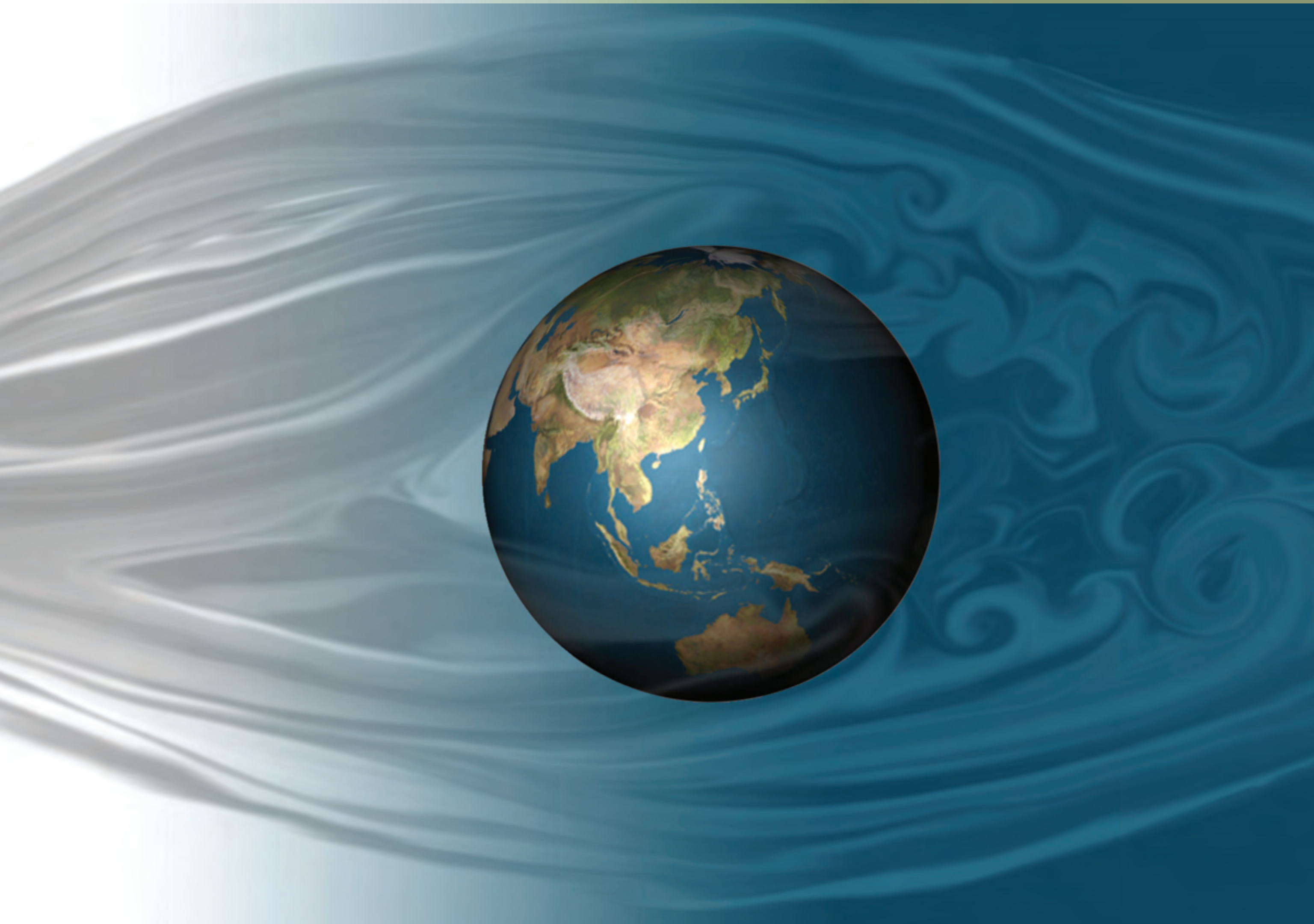
Economic and Social Survey of Asia and the Pacific 2011: Year-end Update



Steering Asia-Pacific Development Through Global Turbulence

UNITED NATIONS
ESCAP
Economic and Social Commission for Asia and the Pacific

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ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

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The *Economic and Social Survey of Asia and the Pacific Year-end Update 2011* analyses challenges for our region since the release of the Survey 2011 in April and provides recommendations on appropriate responses for policy-makers in the region. The principal message of the *Update* is the need to undertake policies to sustain the region's development in the face of a downturn in the global economic landscape.

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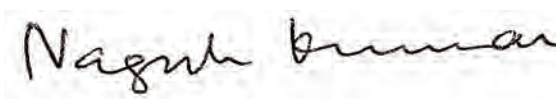

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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
ESCAP	Economic and Social Commission for Asia and the Pacific
FAO	Food and Agriculture Organization of the United Nations
G20	Group of Twenty
GDP	gross domestic product
IMF	International Monetary Fund
PMI	Purchasing Managers' Index
QE	Quantitative easing
SBI	Sertifikat Bank Indonesia

Introduction

The Asia-Pacific region is facing the challenge of coping with a sharp deterioration in the global environment. As forewarned by ESCAP,[1] the developed economies of the world remain mired in the economic crisis which erupted in 2008. After showing welcome resilience during the initial months of the crisis in late 2008, when the effects were largely limited to the financial sector, the region was buffeted by the spillover of the crisis into the real economy and the sharp reduction in demand that resulted within the developed economies in 2009. From 2010 onwards, the region showed impressive strength through export recovery due to an increasingly broad-based pickup in economic activity in developed economies, occasionally supported by fiscal stimulus, and to the growth of intraregional trade, as well as continued robust domestic demand in several Asia-Pacific economies. However, it is now evident that the region will likely have to contend with a more challenging global environment in coming months.

