the previous section, the global recovery faces many risks. The region's outlook, however, is for continued strong growth in 2011–2012, but with the threat of inflation looming closer. When weighing their macroeconomic policy choices, many of developing Asia's policy makers see that the balance has tipped toward avoiding overheating.

Recent trends and outlook

Developing Asia bounced back rapidly from the effects of the global recession and will consolidate these gains in the coming years. The region is projected to grow by 7.8% in 2011 and 7.7% in 2012 (Figure 1.2.1). Growth in 2011, as in 2010, will be broad-based, and rest on both domestic and external demand. Private consumption and investment are expected to take over as the mainstay of domestic demand.

The region's moderation from the rapid 9.0% growth in 2010 stems from slower growth of the major industrial economies, more measured expansion of world trade, and the unwinding of fiscal and monetary stimulus. The exceptional performance of 2010 was partly due to the base effect, following the relatively slow growth in 2009. The moderation marks a welcome return to growth rates that can be sustained without aggravating price pressures.

1.2.1 GDP growth and inflation, developing Asia



Source: Asian Development Outlook database.

Click here for figure data

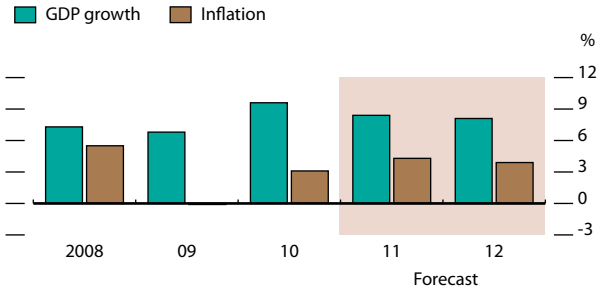
Although macroeconomic policies are heading back to their precrisis positions, most are still accommodative relative to 2008. Price pressures are building, and some countries may need to act preemptively to corral inflation before it accelerates further. Consumer prices rose by 4.4% in 2010, accelerating from 1.2% in 2009—a steeper

rise than in the major industrial countries. The uptick is being driven by 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.

All subregions of developing Asia performed well in 2010. They are expected to continue to do so in the next 2 years, if the major risks are not realized.

East Asia rebounded strongly in 2010 (Figure 1.2.2), led by the return of the PRC to double-digit growth. Aggregate GDP for the five economies in this subregion expanded by 9.6%, faster than the rest of developing Asia. Growth in the PRC of 10.3% was powered by a continuing surge in investment and robust private consumption, and its external trade flows fully recovered from the slowdown in 2009. The recovery in world demand for manufactured goods benefited the subregion's newly industrialized economies (Hong Kong, China; the Republic of Korea; and Taipei,China), and rising demand for raw materials boosted Mongolia. East Asia is expected to moderate somewhat, to 8.4% in 2011 and 8.1% in 2012, as policy stimulus measures are withdrawn.

1.2.2 GDP growth and inflation, East Asia



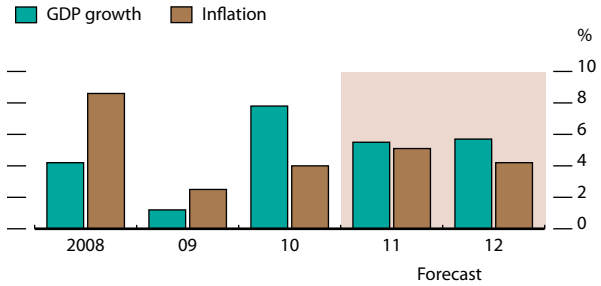
Source: Asian Development Outlook database.
Click here for figure data

The PRC's resilience helped speed the recovery in East and Southeast Asia (Box 1.2.1). Even in 2009—the trough of the global recession—the PRC grew by 9.2% while world output was flat and global trade contracted.

Inflation in the East Asian economies is forecast to pick up in 2011, owing to higher global prices of commodities and oil, reinforced by robust domestic demand. The subregional inflation rate is put at 4.3% in 2011, easing to 3.9% in 2012.

Southeast Asia's exceptionally strong recovery in 2010 (Figure 1.2.3) reflected the steep rebounds of the more open economies. Aggregate growth propelled to 7.8% from just 1.2% in 2009, largely driven by Malaysia, Singapore, and Thailand, whose economies had contracted during the global slump of 2009. Other major economies in this subregion—Indonesia, the Philippines, and Viet Nam—also registered solid growth, after slowdowns in the previous year. Recoveries in exports and investment underpinned expansion. Growth is expected to step down in light of the higher 2010 base, a moderation in export growth, and policy tightening by governments. GDP will expand by 5.5% in 2011 and 5.7% 2012.

1.2.3 GDP growth and inflation, Southeast Asia



Source: Asian Development Outlook database.
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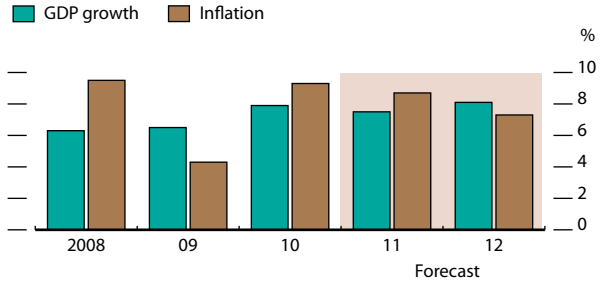
Inflation in Southeast Asia is accelerating. Consumer prices in the subregion rose by a moderate 4.0% on average in 2010, picking up to 5.1% in 2011. However, inflation pressures have been more tenacious in some countries—Viet Nam, for example, is expected to hit double digits. Subregional inflation is expected to come down to 4.2% in 2012, with appropriate policy responses and slower growth in global commodity prices.

South Asia was less affected by the crisis and growth remained fairly strong throughout, dipping only slightly when the global recession hit its nadir (Figure 1.2.4). India is setting the pace for South Asia's overall performance. The subregional

1.2.4 GDP growth and inflation, South Asia



Source: Asian Development Outlook database.
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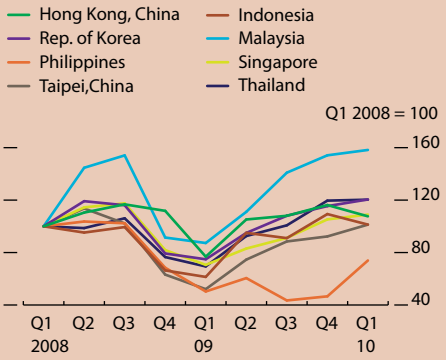
1.2.1 Impact of the People's Republic of China on East and Southeast Asia's recovery

Developing Asia has traditionally relied on exports to the US and other industrial countries for growth. The PRC's emergence as a global heavyweight is fueling hopes that it can supplement the US as an additional source of demand and growth. Those hopes are especially pronounced in East and Southeast Asia, which have close trade links with the PRC.

The box figure shows quarterly export volumes from the two subregions to the PRC. Their export volumes to the PRC decreased by 10%–50% during the global downturn but in most cases more than fully recovered to starting levels. This suggests a possible link between the robust recovery of the two subregions and their exports to the PRC.

Quarterly export volumes to the People's Republic of China



Source: Park and Shin (forthcoming).

Click here for figure data

The PRC's support for GDP growth in the rest of the region involves the trade channel. If the PRC is indeed an engine of growth, there should be a positive relationship between the PRC's imports from, for example, Malaysia and that country's output level.

