

HIGHLIGHTS

- Developing Asia remains broadly on track to reach the growth forecasts published in *Asian Development Outlook 2014*. Despite slower-than-expected expansion in the United States in the first quarter of this year, this Supplement maintains the regional growth forecasts at 6.2% in 2014 and 6.4% in 2015.
- Growth in the People's Republic of China is moderating in line with earlier expectations and should achieve the forecast 7.5% in 2014 and 7.4% in 2015. East Asia as a whole is similarly paced to meet growth projections of 6.7% in both 2014 and 2015.
- With parliamentary elections over, India is expected to pursue long-delayed reform. India's growth forecast is maintained at 5.5% in fiscal year 2014 but upgraded to 6.3% in FY2015 as expected reform bears fruit. With this improved outlook for the largest economy in South Asia, expansion in the subregion is expected to reach 5.4% in 2014 and pick up to 6.1% in 2015.
- Growth in Southeast Asia softened in the first half of 2014 largely because of country-specific factors in Indonesia, Thailand, and Viet Nam. The outlook for the subregion's five largest economies is revised down to 4.8% in 2014, dragging the subregional forecast to 4.7%, but should rebound in 2015 to 5.6%, or 5.4% across Southeast Asia.
- Declining food prices and relatively stable oil prices are keeping developing Asia's inflation in check at 3.5% in 2014 and 3.7% in 2015.

STABLE GROWTH OUTLOOK FOR DEVELOPING ASIA

Outlook for the major industrial economies

As the United States (US) bounces back from weather-related contraction in the first quarter, growth in the gross domestic product (GDP) of the major industrial economies in 2014 should exceed the 1.0% rate recorded in 2013. Softer US growth has been somewhat offset by Japan's robust first quarter performance, while the euro area has generally met expectations. In aggregate, the major industrial economies are anticipated to expand by 1.5%, a downward revision from the 1.9% forecast in *Asian Development Outlook (ADO) 2014*, before picking up to 2.2% in 2015 (Table 1).

Table 1 Baseline GDP growth (%)

	2013	2014		2015	
		ADO 2014	Revised	ADO 2014	Revised
Major industrial economies ^a	1.0	1.9	1.5	2.2	2.2
United States	1.9	2.8	1.9	3.0	3.0
Euro area	-0.4	1.0	1.0	1.4	1.4
Japan	1.5	1.3	1.5	1.3	1.1

ADO = Asian Development Outlook, GDP = gross domestic product.

^a Average growth rates are weighed by gross national income, Atlas method (current US dollars).

Sources: Asian Development Bank. 2014. *Asian Development Outlook 2014*. Manila; ADB estimates.

The US was hit by an unusually severe winter, causing GDP to contract in the first quarter of 2014 by a seasonally adjusted annualized rate (saar) of 2.9%. Relatively strong consumption growth of 1.0% could not offset the large drop in inventories, which subtracted 2.0 percentage points from overall GDP growth, or of slowing

ADB's Regional Economic Outlook Task Force led the preparation of the revised outlook for this ADO Supplement. The Task Force is chaired by the Economics and Research Department and includes representatives from the Central and West Asia Department, East Asia Department, Pacific Department, Office of Regional Economic Integration, South Asia Department, and Southeast Asia Department.

2 ASIAN DEVELOPMENT OUTLOOK SUPPLEMENT

exports, which deducted a further 1.2 percentage points. However, recent monthly data point to a marked turnaround in the second quarter. After peaking in May, the Institute for Supply Management's manufacturing index fell back by 0.1 points to 55.3 in June, while its industrial production index retreated from 61.0 to 60.0. The indexes both remain above 50, denoting increased manufacturing and production. The consumer confidence index rose to 85.2, its highest since January 2008, indicating that the spending public is more upbeat about the health and prospects of the US economy.

Steady nonfarm employment growth, averaging 1.7% from January to June, helped push unemployment down from 6.6% to 6.1% in the same period. Critically, the duration of unemployment has similarly shortened, from an average of 36.6 weeks in 2013 to 33.5 weeks in June. Although creeping upward, inflation remains stable, averaging 1.7% for the year through May.