The Asia-Pacific region is facing the challenge of coping with a sharp deterioration in the global environment

While there was an outbreak of premature optimism in some circles in early 2011, it has become increasingly clear that recovery in the developed economies has come to a grinding halt. This has led to a second stage of the crisis in which the United States of America and the advanced economies of Europe need to tackle their public debt issues amid ailing growth, in contrast to the initial stage of the crisis which had stemmed from the financial sector. The stalled growth performance has also increased the likelihood of a double-dip recession in some economies and is likely to have an adverse impact on the Asia-Pacific region. The impact on Asia-Pacific economies at this stage of the crisis will be felt in the financial markets through heightened risk aversion and higher risk premiums, which may spill over to the real economy in the form of higher capital costs. More fundamentally, slowing growth in developed economies will directly affect Asia and the Pacific through reduced demand in the developed world for their exports.

Many economies in the region continue to grapple with the challenge of inflation. Persistent inflation across countries is significantly influenced by global factors, such as food and oil prices and foreign capital inflows. In addition, some countries with a high proportion of domestic demand in GDP have witnessed additional inflation as a result of local factors. In order to manage the impact on core inflation of these factors, authorities have engaged in substantial monetary policy tightening during the course of 2011. The impact of this tightening has moderated the pace of inflation in many cases. There has also been some decrease in global commodity prices as a result of slowing global growth. Nevertheless, with the level of inflation remaining relatively high, some countries are confronted with the dilemma of maintaining price stability in the face of slackening growth resulting from a deteriorating global environment.

A number of countries in the region have also been severely impacted by the effects of natural disasters, which have not only taken lives and caused severe distress but also negatively affected growth prospects and complicated economic management (see box 1). In the latter half of 2011, severe floods beset Cambodia, the Lao People's Democratic Republic, Myanmar, Thailand and Viet Nam, in South-East Asia, and

1 *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2).

Pakistan, in South Asia, while typhoons took a toll on the Philippines. Thailand has been the most severely affected country, with official economic losses estimated at 1.3 per cent to 1.5 per cent of GDP due to the closure of key industrial estates as well as damage to 12.5 per cent of total agricultural land. The floods are expected to create negative supply shocks around the region, and globally, due to (a) the loss of 7 per cent of regional rice production and (b) major disruptions in industrial production of electronic and automotive parts from Thailand during the fourth quarter of 2011.

Box 1. Flood crisis in South-East Asia: A major supply shock*

Starting in September 2011, heavy flooding in South-East Asia, due to typhoons and high levels of rainfall, developed into major crises with economic and social implications that continue to affect large parts of Cambodia, the Lao People's Democratic Republic, the Philippines, Thailand and Viet Nam. The scale of devastation is reflected in the loss of hundreds of lives, the displacement of millions of people and the severe damage to critical infrastructure, productive, social and cross-cutting sectors. Damage in the affected countries is mostly agricultural in nature, with the exception of Thailand, where industrial areas also suffered. The cumulative production losses for the affected countries are approximately $6.3 billion or 0.9 per cent of their GDP.

Agricultural production declined

South-East Asia is the major production hub for agricultural products. Rice production in the region accounts for over 20 per cent of the world's total rice production and for 60 per cent of the world's rice exports. The flood has most severely affected Thailand's farmland, particularly the key agricultural production areas of the north and centre, which cumulatively account for 46 per cent of the country's agricultural GDP. The Thai Ministry of Agriculture and Agricultural Cooperatives estimates that 1.6 million hectares of cultivated areas are thus far damaged (12.5 per cent of total cropped land). Main-crop paddy production, which had been earlier expected to reach 32 million tons, could be cut by 6 million to 7 million tons. Overall damage to rice production is expected to be 9.5 to 10.5 metric tons, representing about 7 per cent of regional production and about 1.4 per cent of global production.

The industrial sector in Thailand submerged

With the exception of those in the eastern province of Rayong, most major industrial estates in Thailand have been affected by the floods. Specifically, the province with the largest industrial base, Ayutthaya, has seen its manufacturing output (6.1 per cent of GDP) severely affected, particularly in the area of electronics and automotive parts production, where Thailand has become a key hub in the global supply chain. As Thailand is the world's second largest producer of hard disk drives, the disruption in production will potentially affect global notebook computer production in early 2012. In the automotive sector, Thailand is the main production base for exports in South-East Asia, with an annual capacity of 1.8 million units and export value in terms of vehicles and auto parts exceeding $18.5 billion, which represents 9.5 per cent of the country's total exports in 2010. The crisis has had a cascading effect on automotive assembly and production in Thailand and globally, forcing major auto conglomerates to cut production in Japan, the United States and Europe in the fourth quarter of 2011.

Tourism stalled in the fourth quarter of 2011

The flood crisis has also affected the tourism sector in the affected countries. The crisis occurred during the peak tourist season (the fourth quarter of 2011) and affected major high-value destinations, such as Bangkok and Ayutthaya in Thailand, and Siem Reap in Cambodia. Tourist arrivals are likely to decline in the fourth quarter of 2011 by 15 to 20 per cent in these areas.

Macroeconomic impact

ESCAP has estimated the economic impact of the crisis in 2011 to be hardest on Thailand, reducing 2011 GDP growth to 2.0 per cent per year given the estimated economic impact arising from the flood crisis at 1.3 per cent in 2011 as shown in the table below. Other affected countries may show declines in 2011 GDP growth ranging from -0.3 percentage points to negligible. However, over subsequent periods, growth is expected to increase due to economic recovery interventions and reconstruction programs. The current account to GDP ratio in 2011 is expected to show a slightly smaller surplus for the affected countries, with Thailand experiencing the most serious impact—a decline of 0.8 percentage point. Inflation would edge slightly higher for the rest of 2011 in the affected countries, primarily as a result of higher food prices.