Of particular interest are the relative size of the impact of the PRC's imports on Malaysia's GDP and the evolution of this size over time. An impact that is comparable to the impact of US imports would support the view of the emergence of a second engine of growth. Further, an impact that grows over time relative to the US impact would also support a twin-engine paradigm.

When this hypothesis is tested econometrically, two key findings emerge. In the short run, the PRC's imports seem to exert an independent, positive impact on its neighbors' growth. This impact is especially evident if we include the global crisis period. For many countries, exports to the PRC had a quantitatively similar impact as exports to the US on their output

However, in the long run, the positive impact of the PRC's imports on its neighbors' output largely reflects US demand. That is, US demand for final goods is driving the PRC's demand for components from, say, the Republic of Korea.

The evidence has two interesting implications. One is that exports to the US still have a big effect on the performance of East and Southeast Asian economies, despite Asia's growing weight in the world economy. The other is that exports to the PRC contributed to its neighbors' recovery from the global crisis. This provides some grounds for optimism about the PRC's role as a second engine of growth.

Source

Park and Shin (forthcoming).

giant's recovery to 8.6% growth was both robust and broad-based even in the face of fiscal consolidation and a substantial tightening of monetary policy during the year. This helped to boost subregional growth to 7.9% in 2010.

India's strong growth will moderate somewhat—8.2% in 2011—before picking up again in 2012 to 8.8%. Consequently, growth in South Asia is expected to dip to 7.5% in 2011 and come up again to 8.1% in 2012. Sri Lanka's peace dividend continues to support its expansion.

Inflation in South Asia averaged 9.3% in 2010, much above the 4.3% of a year earlier when decelerating inflation generally prevailed. The high subregional average is almost entirely due to high food inflation in India and continued double-digit inflation in Pakistan. South Asia's inflation is expected to stay high at 8.7% in 2011 and ease to 7.3% in 2012, with global food and oil prices the main culprits.

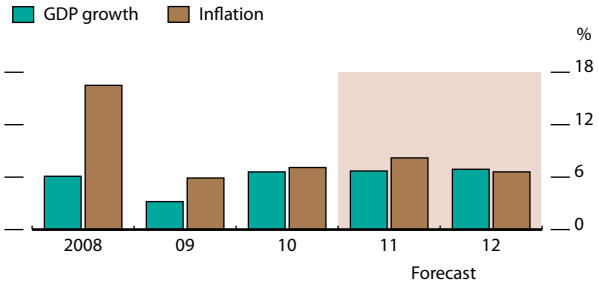
Central Asia's economies benefited from the higher international commodity prices. Much higher prices for the subregion's key exports

(oil, metals, cotton, and gold) supported the recovery (6.6% growth in 2010) and will stay important drivers during the forecast period (Figure 1.2.5).

In Kazakhstan, the largest subregional economy, the recovery was V-shaped, as growth came in at 7.0% on a resurgence in external demand (particularly oil) and domestic anticrisis measures. The non-oil economies strengthened with economic revival in the Russian Federation, their main source of remittances, trade, and finance. Growth in all Central Asia is expected to rise slightly to 6.7% in 2011 and 6.9% in 2012.

Across the subregion, inflation tended to accelerate throughout the year, largely due to higher food prices. It averaged 7.1% in 2010, up from 5.9% in 2009. Subregional inflation is expected to accelerate further to 8.2% in 2011. Higher food prices in all countries and higher energy prices in the oil importers are the main instigators. Moderation in food prices in 2012 will provide some relief, and inflation should ease to 6.6%.

1.2.5 GDP growth and inflation, Central Asia

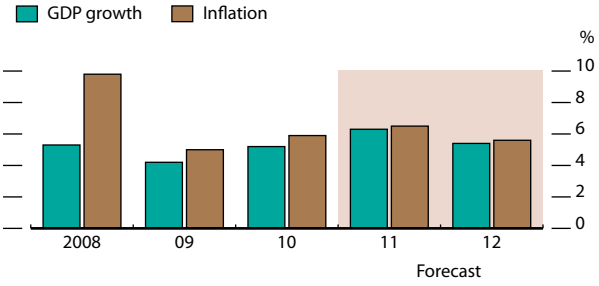


Source: Asian Development Outlook database.
Click here for figure data

Growth in the Pacific strengthened in 2010 (Figure 1.2.6). Most of the 5.2% growth is attributable to the resource-rich economies of Papua New Guinea, Timor-Leste, and Solomon Islands. These economies benefited from higher global prices for mineral and agricultural resources, new investment, and higher government revenue from resources.

Income from tourism and remittances generally increased as the global economic performance improved. However, the solid aggregate growth masked a marginal GDP gain in Fiji (0.1%) and zero to slight growth in most of the small Pacific islands. Growth should reach 6.3% in 2011, due in part to the start of a large natural gas project in Papua New Guinea, before settling back to 5.4% in 2012.

1.2.6 GDP growth and inflation, the Pacific



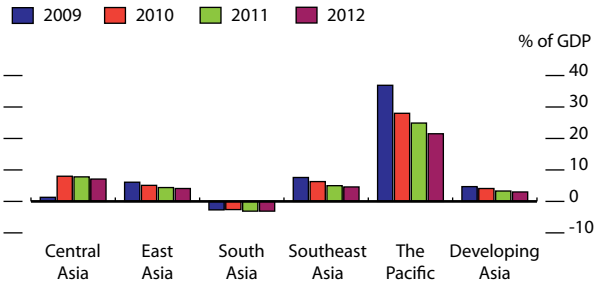
Source: Asian Development Outlook database.
Click here for figure data

Pacific inflation is also picking up alongside global commodity prices as these import-dependent countries cope with rising world food and oil prices. Inflation reached 5.9% in 2010 and is forecast to hit 6.5% in 2011, before falling back to 5.6% in 2012.

Developing Asia's overall current account surplus is falling—from 4.7% of GDP in 2009 to 4.1% in 2010—and is projected to decline further (Figure 1.2.7). Rising commodity prices, especially for oil, and the region's strong GDP growth are raising its imports. Under the forecasts for even higher oil prices with continued strong growth, the balance is projected to fall further to 3.3% of GDP in 2011 and 3.0% in 2012.

It would, however, be premature to interpret this movement as an unwinding of the global current account imbalances that persisted before the crisis. Lasting rebalancing will require key structural changes in both the current account surplus countries in the region and the US.

1.2.7 Current account balance, developing Asia



Source: Asian Development Outlook database.
Click here for figure data

The region is forecast to continue its strong growth in the coming years, with the rate moderating to a more sustainable pace. There are, however, risks.

Risks to the regional outlook

For developing Asia, the main risks to the outlook are possible prolonged sluggish growth in the major industrial countries and the challenge of managing price pressures early. The unfolding effects of the Japanese earthquake and tsunami will also need to be monitored carefully (Box 1.2.2).

Continued slow industrial-country expansion

The downside risks to the global outlook apply as well to developing Asia. While the region has supported industrial-country recovery, it is not clear how well its own growth would hold up if faced with prolonged sluggish growth in advanced economies. As will be discussed in Part 2, *South–South Economic Links,* expanding economic ties outside the region's traditional markets will be important to sustain future growth and global stability, but this shift will not come easily. In the short run, developing Asia's fortunes are still linked with those of the US, eurozone, and Japan.