Noting the economic rebound and stable inflation outlook, the US Federal Reserve is further scaling back its monthly asset purchases. From July, it will add \$15 billion per month to its holdings of mortgage-backed securities and \$20 billion to its holdings of longer-term Treasury securities—or \$5 billion reductions in its monthly purchases of each. While monetary policy will remain highly accommodative in 2014, the federal funds rate is likely to be increased in mid-2015, slightly earlier than assumed in *ADO 2014*.

The US economy looks set to continue to recover, but in light of the first quarter contraction the GDP forecast for the full year is adjusted downward to 1.9% from 2.8% in *ADO 2014*. While the growth forecast for 2015 is unchanged at 3.0%, should inflation pick up faster than currently anticipated, the Federal Reserve may raise interest rates sooner than mid-2015, which could slow growth.

The euro area expanded by a saar of 0.8% in the first quarter of 2014, its fourth consecutive quarter of growth. Strong growth in Germany and Spain was offset by flat growth in France and contraction in Italy. Breaking down GDP into its expenditure components paints a lackluster picture, as investment contributed only 0.1% to growth and private consumption 0.4%. The strong euro weighed on exports. With imports expanding at a faster rate than exports, external demand was a net drag on euro area growth. Government consumption and increasing inventories were the main growth drivers in the first quarter.

While some indicators picked up in the first few months of 2014, their recovery seems to be faltering. The composite purchasing managers' index remains above 50, which indicates economic expansion, but the decline from 53.5 in May to 52.8 in June points to some sluggishness in the second quarter. Industrial production increased by 0.8% in April but then contracted by 1.1% in May. The slight reduction in unemployment to 11.6% since April helped to bolster consumer confidence and retail sales, but the latest data for these indicators show a loss of momentum that may undermine consumer demand.

The harmonized index of consumer prices fell from 0.7% in April 2014 to 0.5% in May. The risk of deflation prompted the European Central Bank to announce a series of policy changes in June. The central bank reduced the refinancing rate that had been at 0.25% since November 2013 to 0.15%, brought the deposit rate below zero to -0.1%, and initiated unconventional measures such as a targeted long-term refinancing operation and a program to purchase asset-backed securities. The measures seek to stimulate euro area growth by reducing interest rates and increasing liquidity in the banking sector to spur lending.

The recovery in the euro area appears to be slow and tentative. High unemployment, subdued credit conditions, and a strong euro keep deflationary pressure strong and continue to pose a risk to growth. The overall outlook for the euro area remains the same as in *ADO 2014*, which forecast GDP growth at 1.0% in 2014 and 1.4% in 2015.

Japan grew by a robust saar of 6.7% in the first quarter 2014, driven by both private consumption and investment. As expected, private consumption surged by a saar of 9.2% in the first quarter in advance of the value-added tax hike, contributing 5.5 percentage points to first quarter growth. Improved corporate profits and inflationary expectation since last year appear to have pushed firms to resume fixed investment. Private investment contributed 2.7 percentage points. Weak external demand and slowing government investment tempered the overall growth pace.

The expected sharp drop in consumption in the second quarter was borne out by the nosedive in retail and wholesale trade indices in April. As the effect of the tax hike fades, both private consumption and investment are expected to support growth in the second half of 2014. However, external demand is forecast to be somewhat weak as the moderate pace of growth in developing Asia persists and as strengthening in the major industrial economies, in particular the US, disappoints earlier expectations.

Expansionary monetary policy, one of the three arrows of Abenomics, appears to be pulling Japan out of deflation as intended. Inflation is firmly in positive territory, just above 1% (excluding the effect from the value-added tax hike) as anchored by inflation expectations. Annual headline inflation averaged 1.5% in the first quarter before more than doubling to exceed 3.0% in April and May. Although inflation is on the rise, monetary policy is expected to remain accommodative during the forecast period.