Estimated economic impact from flood crisis in 2011

Country	GDP	CA (% of GDP)	Inflation
Thailand	-1.3	-0.8	0.1
Lao People's Democractic Republic	-0.3	negligible	0.3
Philippines	-0.3	negligible	0.2
Myanmar	-0.3	negligible	negligible
Cambodia	-0.2	-0.1	0.2
Viet Nam	negligible	negligible	0.1

Source: ESCAP estimates

Key policy recommendations

- Sustain investments in social sectors as part of post-disaster recovery and reconstruction, taking into account regional post-disaster recovery experiences, such as the Post-Nargis Recovery and Preparedness Plan (PONREPP).
- Enhance coordination among agencies with regard to water management and flood prevention. Policies and information sharing should be coherent to avoid segmenting implementation, data and information across various agencies.
- Promote new and strategic investments in the agricultural sector and in related technology that is crucial for economic recovery and food security.
- Improve urban planning and land use practices to reduce the risk as well as the negative impact of natural disasters.
- Cooperate in the establishment of a regional network of early warning systems for natural disasters as well as prepare regional action plans for natural disaster prevention and policy responses.

*For further details, see ESCAP, Policy Brief, "Flood crisis in South-East Asia: A major supply shock", 2011 (forthcoming).

Source: ESCAP

In order to support growth, the measures likely to be adopted by developed economies will present further challenges for the region. As the governments of most developed economies currently have limited scope to engage in much further fiscal stimulus, due to political differences in the United States and the sovereign debt crisis in the euro zone, these governments are likely to maintain a loose monetary stance as their main stimulatory tool. In the United States there is the possibility, at some point, of a third round of quantitative easing. In the euro zone, low interest rates are likely to continue as long as inflationary pressures remain subdued. Injections of further liquidity to the financial markets, combined with the narrowing but still significant interest rate differential with the Asia-Pacific region, will result in the asset markets and currencies in the region continuing to be an attraction for foreign investors. There will, therefore, continue to be the risk of a build-up of asset market bubbles, an exchange rate appreciation and inflationary pressures for the region through this channel. On the other hand, asset markets and exchange rates are currently being destabilized by sharp outflows of capital due to global risk aversion stemming from uncertainties about global financial stability. There is the risk of future periods of such reversals in response to further unexpected global economic events. One such event could be a sovereign debt default for economies in the euro zone which may lead to fears of significant losses by banks in developed economies, thereby causing a credit crunch, a flight to safety, and a repatriation of funds from Asia-Pacific markets.

There is the risk of capital reversals due to global economic events

Apart from inflows of foreign short-term capital, inflationary pressure in the region has been caused by higher commodity prices supported by the injection of global liquidity. One of the main causes of inflationary pressure across the region has been steep rises in food and oil prices. It is now relatively widely accepted, as highlighted previously by ESCAP,[2] that one of the drivers of these price increases since the outbreak of the crisis has been the financialization of commodity markets, fuelled by liquidity resulting from monetary easing in developed economies. The recent sharp falls in some commodity prices, such as oil, without any fundamental change in supply and demand characteristics in the short term and in tandem with past sharp rises in such commodities, brings into sharp relief the impact of financial participants in the commodity markets.

In the face of so many rapidly evolving challenges, policymakers in the region need to keenly monitor the early warning signs of spillovers from the situation in the developed world. The region remains in a relatively favourable situation in terms of protecting its economic dynamism in the face of these challenges due to its strong macroeconomic fundamentals. If serious pressure on growth performance were to materialize, the strong budgetary positions of many countries would allow the enactment of short-term fiscal stimulus measures, as some countries have already begun doing. Furthermore, the relatively high interest rates in the region would provide space for monetary easing. In terms of the banking sector, the region is not likely to be hit significantly by losses due to a sovereign debt default, as most regional banks have limited direct exposure. Nevertheless, a credit crunch may have a significant impact in the region due to the reliance of some economies on borrowing from abroad, while sudden capital outflows could place asset markets and currencies in some economies under strain, as was the case in 2008, and as some economies have already begun to witness.

2 *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2).