Uncertain regional impacts from the Japanese disaster

The massive earthquake and tsunami that hit Japan on 11 March 2011 pose a risk, too, especially if production disruptions persist for some time. In addition to the effect on exports in the short term, extended disruptions would affect the regional production networks. The region is also closely tied to Japan through foreign direct investment and other financial flows.

Building inflation pressures

Higher international oil and food prices are posing a risk for global growth generally. Developing Asia, as a net importer of commodities, could see the recent price surges undermine its performance, too.

Fuel enters the household consumption basket directly, but oil is also a critical factor of production. Rising oil prices push up production costs and hence overall price levels. In contrast, food price effects are limited to the direct effects, but they also account for a large share of household spending in the region (Table 1.2.1). For example, the share of food is around 30% in the PRC and over 45% in India.

Model simulations show that a 30% increase in both oil and food prices over their 2010 levels can depress the region's growth by 0.7 percentage points and can add 1.7 percentage points to its inflation rate (Box 1.2.3). The macroeconomic effects of oil price shocks tend to be bigger because of their indirect effects through higher input costs.

As production levels return to their potential, internal price pressures could add to the effects of the external price shocks. Although still manageable, inflation is trending upward, and some economies are showing signs of overheating. Capital inflows from industrial countries, where the monetary stance remains loose, may add further price pressures. As the recovery firms, policy makers may need to put a higher priority on containing inflation.

Table 1.2.1 Food weights in consumer price index baskets

Economy	Share (%)
Developing Asia	
Bangladesh	58.84
Philippines	46.58
India	46.19
Sri Lanka	45.50
Cambodia[a]	44.78
Pakistan[b]	40.34
Viet Nam	39.93
Indonesia[c]	36.20
Thailand[a]	33.01
Malaysia[a]	31.40
China, People's Rep. of[b]	30.20
Hong Kong, China	26.67
Taipei,China	26.08
Singapore[a]	22.05
Korea, Rep. of[a]	14.04
Major industrial economies	
Japan[b]	25.90
United States[b]	14.80
Eurozone	14.00

[a] Includes nonalcoholic beverages. [b] Includes beverages. [c] Includes beverages and tobacco.

Sources: CEIC Data Company (accessed 1 March 2011); National statistics websites.

1.2.2 Tohoku disaster: Effect on developing Asia's economies

Japan is the world's third-largest national economy, and the recent earthquake and tsunami are bound to reverberate on the global and Asian economies through various channels.

The main mechanism will be trade. The earthquake will trigger a short-term decline in the exports of Japan's major trading partners. Japan accounts for a significant share of developing Asia's trade (Box figure 1), especially East and Southeast Asia.

1 Share of Japan in exports and imports, 2009

PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; SIN = Singapore; TAP = Taipei,China; THA = Thailand.

Sources: International Monetary Fund. 2011. Direction of Trade Statistics. February; CEIC Data Company (both accessed 21 March 2011).

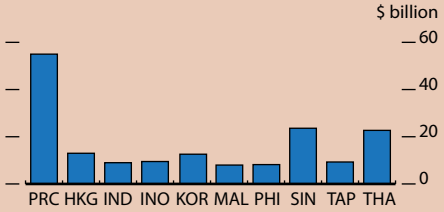
Click here for figure data

In trade, since Japan plays an important role in global supply chains and regional production networks, short-run regional and global production may be disrupted. As production of semiconductors, auto parts, and optical lens is suspended in the quake-hit Tohoku region, concern about a shortage of supply is growing within and outside Asia. Such disruptions are especially significant for East and Southeast Asia, which are tightly integrated with Japan in regional production networks. This production network linkage is why, for example, the PRC runs a large and persistent trade deficit with Japan.

Beyond the short run, the impact on trade will be mixed and differ for different products and different countries. For example, imports of reconstruction materials and energy products will rise.

Finance is another important channel, as Japan is a major exporter of capital and a significant source of foreign direct investment (FDI) for countries in the region (and beyond). Again, because of the production network links, Japanese investment is particularly notable in East and Southeast Asia (Box figure 2). As Japanese firms focus on reconstruction at home and bolster their balance sheets, they will curtail their FDI and other outward investment.

2 Japan's outward FDI stock, end-2009



Note: For country acronyms, see Box figure 1.

Source: Japan External Trade Organization.

Click here for figure data

Another channel of impact is commodity market prices. Japan is a globally significant net importer of commodities. It imports, for example, around 4.3 million barrels of oil a day. Unsurprisingly, some commodity indexes initially fell heavily after news of the earthquake, though the impact on most commodity prices will wear off quickly.

Where there may be some lingering effects is in energy markets. The unfolding nuclear crisis may raise worldwide concerns about the safety of nuclear energy, and may benefit energy exporters such as Kazakhstan and Timor-Leste if those concerns lead to a medium-term shift in the global energy mix.

Other transmission channels include tourism from Japan and remittances of those foreign workers likely to be affected in the very short term. But the overall negative impact on developing Asia is likely to be limited in both magnitude and duration, and concentrated in East and Southeast Asia.

The disaster shows that even well-prepared advanced economies find it difficult to cope with natural shocks, and thus the need to be well prepared. This is even more urgent for developing Asia, which accounted for 61% of global fatalities and 90% of all people affected by natural disasters in 1970–2008. Developing countries are of course more vulnerable to natural disasters because of weaker infrastructure and lack of anticipatory measures.

In developing Asia, earthquakes are the single most destructive disaster, accounting for just over 420,000 deaths and $156 billion in damage in 2000–2010 (Box table).

A wide range of policies are available for developing Asia to reduce its vulnerability. Above all are anticipatory measures, including the built and natural environments; early-warning systems; and emergency-response plans.

Natural disasters in developing Asia, 2000–2010

	Earthquake		Flood		Storm		Drought		Epidemic
	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths
Central Asia	74,965	5.6	5,910	10.5	727	1.6	180	0.8	3,708
East Asia	91,003	130.9	9,302	66.6	5,582	73.4	134	10.8	769
Pacific	59	0.0	56	0.1	270	0.1	0	0.0	381
South Asia	73,221	6.9	18,668	19.7	6,856	2.9	20	1.5	2,964
Southeast Asia	183,979	12.8	7,701	5.8	147,457	9.4	0	0.7	2,034
Total	423,227	156.3	41,637	102.7	160,892	87.4	334	13.8	9,856

Source: EM-DAT, The International Disaster Databases, Centre for Research on the Epidemiology of Disasters. http://www.emdat.be/database (accessed 16 March 2011).

1.2.3 Macroeconomic impacts of oil and food price shocks: Simulation results

The impact of higher global oil and food prices on developing Asia were simulated using the Oxford Global Economic model.[1] The model was used to generate projections of two key economic variables—GDP growth and consumer price inflation—in 10 regional economies listed in Box figure 1. The simulations help to quantify the short-run effects of changes in macroeconomic variables.

The model assumes that the region's monetary authorities will gradually tighten monetary policy over the next 2 years in response to the inflation impact of higher oil and food prices. Monetary adjustment is motivated by inflation concerns, but it will have a negative effect on private demand, especially investment, and hence growth.