In sum, Japan's stronger performance in the first quarter of 2014 suggests slightly faster growth in 2014, now forecast at 1.5%, up from 1.3% in *ADO 2014*. Given these developments, the value-added tax is expected to be hiked further from 8% to 10% on 1 October 2015, as currently scheduled. Concerns remain regarding the implementation of reform under the third arrow of Abenomics. In June, the government announced its intent to relax immigration regulations to address the labor shortage in construction and to reduce corporate tax rates; both reforms are scheduled to start in 2015, but actual implementation and

feasibility remain uncertain. Reflecting the higher base in 2014, GDP growth in 2015 is now expected at 1.1%, slightly slower than the 1.3% forecast in *ADO 2014*.

Regional economic outlook

Growth outlook

The growth outlook for developing Asia is stable, with the region projected to grow steadily at 6.2% in 2014 and 6.4% in 2015, the same rates envisaged in *ADO 2014*. Slight downward revisions to GDP forecasts for Central Asia, Southeast Asia, and the Pacific are balanced by upward adjustments for South Asia (Table 2).

Table 2 GDP growth, developing Asia (%)

	2013	2014		2015	
		ADO 2014	Revised	ADO 2014	Revised
Developing Asia	6.1	6.2	6.2	6.4	6.4
Central Asia	6.5	6.5	6.3	6.5	6.1
East Asia	6.7	6.7	6.7	6.7	6.7
China, People's Rep. of	7.7	7.5	7.5	7.4	7.4
South Asia	4.7	5.3	5.4	5.8	6.1
India	4.7	5.5	5.5	6.0	6.3
Southeast Asia	5.0	5.0	4.7	5.4	5.4
ASEAN-5	5.2	5.2	4.8	5.6	5.6
The Pacific	4.9	5.4	5.2	13.3	13.2

ADO = Asian Development Outlook, ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product.

Note: **Developing Asia** refers to the 45 members of the Asian Development Bank. **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. **East Asia** comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei, China. **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. **Southeast Asia** comprises the ASEAN-5 (Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam) plus Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Singapore. **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Sources: Asian Development Bank. 2014. *Asian Development Outlook 2014*. Manila; ADB estimates.

In East Asia, moderating growth in the People's Republic of China (PRC) in the first half of 2014 was in line with expectations in *ADO 2014*. Following growth of 7.4% year on year in the first quarter, steady consumption, targeted government measures to stabilize investment, and a pickup in external demand maintained second quarter growth at 7.5%. A broad range of activity indicators have improved since the first quarter. Industrial production expanded by 8.8% in the second quarter, slightly above the 8.7% growth recorded in the first quarter. More rapid expansion of services lifted their growth rate to 8.0% for the first half of the year from 7.8% in the first quarter. Retail sales grew by 10.8% in the second quarter of 2014, pointing to healthy

consumer demand. Real estate indicators, by contrast, signal continued weakness but this is compensated by accelerated infrastructure investment. Overall, the PRC is on track to meet *ADO 2014* growth forecasts of 7.5% in 2014 and 7.4% in 2015.

The growth picture is mixed for the rest of East Asia. First quarter growth accelerated in the Republic of Korea and Taipei, China. The Republic of Korea grew by 3.9% on robust exports and construction, while Taipei, China expanded by 3.1%, supported by solid domestic consumption and exports. However, growth in Hong Kong, China moderated to 2.5%, mainly from weaker exports, while Mongolia decelerated to 7.4% as local currency depreciation dampened domestic demand and foreign direct investment fell drastically. With the PRC forecasts unchanged, the net result of a stronger outlook in Taipei, China and a weaker outlook in Mongolia is that East Asia's growth outlook is unchanged from *ADO 2014*, at 6.7% in 2014 and 2015.

Improving prospects in India, South Asia's largest economy, buoy the subregional growth outlook somewhat. Parliamentary elections in April brought a single-party majority to India's lower house for the first time since 1984, which should provide an opportunity to initiate reforms that proved difficult for coalition governments. The new government outlined a 10-point plan to revive the Indian economy, prioritizing infrastructure and investment reform, the prompt resolution of interministerial issues, efficient policy execution, and government policy stability. Although the government budget released in July lacked detail on structural reform, greater political certainty should be more conducive to investment, supporting the expectation that infrastructure investment will pick up. The *ADO 2014* growth forecast is maintained at 5.5% for FY2014 but upgraded from 6.0% to 6.3% for FY2015 as anticipated reforms bear fruit.