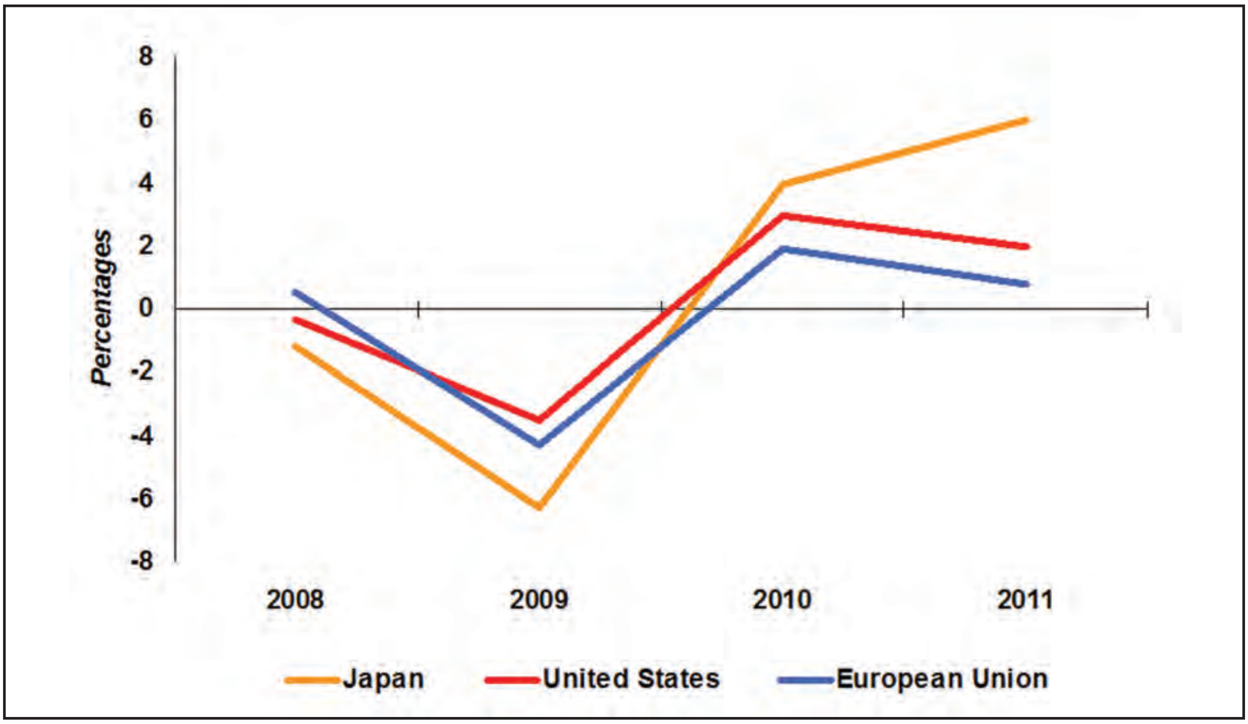
Emerging headwinds for Asia and the Pacific

Second phase of crisis in developed economies

The United States and the economies of the euro zone—the major developed economies and the region's key export markets—have been experiencing stalled growth, due primarily to concerns about sovereign debt levels. Growth data in 2011 indicate a slowing down in the recovery process in these economies (see figure 1). Notwithstanding some fluctuations in quarterly growth performance in 2011, particularly in the United States, annual growth performance for both the United States and the euro zone is expected to be significantly lower than in the previous year. Meanwhile, growth in Japan was adversely impacted due to the after-effects from the tsunami and the nuclear incident in early 2011. The subsequent increase in growth in Japan due to the resumption of normal economic activity and the reconstruction of affected areas, while beneficial for the economy, is not likely to contribute significantly to growth in the rest of the region due to the diminishing importance of the economy as an export market.

The region's key export markets have been experiencing stalled growth due to concerns about sovereign debt levels

Figure 1. Real GDP growth of major developed economies, 2008-2011



Sources: ESCAP, based on national sources and data extracted from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 24 November 2011).

Notes: Data for 2011 are reported as annualized data up to third quarter.

Some reasons for the slowdown in developed economies are fundamental in nature and cloud their prospects in 2012

There are a number of time-specific reasons for the slowdown in the United States and euro zone — high oil prices in early 2011 and the impact on global supply chains of the disaster in Japan. However, additional reasons for the slowdown are more fundamental in nature and lead to concern in terms of the prospects for the economies in 2012. These concerns revolve around the fact that fiscal stimulus measures enacted at the onset of the crisis have been increasingly phased out. Furthermore, the overriding importance being given to reducing debt in these economies means that there is not likely to be significant additional fiscal stimulus in the future.

There are differing reasons for the limited ability of the United States and the euro zone to provide further significant stimulus, although the implications are similar. In the case of the United States, the cause is differences between the fundamental views of the parties in the legislature regarding the country's debt situation. These differences were manifested in the debate over the raising of the country's debt ceiling in August 2011. This debate, apart from its technicalities, was significant in serving to highlight the scant likelihood that there would be any further substantial fiscal stimulus in the United States. Nevertheless, the conditions eventually agreed upon in order to raise the debt ceiling, while relatively stringent, were not sufficient to satisfy many in the financial markets, as evidenced by the subsequent and unprecedented downgrading of the country's sovereign debt from AAA status by the rating agency Standard & Poor's. Apart from the belief that the amount of deficit reduction agreed over 10 years did not go far enough, the fundamental concern driving the downgrade was the realization of the depth of the political impasse, at least until the presidential elections of 2012. This impasse implied that further negotiations on the details of the deficit reduction agreement to be concluded at the end of the year were not likely to be resolved satisfactorily. There is the risk that the negotiations will fail to achieve the necessary mix of policies that would both promote growth recovery in the short term and sufficient debt reduction in the medium term. Such an agreement would require a credible debt-reduction plan which would tackle the major budgetary areas, which are non-discretionary items, but would allow for continued spending in the short term. Without such a combination of policies, there is a possibility that the mix of growth and debt reduction will not be sufficient to reduce debt to GDP ratios substantially in the medium term, resulting in louder calls for even more self-defeating austerity measures.

For most of the euro zone, further fiscal stimulus is even more unlikely, given the pressure from the financial markets to engage in austerity measures. Another source of pressure comes from attempting to avoid the excessive deficit procedure established by the European Commission to discipline countries with insufficiently prudent fiscal policies. Without stringent austerity measures, the financial markets are driving up borrowing costs to punitive levels for a number of euro zone economies that need to continue issuing debt. Apart from Greece, Ireland and Portugal, which have already entered into bailout programmes with the European Union and the International Monetary Fund (IMF), larger euro zone economies with debt concerns, such as Italy and Spain, are also under pressure from the financial markets.