To trace the potential impact of the rise in global oil and food prices on developing Asia in 2011 and 2012, the following scenarios were run. To simulate effects of international price spikes, global oil prices were increased temporarily by 30% in 2011 (from the 2010 level) and then allowed to fall back by 3% in 2012. This would correspond to a scenario where market fears about Middle Eastern supply subside as the Libyan civil conflict moves toward some sort of resolution.

Similarly, global food prices were increased temporarily by 30% in 2011 (from the 2010 level) and then reduced by 5% in 2012. This corresponds to a scenario where temporary weather-related production shortfalls are the immediate catalyst of the price surge.

The two shocks are examined separately, and as a joint shock. There is some relationship between oil and food prices: higher oil prices raise production costs, such as fertilizers, irrigation, and transport. The effects of the shocks are compared with the baseline of oil and food prices remaining at their 2010 levels.

The model simulations show that oil and food price shocks could dent developing Asia's growth but do not derail the robust momentum of its recovery. An oil price shock has a visibly bigger effect. This is plausible since the region's dependence on imported oil is substantially higher than its dependence on imported food. An oil price shock cuts the region's growth by 0.5 percentage points in 2011 and 0.7 percentage points in 2012.

The impact of the food price shock retards the region's growth by 0.1 percentage points in 2011 and 0.2 percentage points in 2012.

Predictably, combining the oil and food price shocks magnifies their impacts. Together they knock off 0.7 percentage points and 0.8 percentage points from growth (Box figure 1). Singapore and the Philippines will be most adversely affected in 2011, India and Malaysia in 2012.

Oil and food price shocks add substantially to the region's inflation in the short run. An oil price shock has the bigger impact, lifting it by 1.0 percentage points in 2011 and 0.6 percentage points in 2012. A food price shock lifts regional inflation by 0.7 percentage points and 0.6 percentage points. Although food prices have a more direct effect on consumer price inflation than oil prices, pass-through from global prices to local prices may be higher for oil due to higher import dependence.

Higher oil and food prices together add 1.7 percentage points to inflation in 2011 and 0.9 percentage points in 2012 (Box figure 2). The projected impact will be highest in India and Singapore in 2011, where inflation will rise by more than 2 percentage points each. The impact for 2012 will be less than 1 percentage point in most of the 10 economies.

1 Changes in GDP growth rates due to joint oil and food shocks

Source: ADB estimates.

Click here for figure data

2 Changes in CPI inflation due to joint oil and food shocks

Source: ADB estimates.

Click here for figure data

Overall, the results indicate that an oil price shock would have a bigger impact on developing Asia's short-run macroeconomic performance than a food price shock. This is true for both inflation and, particularly, growth. Such results stem from the region's greater dependence on imports for oil than for food. Also, the two shocks would have a bigger effect on inflation than on GDP growth. In light of the region's robust recovery in 2012 and incipient inflation pressures, the results further strengthen the case for stepping up vigilance on inflation.

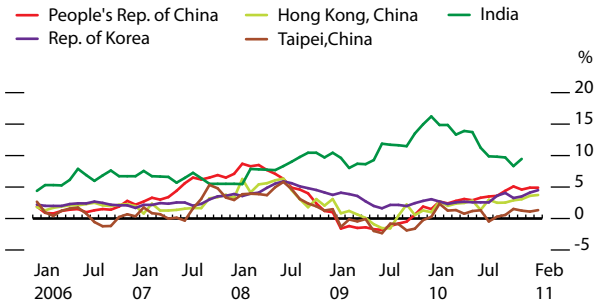
1. The model uses a macroeconometric approach that provides both forecasting and policy analysis tools. It allows significant cross-country differences in model structures but applies the same functional form of equations across countries, where possible. As a general equilibrium model, it traces the economywide effects of exogenous shocks and allows for endogenous monetary policy responses to shocks. See http://www.oef.com/OE_FA_Display_Frm.asp?Pg=GlobMod&Txt=Economic%20Models.

Inflation as a growing concern

Economic growth in Asia has been robust but it has been paced by rising inflation, sparking worries about its sustainability as this combination signals overheating. Figures 1.3.1 and 1.3.2 display year-on-year aggregate consumer price inflation in 11 developing Asian economies in the last 5 years. In virtually all cases, inflation since the global crisis is back on a rising trend, and is comparable to its precrisis rate.

At this stage, inflation in Asia may not yet be a serious problem, though it may become one. Growing uncertainties from tensions in the Middle East as well as the recent natural disaster in Japan and its consequent nuclear disruption raise the risks for higher prices of oil and commodities. This tendency intensifies pressures for further inflation hikes in Asia, requiring policy makers to pay greater attention to it. If inflation is allowed to accelerate further, it could threaten to derail growth in the region.

1.3.1 Inflation trends, East Asia and India



Source: CEIC Data Company (accessed 10 March 2011).

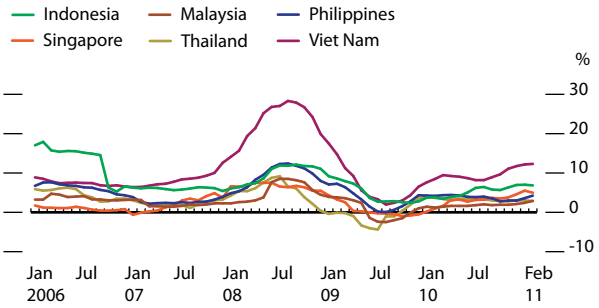
Click here for figure data

Why inflation matters for developing Asia

One reason why the region should now focus on inflation is the impact of rising global commodity prices on domestic prices. The oil price surge is a global external shock, largely beyond Asia's control. Soaring global oil prices often lead to higher domestic retail fuel prices, and broadly to higher production costs and overall prices.

The impact of higher global food prices on overall domestic prices can be substantial since food accounts for a large share of Asia's consumption basket (Table 1.2.1 above). In some countries, food accounts for at least 30% of the consumer price index. Food price inflation in these countries has reached double-digit levels in recent months, driving up general inflation.

1.3.2 Inflation trends, Southeast Asia



Source: CEIC Data Company (accessed 10 March 2011).

Click here for figure data

A key factor why inflation should be a main priority for the region's policy makers is its impact on poverty and inequality. In the case of high food prices, the poor are especially vulnerable since they spend a large portion of their income on food. Inflation, especially food price inflation, can push those who subsist within the margins or just above the poverty line into poverty. Recent estimates indicate that a 10% increase in domestic food prices would raise the number of poor in developing Asia by about 65 million, a 7.2% increase in the number of poor (Box 1.3.1). Heightened inflation can thus dilute the region's hard-won gains in poverty reduction.

By disproportionately harming the poor, inflation not only worsens poverty but can exacerbate inequality (Easterly and Fischer, 2001; Romer and Romer, 1998). Unlike the rich or the nonpoor, those living in poverty typically lack the financial assets and human capital that can protect them against the effects of inflation. In addition, since a large portion of

1.3.1 The likely poverty impact of global food inflation

A shock in the global food prices would have a direct adverse impact on poverty as the poor tend to spend more of their income on food. According to ADB (2011), about one-third of an increase in global food prices is transmitted to local food prices in the region. This means that the recent 30% or so rise in global prices will raise local prices by about 10%.

The same study estimates that a 10% rise in domestic food prices in developing Asia risks creating an additional 64 million people living on less than $1.25 per day, or pushing up the percentage of poor by about 2 points (Box table). The impact is even larger for a 20% and 30% increase in local food prices. Quite clearly, the impact of higher food prices on the region's poverty is substantial.