Adding to the boost in subregional growth forecasts from the improved outlook in India, Pakistan recorded growth in the fiscal year that ended in June that surprised on the high side at 4.1%, above the *ADO 2014* forecast of 3.4%, and Nepal saw a strong finish to its fiscal year. With outcomes in economies other than Afghanistan basically in line with earlier expectations, the forecast for South Asia in 2014 is nudged up 0.1 percentage points to 5.4%. The improved outlook for India pushes up the 2015 forecast for South Asia from 5.8% to 6.1%.

Recent data suggest that Southeast Asia has softened since the publication of *ADO 2014* as growth prospects faltered in Indonesia, Thailand, and Viet Nam. In Indonesia, first quarter 2014 growth slowed to 5.2% as soft external demand, low commodity prices, and a temporary ban on exports of selected minerals undermined recovery in net exports. Domestic demand remained robust, however, with growth in private consumption driven by election spending, easing inflation, and improved consumer confidence. Thailand's political deadlock has affected domestic demand and tourism. The Thai economy contracted

4 ASIAN DEVELOPMENT OUTLOOK SUPPLEMENT

by 0.6% in the first quarter and is likely to have contracted further in the second quarter. However, improved consumer confidence since the military takeover in May is a tentative sign that a modest recovery may take hold in the second half of the year. Viet Nam's growth forecast is slightly adjusted to account for tensions with the PRC and their effect on economic activity, including recent factory riots. Growth forecasts for other Southeast Asian economies are generally in line with *ADO 2014* expectations. With aggregate growth in the subregion's five largest economies downgraded by 0.4 percentage points to 4.8% in 2014, the revised forecast for Southeast Asia as a whole is revised down to 4.7%. As the factors slowing growth in 2014 are expected to be temporary, the forecast of growth at 5.4% in 2015 is maintained.

Growth in Central Asia is gradually moderating, with many economies affected by a deteriorating outlook for the Russian Federation. Revised projections reflect weaker-than-expected performances in Kazakhstan, the Kyrgyz Republic, and Uzbekistan so far this year. In particular, Kazakhstan posted its slowest quarterly growth since the 2008–2009 global financial crisis—3.8% in the first quarter of 2014—which prompted the government to start a \$5.5 billion stimulus program for 2014 and 2015. The economic slowdown in the Russian Federation will likely drag down remittances and export demand, undermining growth in the Kyrgyz Republic and Uzbekistan. The upward revision of an already strong performance forecast for Turkmenistan in 2015, as gas exports climb, cannot compensate for stubbornly moderating growth in Kazakhstan and Uzbekistan. Aggregate *ADO 2014* growth projections for the subregion are revised down from 6.5% in both years to 6.3% in 2014 and further to 6.1% in 2015.

Damage caused by Tropical Cyclone Ita in Solomon Islands and unexpectedly weak early-year economic indicators for Palau and Timor-Leste are holding back growth in the Pacific. The Solomon Islands economy may now contract by 1.0% in 2014 as cyclone-related flooding in Honiara and the capital city's neighboring provinces reverses the 3.0% expansion forecast in *ADO 2014*. The cyclone affected over 50,000 people, killing 22 and leaving roughly 9,000 homeless. Moreover, the storm extensively damaged transport and other public infrastructure, private property, and gold and agricultural production. In Palau, disappointing construction activity and tourist arrivals in the fiscal year to date prompt a downward revision in the 2014 growth forecast. In Timor-Leste, indicators of tax revenue collections and private sector credit growth have underperformed expectations, prompting a reduction in the 2014 growth forecast for GDP excepting petroleum. Overall GDP in the Pacific is expected to grow by 5.2% in 2014, or 0.2 percentage points less than the *ADO 2014* forecast. In 2015, the pace is expected to soar to 13.2%, led by a one-time growth surge in Papua New Guinea from its first full year of liquefied natural gas exports.