The pressure has resulted in fast moving, almost daily, developments, as affected governments attempt progressively more drastic measures to reassure the markets. The "troika" of international organizations involved in lending to Greece in late

October 2011 agreed to an arrangement with the Government of Greece which involved a voluntary restructuring of its debt, resulting in an estimated 50 per cent write-down on the value of its loans, along with further austerity measures, as part of a deal which required the recapitalization of banks at risk and increased the resources of the European bailout fund to buy affected sovereign bonds. The inability of the Government of Greece to obtain the agreement of parliament for the austerity measures required as part of the deal resulted in the collapse of the Government and the appointment of an interim administration. The inability of the Government of Italy to persuade its parliament to undertake further austerity measures had the same result. Both new administrations have professed an intention to continue with similar austerity measures as the previous administrations in order to retain the confidence of their lenders. Relatively healthy economies in the euro zone are also increasingly seeing concerns from the markets; France, for example, has had to undertake austerity measures to convince the markets that it will not lose its AAA credit rating following the rating downgrade of the United States. Deliberations at the G-20 summit in Cannes, France, in November 2011 were dominated by the euro zone crisis, overshadowing other important concerns, although the political complexities of developing a united approach impeded any firm progress on the issue.

A significant concern for the euro zone is that further borrowing from the financial markets at acceptable rates may not be possible even with the austerity measures currently being demanded, as those measures will have such a negative impact on growth that debt as a proportion of GDP may fail to move sufficiently downwards. This is because GDP may not increase significantly due to slowing growth, and debt may not decrease as much as expected as tax revenues decline and social security payments increase in a climate of slow growth. In such a situation, different solutions may be required in order to continue issuing debt or to revive growth. One possibility is for the European Central Bank to purchase the sovereign debt of affected economies at rates lower than those being demanded by the market. This, however, is unpalatable to healthier euro zone economies because of the potential to create inflation, since the result of such a purchase would be a large-scale increase in the money supply of the euro zone. Another option, which would not have such an impact on the money supply, would be to require greater fiscal union between the member economies. This would, for instance, allow debt issuance at more moderate rates of interest by a central euro zone body, which would assume responsibility for spending decisions regarding the debt. However, this option is also unpalatable to the healthier economies in the euro zone, which do not wish to see their borrowing costs increase and do not wish to remove the pressure on affected countries to take appropriate corrective action.

Further borrowing for the euro zone may not be possible even with the austerity measures currently being demanded

At the other end of the spectrum is the option for any of the affected economies to return to a national currency, abandoning the euro completely. This may be a viable option for countries that choose to restructure their debts by a much larger degree than is possible with the voluntary agreement of lenders. An outcome of a switch back to a national currency would be that economies would be able to engage in currency devaluation to increase their export possibilities. Clearly, this would be a last option, given the decades of effort that have gone into the common currency project, and would quite possibly set off an unpredictable and unwelcome chain of events in the global financial markets at a time of continued economic crisis.

A key risk is the possible impact on major banks in Europe and other developed economies. There is the possibility that any defaults on euro zone sovereign debt held by the banks will result in the failure of some banks as well as general confusion regarding the health of major banks due to the complexity of interbank relationships in financial instruments related to sovereign debt. The result could therefore be a renewed global banking crisis characterized by a possible credit crunch and the need for government bailouts.

The main option to stimulate developed economies will be the further loosening of monetary policy

Given the difficulties in undertaking any further fiscal stimulus, the other main option open to policymakers, in both the United States and the euro zone, to stimulate their economies is the further loosening of monetary policy. In the United States, further reduction of interest rates is not possible given their near-zero levels. Therefore, unconventional methods of loosening monetary policy are required. The United States Federal Reserve, in August 2011, undertook one such measure by pledging to not raise interest rates until mid-2013. By doing so, the Reserve is attempting to keep long-term interest rates low by influencing expectations. This has been a significant measure, given that inflation concerns meant that the markets were not sure that interest rates would remain low for such an extended period. Another measure taken to influence long-term interest rates was the Reserve's announcement, in September 2011, of a programme to replace its short-term bond holdings with long-term ones in order to reduce long-term interest rates, which are more relevant for business investment decisions. Nevertheless, in spite of their innovative character, there is a risk that these measures may not be very effective in view of the already low interest rate levels. While there remains some room to further reduce interest rates in the euro zone, as was done in November 2011, that room is also rather limited due to their also fairly low levels, and because of the greater inflation focus of the European Central Bank given the diverse membership of the euro zone.

The most potent tool that remains in the armoury, due to the large scale in which it can be implemented, is another round of quantitative easing. However, the previous round of quantitative easing, often referred to as QE2, did not prove to be very effective. There is little reason to believe that further quantitative easing would be any more effective. As in the previous round, such easing would be expected to work through increased lending by the banking sector and by encouraging the public to borrow, thereby increasing consumption and investment. However, the banking sector already possesses a large amount of funds which it chooses not to lend to the public, as there exist less ostensibly risky investment vehicles, such as United States Treasury bills and emerging markets' assets, and, therefore providing further funds does not offer a significant fillip for domestic lending. For the public, on the other hand, quantitative easing is professed to increase wealth, and therefore consumption, by increasing domestic equity values. As bond prices fall through the easing programme, equities become more attractive. However, there was no substantial consumption effect during the most recent round of easing because domestic equity prices have not seen the full benefit of the programme, as investors have directed part of their attention to more attractive foreign assets, and any increase in wealth from equity price rises is being conserved by the public in the face of stagnant housing wealth and employment concerns in a labour market that is still fragile. Another way in which quantitative easing can act to support growth is by depreciating the dollar and therefore supporting the exports of the United States. However, this is also not likely to have substantial effects, as exports account for a relatively small proportion of the economy. Despite concerns about its efficacy, the various marginal benefits of a new round of quantitative easing may make the option attractive as one of the few viable alternatives for creating some growth in the absence of fiscal policy measures.