Given the growing frequency with which global food price shocks are hitting the region, policy makers should pursue short- and long-term policy responses to strengthen their food and energy security. A wide range of policies would better prepare developing Asia for a world of high and volatile global commodity prices.

In addition to domestic policy responses such as promoting agricultural investment and improving the domestic food supply chain, collective action can lessen vulnerability. National, regional, and global policy responses and coordination will help the region better cope with the impact of food price surges and volatility.

Impact of domestic food price increase on poverty for developing Asia

	Poverty before price increase	Poverty after food prices increase by:		
		10%	20%	30%
Proportion of poor (%)	27.1	29.0	30.9	32.9
Number of poor (million)	903	968	1,032	1,097
Change in number of poor (%)		7.2	14.3	21.4

Notes: Calculations are based on a $1.25-a-day poverty line. The estimates of poverty impact have been derived using the price elasticity of poverty, which indicates the percentage increase in poverty when food prices increase by 1%. This elasticity was estimated for both headcount ratio and poverty gap ratio for each of the 25 countries in Asia and the Pacific using the latest POVCAL database.
Source: ADB (2011).

Source

ADB (2011).

their income is spent on food, rising food prices mean they will have less for spending on other essentials. This limits their opportunities to engage in more productive activities. By narrowing economic opportunities, especially among the poor, inflation can undermine efforts to promote inclusive growth, which spreads the benefits of growth to the broader population.

High inflation is a direct threat to stable and inclusive growth since rising domestic prices can lead to social tensions. Indeed, rapidly soaring domestic prices have triggered social unrest in a raft of countries. For example, in 2008 rising soybean prices triggered riots in Indonesia and soaring rice prices in Bangladesh sparked large protests. More recently, in December 2010, India was hit by riots over high onion prices. Outside Asia, escalating food prices led to riots in Algeria and Tunisia.

In the case of the PRC, policy makers recognize high inflation as a risk to building a "harmonious society," a strategic policy shift geared toward spreading the benefits of economic development to maintain social harmony and stability. The authorities are pushing for more inclusive growth against the backdrop of inflation pressures and growing social problems. Since inflation is a major issue, the country's Economic and Social Development Plan for 2011 will focus on maintaining stable prices.

Looking ahead, there is a growing risk that nominal wage inflation will cause a wage–price spiral in developing Asia. The process may begin with workers demanding higher nominal wages to maintain or increase their real wages in the face of higher prices, which eventually forces firms to increase prices to protect their profit margins. A major cyclical driver of nominal wage increases is strong aggregate demand due to the region's

robust and speedy recovery. A more structural factor is that developing Asia, labor abundant until now, may be reaching the end of surplus labor.

Surplus labor enables economies to maintain wages at relatively low and stable levels. As the surplus labor dissipates, however, developing Asia will have to grapple with rising wage pressures. The shift in Asia's demographic pattern from high to low fertility rates and population growth point to a gradual loss in surplus labor. Such a shift has led to a decline in the growth of the working-age population (Figure 1.3.3).

In the case of the PRC, the turning point is set to arrive after 2015. Between the mid-1980s and the late 1990s, about 30%–40% of the country's agricultural workers were considered surplus labor. Given demographic shifts and transfer of labor from agriculture to nonagriculture and from rural to urban areas, surplus labor has significantly declined (Cai, 2011). This decline, along with strong demand due to high economic growth, has increased the pressure for higher wages. Indeed, trends in 2000–2008 indicate fast-rising nominal wages in the PRC, averaging about 15% a year (Figure 1.3.4).

On the demand side, robust economic growth throughout Asia in 2010 seems to have pushed aggregate demand to catch up with, if not exceed, its potential output level by the start of 2011. The output gap has recently been positive in many countries, and is increasingly so (Figures 1.3.5 and 1.3.6). This suggests that countries have fully recovered from the recent crisis and are back to prior modes of operation with all their challenges, including labor market tightness (which could push wages higher) and domestic inflation pressures.

As demand pressures are already in play in most Asian economies, normal monetary policy operations are back. Given the mixed nature of Asia's recent inflation pressures, however, relying solely on monetary policy to curb inflation may have limitations since it will not be very effective to control cost-push inflation.

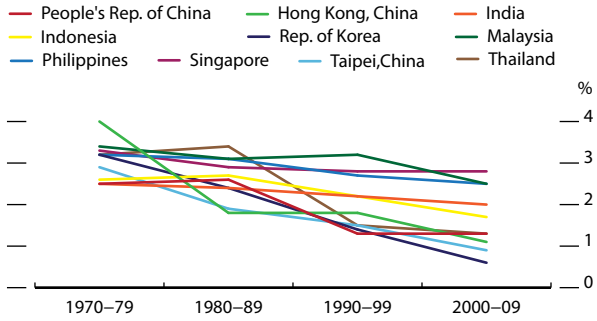
Monetary policy needs to react appropriately to inflation pressures in the region as it manages not only current inflation but also its expectations. If current inflation pushes up expectations, monetary policy should move immediately, but appropriately. This shift is required to signal that the monetary authorities will not be easy on future inflation. The move also has to be credible, and so has to be based on its likely impact on the economy in general.

Policy responses

To cope with international commodity price rises, most Asian economies have shown greater willingness to let their currencies appreciate, particularly after June 2010 (Figure 1.3.7).

In addition, authorities around the region have imposed tariff-relief measures to reduce the burden on prices for

1.3.3 Working-age population growth



Note: Refers to ages 15–64.

Sources: CEIC Data Company; World Bank. World Development Indicators online database. http://databank.worldbank.org (both accessed 16 March 2011).

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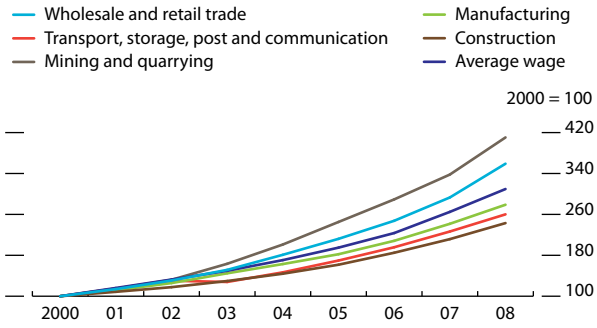
1.3.4 Average wage in the People's Republic of China



Source: CEIC Data Company (accessed 16 March 2011).

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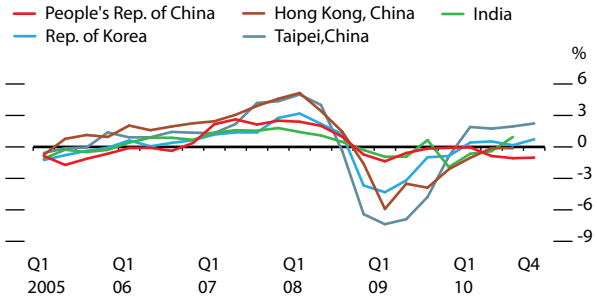
1.3.5 Output gaps, East Asia and India

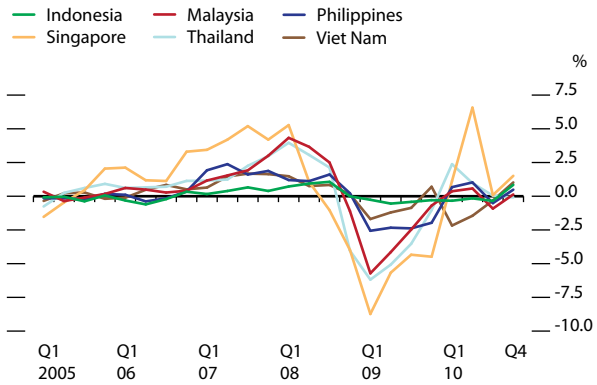


Note: All the gaps are calculated as the relative difference between (X12 seasonally adjusted) actual output and its Hodrick-Prescott–filtered trend.