Inflation outlook

Relatively stable oil prices and declining food prices are helping to keep inflation in check in developing Asia. Consumer prices in the region are now forecast to rise somewhat more slowly in 2014 than projected in *ADO 2014* (Table 3).

Table 3 Inflation, developing Asia (%)

	2013	2014		2015	
		ADO 2014	Revised	ADO 2014	Revised
Developing Asia	3.4	3.6	3.5	3.7	3.7
Central Asia	5.8	9.0	7.6	7.4	7.0
East Asia	2.4	2.5	2.5	2.9	2.9
China, People's Rep. of	2.6	2.6	2.6	3.0	3.0
South Asia	6.2	6.4	6.3	6.2	6.1
India	6.0	6.0	6.0	5.8	5.8
Southeast Asia	4.2	4.3	4.3	4.0	4.0
ASEAN-5	4.5	4.6	4.6	4.2	4.2
The Pacific	4.5	5.9	4.5	5.1	4.5

ADO = Asian Development Outlook, ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product.

Note: **Developing Asia** refers to the 45 members of the Asian Development Bank.

Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. **East Asia** comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei, China. **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. **Southeast Asia** comprises the ASEAN-5 (Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam) plus Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Singapore. **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Sources: Asian Development Bank. 2014. *Asian Development Outlook 2014*. Manila; ADB estimates.

Despite unrest in the Middle East, international oil markets have generally traded within a narrow band in 2014. Following renewed militant attacks in Iraq, the price of a barrel of Brent crude nearly reached \$115 on 19 June, the benchmark's highest price in 9 months. However, the June average of \$112 per barrel was still within the \$107–\$112 range it has maintained for the past 12 months. Prices have since retrenched partly in response to increased supplies from Libya and the rapid expansion of unconventional oil production in North America. Moreover, the Government of Saudi Arabia—the balancing producer with the largest spare capacity—has promised to keep the global market well supplied within a price range of \$100–\$110 per barrel. The price of crude oil is now projected to drop from its 2013 average of \$109 per barrel to \$108 in 2014 and \$104 in 2015, both declines smaller than forecast in *ADO 2014*.

Food prices fell again in June by 7.6% year on year, continuing the decline begun in April 2013. Grains exhibited the largest

decline, falling by 21.6% on average in the first 6 months of this year. Absent adverse weather or a sharp spike in energy prices, food prices are forecast to decline by 3.5% in 2014 and 1.0% in 2015, as projected in *ADO 2014*.

Inflation for the region as a whole is now projected to rise more slowly in 2014 than forecast in *ADO 2014*, by 3.5% instead of 3.6%. The slight revision stems from a lower inflationary outlook in Central Asia, South Asia, and the Pacific. In Central Asia, the inflation forecast for Kazakhstan is revised down because the

government stepped in to contain the impact of the February 2014 currency devaluation with controls on wage and pension increases, price ceilings introduced for some food and fuel products, and frozen utility tariffs. In South Asia, Pakistan now expects slower inflation across 2014 and 2015 as an appreciating Pakistan rupee helps contain local prices for imports. The large adjustments to the forecasts for the Pacific reflect technical accommodation to the revised methodology for calculating Timor-Leste's consumer price index.

Asian Development Outlook Supplement

The *Asian Development Outlook* is ADB's main economic forecasting product. It is published each April with an *Update* published in September and brief *Supplements* published in July and December.

Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to approximately two-thirds of the world's poor: 1.6 billion people who live on less than \$2 a day, with 733 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of ADB or its Board of Governors or the governments they represent. ADB encourages printing or copying information exclusively for personal and noncommercial use with proper acknowledgment of ADB. Users are restricted from reselling, redistributing, or creating derivative works for commercial purposes without the express, written consent of ADB.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444 information@adb.org
www.adb.org

In this publication, "\$" refers to US dollars.