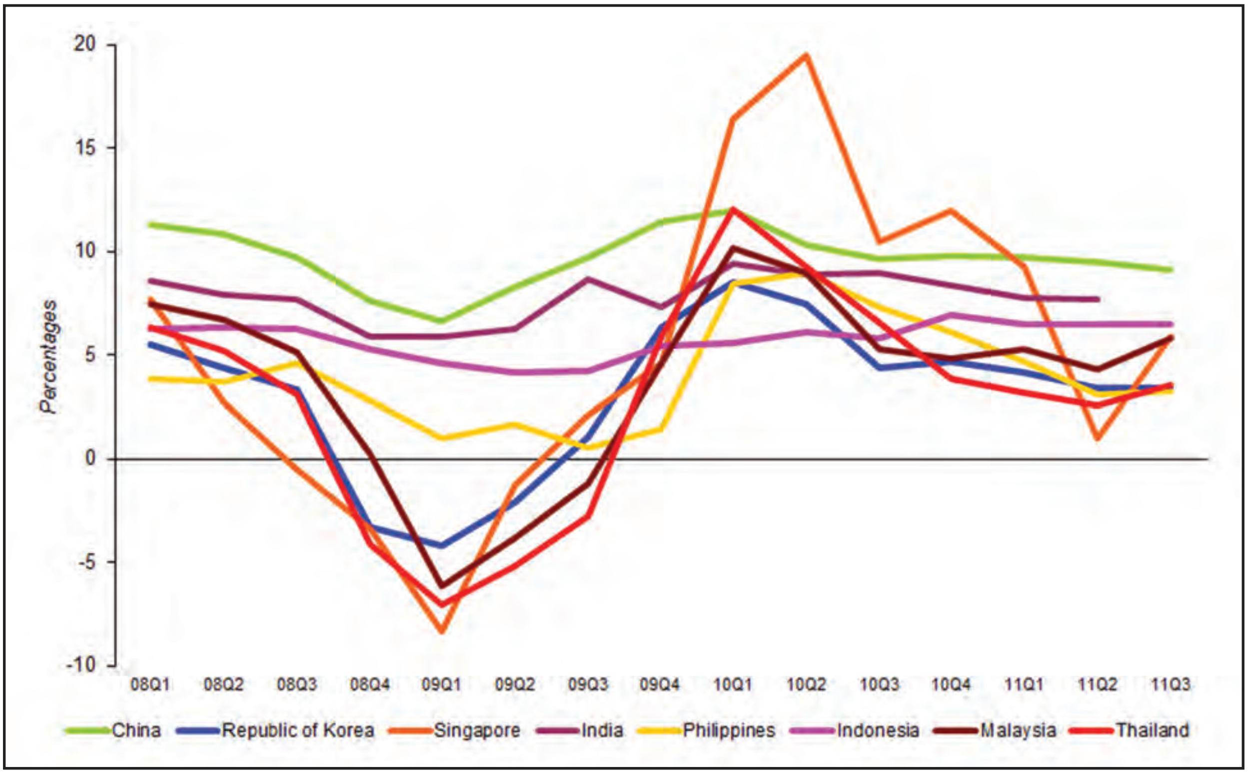
Loose monetary policies pursued in the developed world will lead to the region having to manage the resulting influx of foreign portfolio capital

However, if loose monetary policies are pursued in developed economies, emerging Asia-Pacific economies, along with other developing economies around the world, will have to manage the resulting influx of foreign portfolio capital. Furthermore, the increase in global liquidity may be directed, in part, to the commodity markets in food and oil, thereby spurring inflationary pressure for the region through the import of these items. Another risk for the region would come from an increase in protectionist measures in the developed economies. During most economic downturns, there is typically a temptation to protect domestic industries by restricting competition from imports. This can lead to both measures to depreciate the currencies of developed economies and trade-related measures to support exports or restrict imports. As a consequence of the weakening exchange rates of some developed economies and continued pressure from short-term capital inflows, there is the possibility of a global currency war in which the region will be obliged to engage in significant exchange rate intervention, as well as measures such as capital controls, to maintain export competitiveness. This situation arises for economies which are seen as investment havens at a time of scant global investment opportunities. A number of such economies across the globe, for instance Switzerland and Japan, have already reacted with rarely used measures, such as declaring exchange rate bounds, and engaging in large-scale currency intervention. In August 2011, Japan intervened with nearly $60 billion to prevent the yen from breaking the barrier of 76 to the dollar, and, in early September, Switzerland declared an upper bound to the exchange rate between the Swiss franc and the euro and intervened to avoid excessive appreciation of the franc.

Varied Asia-Pacific exposure to the slowdown in the developed world

Despite the perilous state of the developed economies, the growth impact on Asia and the Pacific will depend very much on the individual circumstances of each economy. The initial signs of slowing growth in some economies of the region can be seen in their performance in recent quarters (see figure 2). There are two key aspects driving the degree of exposure of economies in the region. One is the extent to which the export sector is important as opposed to domestic demand. In this respect, the Asia-Pacific region possesses prominent examples of both sets of economies. While many economies in the region are notable for their export dependence, others are key players in driving global growth due to considerable domestic demand. The other aspect, which provides a widening avenue of opportunities, is the scope and depth of intraregional trade that can be channelled to the economies with large domestic demand and investment.