Source: ADB estimates.

Click here for figure data

1.3.6 Output gaps, Southeast Asia



Note: All the gaps are calculated as the relative difference between (X12 sesonally adjusted) actual output and its Hodrick-Prescott–filtered trend.

Source: ADB estimates.

Click here for figure data

imported food components, with some even introducing export bans to guarantee the adequacy of domestic food supply (Table 1.3.1). The success of these measures, however, varies by country. For example, domestic food price inflation still dominates consumer price inflation in Indonesia and the Republic of Korea, but not the Philippines.

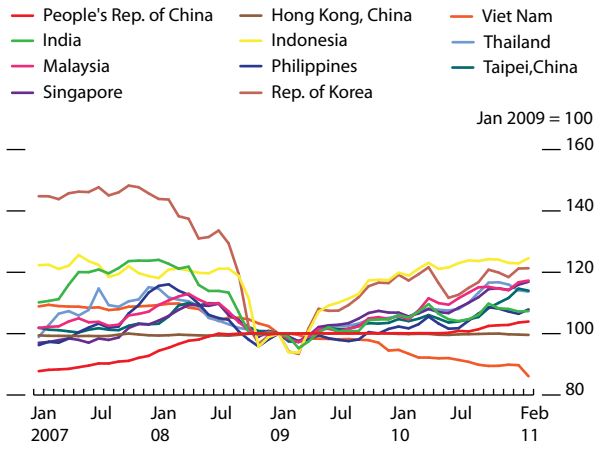
With food inflation in some countries still high, even after currency appreciation and tariff reductions, there may also be domestic factors propping up the price of food. Therefore, dealing with high domestic food inflation by addressing the external problems may not be enough. Resolving domestic hindrances like problems in the domestic supply chain and infrastructure shortfalls may also be required.

Responding to the stronger than expected recovery and recent inflation trends, emerging markets around Asia have started their monetary tightening cycle, with gradual increases in their benchmark interest rates, though at different speeds (Figure 1.3.8). Viet Nam, India, and Malaysia were among the first, in the first half of 2010, while Indonesia and the Philippines kept their benchmark rate unchanged, with Indonesia beginning to lift it only in February 2011 and the Philippines in March, pointing to a varied sense of urgency among monetary authorities.

Countries have also taken other tightening measures to manage the growth in aggregate liquidity that was partly attributable to the remnants of the massive liquidity expansion during the crisis. The PRC, India, and Indonesia, for example, raised their reserve requirements in 2010 to absorb the liquidity effect of expansionary monetary policy during the crisis. Malaysia and Viet Nam have also indicated their intention to follow suit in 2011 as a preemptive measure to contain excessive buildup of liquidity in the domestic financial system.

The task of managing high levels of liquidity in Asia is complicated by a strong domestic credit expansion following the region's rapid recovery, and huge net private capital inflows chasing higher returns in a region with stronger economic fundamentals and

1.3.7 Exchange rate index relative to the US dollar



Source: ADB estimates based on data from CEIC Data Company (accessed 15 March 2011).

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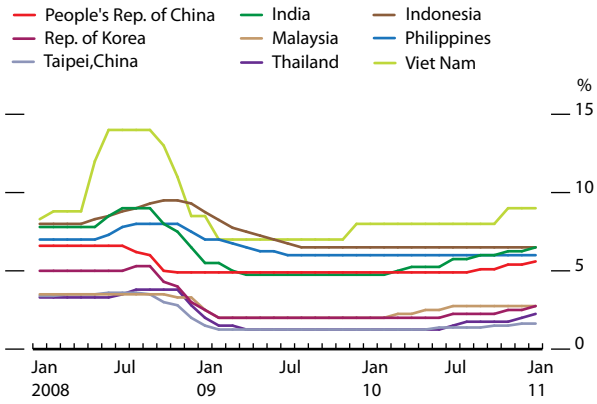
1.3.8 Benchmark rates in selected Asian economies



Source: CEIC Data Company (accessed 15 March 2011).

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Table 1.3.1 Actions taken in response to soaring international food prices

Country	Response to food price increases
Indonesia	Duties suspended on food-related items: products and materials, raw materials for animal feed and fertilizers (24 January–31 December 2011)
Korea, Rep. of	Tariff on flour cut from 4.2% to 2.5% (January–June 2011)
	Tariffs on corn, soymeal, and 32 other items to be reduced from 1% to 0% (March–December 2011)
	Tariff-free import limit for pork raised from 50,000 tonnes to 110,000 tonnes; for powdered milk raised from 21,000 tonnes to 30,000 tonnes (started February 2011, no specific duration)
Pakistan	Exports of onions via land banned
Philippines	Tariff lifted on refined sugar; zero tariff on milling wheat (29 January–31 December 2010)
Sri Lanka	Tariff on milk powder cut (amount not specified; beginning 24 January 2011)

Source: ADB staff compilation.

more favorable monetary settings than most of the rest of the world. Some countries have therefore imposed limited and targeted capital controls to reduce inflows of short-term capital (Table 1.3.2).

Table 1.3.2 Selected capital control measures in developing Asia

Instrument	Strengths	Weaknesses	Recent examples
Tax measures	Targeted measures can be more easily calibrated to size of risks	Calibration can be difficult in practice	*Korea, Rep. of*: Reimposition of 14% withholding and 20% capital gains taxes on foreign purchases of government bonds (18 November 2010) *Thailand:* 15% tax on interest income and capital gains earned by foreign investors (12 October 2010)
Minimum investment periods	Increase incentives to invest in longer-term assets	Reduce but do not eliminate the flow	*Indonesia:* 1-month minimum holding period for central bank money market certificates (16 June 2010)
Quantitative limits	Countries can directly control how much capital is let in	Allocation and monitoring of allowance can be difficult	*China, People's Rep. of*: Limits on Hong Kong, China banks' net open positions and ability to access yuan through the mainland's foreign exchange market (3 January 2011) *Indonesia:* Short-term external bank borrowing limited to 30% of capital (29 December 2010) *Korea, Rep. of:* Cap on banks' foreign exchange derivatives books (20 December 2010)

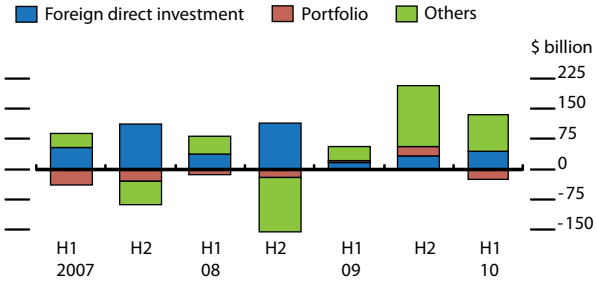
Source: Institute of International Finance (2011).

Figure 1.3.9 illustrates the amount of capital flows in eight developing Asian economies. Net inflows have been high since the second half of 2009 largely because since the crisis, most of Asia has been performing better than industrial economies, promoting greater returns differentials. Highly expansionary monetary policy stances in industrial economies, particularly quantitative easing in the US, has also supported the flow of capital to the region as some of the resultant liquidity is finding its way into emerging economies (Box 1.3.2).

More liquidity can, of course, buttress economic activity. Too much, however, can be damaging, tending to overheat an economy as it pushes demand ahead of what the economy can potentially supply. Unless managed appropriately, overabundant liquidity can destabilize an economy, and render a country's finance sector more vulnerable to a crisis.

The issue becomes thornier if some of the liquidity comes from short-term external flows, which can be volatile. This component has been quite significant in the composition of recent capital inflows to Asia. Figure 1.3.9 suggests that net inflows, in the form of portfolio and other flows through banking channels, have dominated the net influx of capital in the last 2 years. Not only are they potentially destabilizing for Asia's finance sector in general, but they can also contribute to speculative asset bubbles and inflation.

1.3.9 Net capital flows, emerging Asia



Note: Based on data for People's Rep. of China; Hong Kong, China; Indonesia; Rep. of Korea; Philippines; Singapore; Taipei,China; and Thailand.

Source: ADB estimates based on data from CEIC Data Company (accessed 22 March 2011).

Click here for figure data

1.3.2 Impact of quantitative easing in the United States on Asia

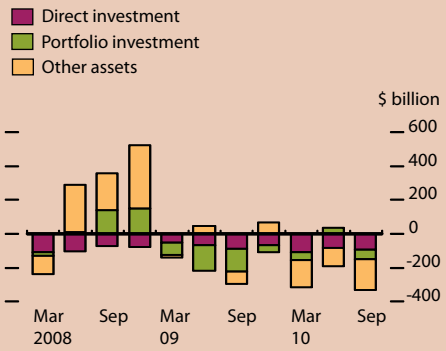
The adoption of quantitative easing by the United States (US) Federal Reserve in early 2009 aroused widespread concern in Asia and elsewhere over its possible impact on weakening the US dollar and stimulating capital outflows to emerging economies and possibly stimulating inflation pressures.

Quantitative easing consists in the Federal Reserve's two major programs of outright purchases of US Treasury notes and bonds, as part of its Large-scale Asset Purchases program, which includes agency securities and mortgage-backed securities. The first block of purchases of $300 billion of Treasury coupon securities was announced on 18 March 2009 and the first operation was conducted a week later. Purchases continued at a pace of about $10 billion a week over the subsequent 5 months, and then slowed through the end of October.

The second tranche of purchases of $600 billion of Treasuries was announced on 3 November 2010, and is expected to be completed by end-June 2011.

How did US capital outflows react during this period? The box figure shows that US gross outward portfolio investment in April–September 2009 returned to a large outflow of $280 billion, about double the quarterly rate of January–March of $73 billion, and a reversal of large withdrawals of capital the previous year. Other private assets showed a smaller outflow of $24 billion. This suggests that the liquidity created by the purchase operations leaked overseas.

Private gross capital outflows, United States



Source: CEIC Data Company (accessed 22 March 2011).

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The latest episode of increased US capital outflows corresponds to the return of high net inflows in Asia in the second half of 2009.

Although it is difficult to disentangle these flows from the general increase in economic optimism at the time, at least part of the leakage from quantitative easing does seem to have been channeled through to Asia.

Policy consistency and the dilemma for Asian policy makers

Managing current inflation pressures is not easy for Asian policy makers. Increasing benchmark policy rates to fend off potential demand pressures on inflation would prompt wider interest rate differentials between Asia and industrial nations, hence potentially attracting further volatile capital inflows. Such inflows would compound the difficulties of handling domestic demand pressures by creating greater liquidity in the system. They would also increase risk of capital reversals that could destabilize the finance sector.

The large inflows of capital to Asia will also increase pressure for Asian currencies to appreciate. Allowing the exchange rate to adjust would cushion the economy from the effects of excessive capital inflows. In fact, greater exchange rate flexibility is a sustainable response to a permanent increase in capital inflows by inducing a fundamental revaluation of domestic assets relative to foreign assets. Such flexibility introduces two-way risks for investors, hence potentially discouraging speculative capital inflows. Appreciation also helps fend off inflation pressures from increases in international commodity prices by keeping the local currency price of these goods down.

Appreciating their currency, however, may not appeal to policy

makers who are concerned about the impact it would have on their export sector, particularly as the resurgence in exports supported the rapid pace of economic recovery in Asia. A unilateral currency appreciation is often undesirable since it hurts the export sector immediately by reducing the economy's international price competitiveness.

Avoiding appreciation in these circumstances requires policy makers to intervene in foreign exchange markets, but this raises two immediate issues. First, continued interventions could trigger a "currency war," as countries strive to maintain low exchange rates vis-à-vis their neighbors.

Second, interventions to avoid appreciation could be self-defeating. They will have an expansionary effect on domestic liquidity, hence further increase domestic inflation pressures, which would also damage international competitiveness in the longer run through real exchange rate appreciation.

Of course, the authorities may attempt to sterilize the expansionary domestic liquidity effects by reducing the domestic credit component of their monetary base. Such sterilization is, however, often only effective in the short run, difficult to execute, and costly to implement. Foreign exchange intervention against nominal appreciation therefore should not be a first-recourse option.

The nature of capital inflows is also a reason that Asian policy makers may hold back from relying only on exchange rate appreciation to deal with current inflows. Exchange rate flexibility may be an effective tool against a sustained surge of capital inflows. But using only this approach if the inflows are temporary may involve side effects to the economy. As the flow of capital reverses, the exchange rate will need to adjust to the opposite direction. With temporary capital flows, this implies high-frequency currency fluctuations, creating more problems since they tend to invite more speculative attacks.

Imposing selective and carefully designed temporary capital control measures on inflows may therefore be an option. With such measures in place, emerging Asian economies may gain room for managing their domestic inflation without exerting too much pressure on exchange rate appreciation. The effectiveness of capital control measures themselves, however, is debatable. Not only do they require a high degree of administrative capacity to implement, but they also should be exercised temporarily, as they tend to lose their effectiveness over time (Kawai and Takagi, 2008).

The above discussions provide possible policy responses to dealing with the problem of large capital inflows that is accompanying the quest to curb inflation pressures in Asia. Once a country can identify whether its influx of capital is permanent or temporary, it can take appropriate steps more easily. Unfortunately, such identification is difficult, so countries will have to decide on the nature of the problem while taking the necessary actions.

Possible solutions

The appropriate policy response for dealing with capital inflows therefore differs by the specific nature of the problem. The state of a country's current account imbalances and the alignment of its exchange rate with

respect to its economic fundamentals offer a guideline for determining the appropriate steps.

Letting the exchange rate move more flexibly to avoid further disruptive capital inflows may be a better policy for countries that have undergone persistent current account imbalances and misalignment between the exchange rate and fundamentals. It may help these countries to realign the exchange rate to be more in line with fundamentals, hence promoting sustainable economic growth and stability. In contrast, countries without such symptoms may be better relying more on temporary policies, such as capital controls, that fend off excessive capital inflows. This policy, however, should not be used permanently as it will be unsustainable over the long run.