Figure 2. Real gross domestic product growth, year-on-year, in selected developing ESCAP economies, 2008-2011



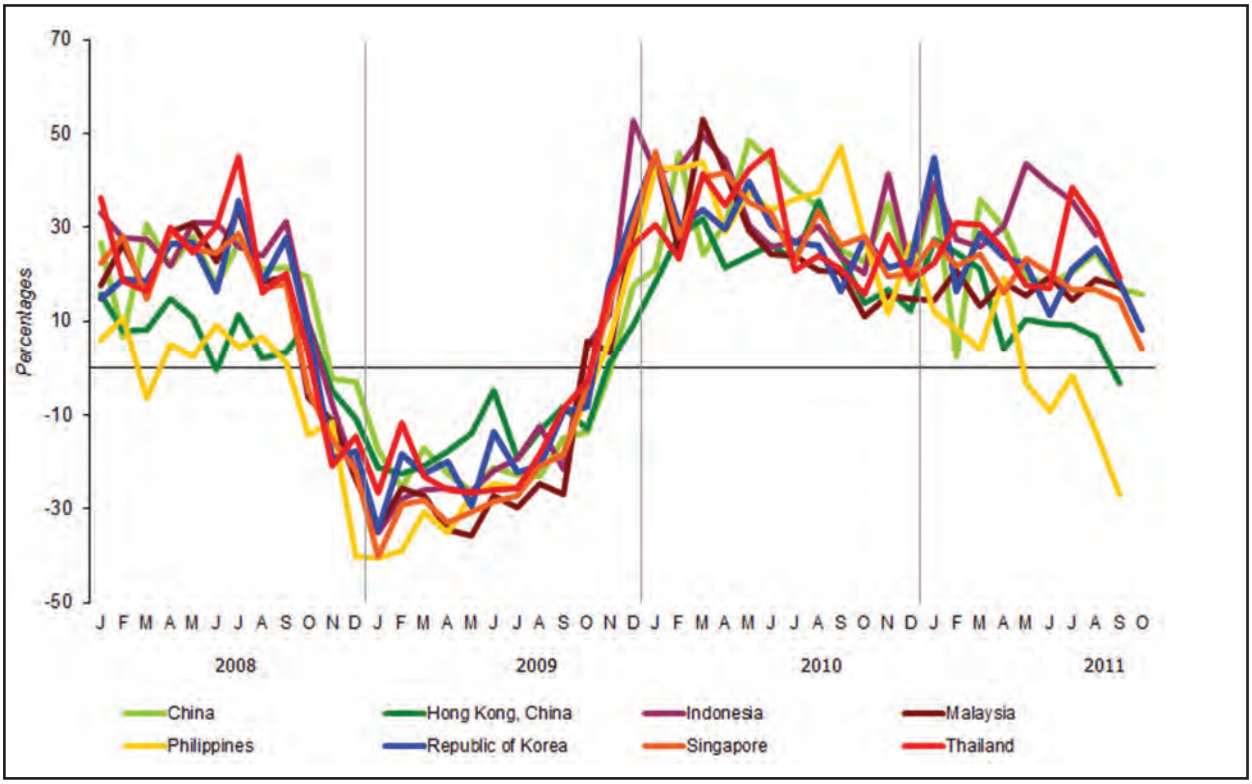
Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 30 November 2011).

The economies which will face the greatest growth pressure are the manufacturing export-dependent economies of East and South-East Asia

The economies in the region which will face the greatest growth pressure from the developed world slowdown are the manufacturing export-dependent economies of East and South-East Asia. The signs of such a slowdown can already be seen in the export growth performance of these economies in recent months (see figure 3). These are the economies which have the highest share of their GDP accounted for by exports. Among the economies which have the greatest exposure are China, Malaysia, the Philippines, the Republic of Korea, Singapore, Thailand, Taiwan Province of China and Hong Kong, China. Economies in the region which may also experience a slowdown in exports due to the global situation are commodity exporters. The impact on this group is less certain, as not all commodity prices may move downwards in line with global growth. For example, food prices may exhibit less of a connection with global growth than oil or metals prices. Therefore, certain commodity producers in the region may be more negatively affected than others.

On the other hand, the economies with the smallest impact on growth from the slowdown of developed economies are those with large and robust domestic sectors and limited reliance on exports as drivers of growth, the most prominent examples being India and Indonesia. Strong domestic demand in India and Indonesia are related to a high proportion of consumption in GDP. China is a special case in that, while exports are important to the economy and a significant proportion of investment is tied to the export sector, domestic demand and investment also play an important role and will provide some cushioning to growth. However, investment in China since the onset of the 2008 crisis has not always been based on fundamental factors, having been supported in some cases by policies engendering strong credit growth. It is also somewhat the case that consumption in India and Indonesia has been supported by real interest rates which have been relatively accommodating and have therefore encouraged the public to redirect some of its income from savings to spending. China and India remain concerned with relatively high inflation rates by historical standards, and their ongoing moves to tighten monetary policy over the past year may constrain previously robust domestic demand to some degree. Indeed, recent growth performance in these large economies indicates the impact of policy tightening: GDP growth in India and China in the third quarter of 2011 was at 6.9 per cent and 9.1 per cent respectively —the lowest rate in two years for both countries.