How to measure the extent to which a country falls under each category is complicated. It is also politically sensitive. No commonly agreed measures or guidelines have been developed. This highlights the need for countries to coordinate setting their policies, particularly when they deal with potentially disruptive capital flows. Any unilateral act to let the currency move more flexibly, or even to impose capital controls, can result in an unfavorable situation for the country taking that step, hence potentially leading to some kind of "prisoners' dilemma" type of solution.

Fortunately, G20 members have recently started efforts to work on introducing indicative guidelines that can be used to assess a set of indicators, including a country's current account imbalance by considering exchange rate and other macroeconomic policies and indicators. Such guidelines will be useful for differentiating countries. The guidelines will promote adoption of more appropriate policy by countries dealing with capital flows in a more coordinated manner, hence potentially being more effective. Asia has many lessons to offer that would be useful in introducing these practical guidelines.

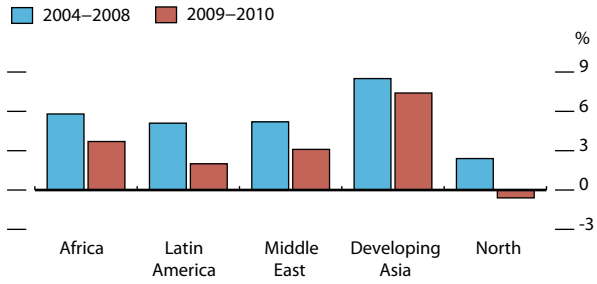
Rising inflation pressures coupled with potentially destabilizing capital inflows is an immediate challenge facing policy makers in the region. Another issue, though, is how to maintain regional growth in light of expected sluggishness in the major industrial countries. Looking to other developing-country markets may be promising.

Solid rebound in the non-Asian developing world

The world economy is in the midst of a two-speed recovery from the recent global crisis—a recovery in which developing countries are rapidly rebounding while industrial countries are still struggling to find their feet. The earlier analysis looked closely at developing Asia, but what about Africa, Latin America, and the Middle East?

In Africa, growth declined from an average of 5.8% in 2004–2008 to 2.7% in 2009 but bounced back to 4.7% in 2010. Latin America suffered a 1.8% contraction of output in 2009, from an average of 5.1% in 2004–2008. The region rebounded sharply, however, growing by 5.7% in 2010. In the Middle East, growth fell sharply from an average of 5.2% in 2004–2008 to 2.1% in 2009 but recovered strongly to 4.1% in 2010. The pattern of crisis and recovery is broadly similar across the three regions—a sharp deceleration followed by a robust upturn—and to that of developing Asia (Figure 1.4.1).

1.4.1 Average GDP growth



Source: ADB calculations based on data from International Monetary Fund. *World Economic Outlook,* October 2010; World Development Indicators online database (accessed 28 January 2011); and *Asian Development Outlook* database.

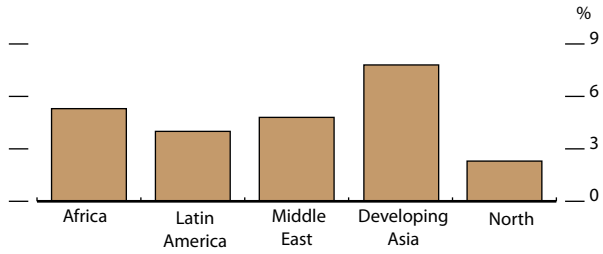
Click here for figure data

There have been a number of common factors behind the relatively quick recovery of Africa, Latin America, and the Middle East. Above all was the turnaround in the external environment and normalization of global trade. In particular, the sharp rebound in global commodity prices benefited all three regions since many countries in the non-Asian developing world are major commodity exporters. Another common driver of the recovery has been accommodative fiscal and monetary policies, which supported demand and growth. In some countries, an improved policy environment facilitated the stimulus. For example, many Latin American countries have pursued more prudent fiscal and monetary policies since the late 1980s.

At the same time, there were a number of differences across the three regions. For example, Africa, Latin America, and the Middle East differ substantially in the level of their integration into the global financial system. This explains why the national financial systems of Africa suffered relatively little damage from the crisis, and the region's financial markets continued to function. In contrast, the crisis had a major impact on the financial stability of Latin America due to its high degree of integration into that system. This helps to explain why the region's output contracted in 2009.

Despite such differences, the non-Asian developing world has by and large recovered swiftly and robustly from the global crisis. Developing Asia leads the global recovery but the South as a whole has outperformed the North since the start of the crisis and is projected to continue to do so in the near future (Figure 1.4.2).

1.4.2 Projected GDP growth, 2011–2012



Source: ADB calculations based on data from: International Monetary Fund. *World Economic Outlook,* October 2010; World Development Indicators online database (accessed 28 January 2011); and *Asian Development Outlook* database.

Click here for figure data

The South has fared better during the crisis primarily because the nature of the crisis was fundamentally different for the two blocs.

For the North, in particular the US but also for the EU to some extent, the crisis was an internal financial crisis. These typically have lingering adverse effects. Past experience suggests (IMF, 2009) that recessions caused by financial crises tend to be more severe and protracted than crises arising from other shocks.[2] At the same time, recovery from financial crisis–related recessions tends to be slower because private consumption and investment remain depressed longer as firms and households deleverage and rebuild their balance sheets.

In contrast, the crisis for the South was largely an external trade shock with only temporary effects, primarily on the real economy. For such a shock, the economy gets back on its feet as soon as external demand recovers. This helps to explain why the South has roared back as global trade revived along with the recovery of the world economy. In short, the asymmetric North–South recovery is in part a consequence of the asymmetric nature of the global crisis—financial (North) and trade (South).

The South's limited financial links with the North and its consequent relative immunity to the financial contagion was, however, largely the consequence of its own financial underdevelopment. While this protected the South by chance this time around, it carries serious risks of its own, as evident in the Asian financial crisis of the late 1990s. Underdeveloped capital markets may also hinder the allocation of capital to its most efficient uses, thus inhibiting long-run growth. More generally, the South faces some serious challenges and risks to its own growth, even in the short term, and its continued robust growth is far from guaranteed.

But even with such risks and challenges, the South on balance is better positioned than the North to sustain growth in the short run for the reasons outlined above. Long-term structural factors such as the law of diminishing marginal returns to capital and technological catch-up also strongly favor the South, which still remains far poorer than the North.

Still, there is nothing automatic about the process: developing Asia must continue pursuing closer trade, investment, and other economic links with other parts of the South, an issue examined in Part 2. The fact that the non-Asian developing world's improved performance in recent years is partly due to stronger fundamentals and policies further reinforces the case for seeking closer ties.

While those links are underdeveloped at present, the global crisis highlighted the large potential for mutual benefit. For example, developing Asia (including the PRC) is likely to have been a major source of growth in global demand for commodities, a key export for the non-Asian developing world. Broader and deeper South–South links will not only benefit the South, but also the North and the world economy by strengthening the South.

Endnotes

1 This section is based on ADB (2011).

2 The definition of a financial crisis is based on Reinhart and Rogoff (2009) and Kaminsky and Reinhart (1999).

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