Figure 3. Growth in exports, year-on-year, in selected developing ESCAP economies, 2008-2011



Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 24 November 2011)

A mitigating factor is the increasing importance of intraregional trade. Boosting such trade in tandem with domestic demand in the region is the most critical medium-term policy approach necessary in order to adjust to the shifting global balance of growth. However, the shift from extraregional to intraregional trade and demand will not be sufficient to make up for the slowdown in the markets of the developed economies in the short term. Thus, it may be necessary to temper expectations of larger support for the region's exports than in previous instances of a slowdown in demand from the traditional export markets. The slowdown in the overall manufacturing sector in many economies of the region, as seen from the declines in Purchasing Managers' Indices (PMIs) in recent months, is a clear indicator of the continued importance of the developed economies, as it coincides with the slowdown in the developed economies. Trade within the region is indeed growing faster than the region's trade with the rest of the world. While exports from the Asia-Pacific region to the rest of the world roughly doubled between 2000 and 2009, intraregional exports rose almost 2.5 times.[3] However, the importance of intraregional exports, when compared to total exports, has so far only increased marginally as a result of these trends. The share of intraregional exports in total Asia-Pacific exports increased from about 49 per cent in 2000 to about 52 per cent in 2009[4] with a potential to be even higher. Furthermore, the proportion of intraregional exports which supply final demand in the region is substantially lower, as a significant portion of exports of the medium-income and high-income economies of the region are intermediates which are processed in another country and exported onward to the developed economies. China is the most prominent destination for intraregional intermediate inputs, with the country's large proportion of exports to developed economies providing a somewhat better picture of the true importance of developed economies to the economies in the region. If demand from developed economies were to slow down significantly and remain sluggish in 2012, the ripple effect across the regional supply chain might eventually be reflected in intraregional exports.

Intraregional demand will not be as supportive as it was at the start of the crisis due to less stimulus in large regional economies

A major reason why intraregional demand will not be as supportive for exporting economies as it was at the start of the crisis is the lower likelihood of significant stimulus in the major economies with large domestic demand. The two largest developing economies in the region, China and India, have been more concerned with controlling price increases than with maintaining growth, which remains at relatively robust levels. ESCAP analysis[5] shows that strong growth in China was a key factor in the export recovery of the region after the onset of the crisis and before the subsequent uptick in demand from the developed economies. Demand from India was also a factor in supporting growth in the region. India is known as an economy with large and growing domestic consumption which maintains trade deficits with most of the region. In 2010, for example, the ASEAN economies had a trade surplus with India of $13 billion, representing 17 per cent of the total trade surplus of ASEAN members, and China had a trade surplus with India of $21 billion.[6] Currently, the policy regimes in both China and India have moved from stimulus to monetary tightening in order to moderate the respective drivers of domestic demand in the economies through greater reliance on productive investment and private consumption demand. It is this two-track nature of growth in the region, with the domestic-demand oriented group dominated by inflation concerns and the export-oriented group dominated by growth concerns, which implies that intraregional demand may prove less supportive for growth in the short term than in previous years.

Nevertheless, it is clear that the widely diverging growth performance of the large developing economies of the region and the developed economies of the world means that intraregional demand will become increasingly important to the exporting economies of the Asia-Pacific region. China has become the most important export market for a number of economies in the region because, since the crisis, robust growth in exports to China has outpaced exports to the sluggish developed economies. However, it is unclear whether economies will benefit in the same fashion from growing intraregional demand, as was the case when robust developed economies outside the region supported demand in the past. China, which remains the largest domestic market in the region at present, is gradually moving towards a more domestic-demand-led economy. However,

3 *Asia-Pacific Trade and Investment Report 2011* (United Nations publication, Sales No. E.11.II.F.8.), Chap. 1, p. 9.
4 *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2), Chap. 3.
5 Ibid., Chap. 1, p. 11.
6 *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2), Chap. 1, p. 16..

the most important sector of the domestic economy is the investment sector. The import demands of this sector are centred around natural resources. Therefore, the benefiting economies in the region would tend to be commodity exporters. On the other hand, manufacturing exporters would need to rely on the further growth of consumption in China. Furthermore, studies have indicated that the import content of consumption goods in China is quite low compared with that of advanced countries.[7] This implies that a consumption boom in China may have a limited impact on export growth in the region. To become a sustainable trade leader in the region, China will need to raise not only domestic consumption, but also the intraregional import content of its domestic consumption.[8] Other large economies in the region, such as India and Indonesia, offer a more consumption-led economy for exporters of manufactured goods. However, the income level of Indonesia and India are currently lower than that of China.

Continuing inflationary pressure from abroad

The rising pace of inflation during the earlier part of 2011 has been moderated by monetary policy tightening across much of the region, as well as by decreases in some global commodity prices. While much of the pressure for price increases was supply-led and came from abroad due to high global food and oil prices, strong growth in economies due to robust exports and strong domestic demand also contributed to demand-led inflation. The importance of these drivers of inflation differs in degree across the region. Domestic-demand-led economies are more concerned about demand-side inflation, whereas exporting economies are influenced more by imported inflation. For such exporting economies, with demand-led pressure receding due to the less supportive global environment for exports in recent months, the main inflationary spur is now concentrated on the outlook for global food and oil prices. It is not certain if lower global growth will necessarily result in significant reductions in such prices as there are a number of countervailing price drivers at work. For domestic demand-led economies, managing the domestic drivers of inflation will continue to be a policy issue. In some of these economies, growth has also been slowing down due to the strong monetary policy measures taken to bring prices under check. Managing the different drivers of inflation across the region will be a challenge for policymakers as the economies in the region are currently experiencing a period of imperilled growth performance.

Growth has been slowing in domestic-demand led economies due to the strong monetary policy measures taken to bring prices under check

During 2010, inflation emerged as a pressing concern across much of the region (see figure 4), though the increase in prices was driven by different factors for particular groups of economies. In the more globalized exporting economies of South-East and East Asia, price rises were spurred by high global food and oil prices (see figure 5) along with capital inflows into the relatively open financial markets. High global food and oil prices were supported by a combination of concerns regarding political upheaval in oil-producing economies in the Middle East, weather-related supply disruptions in key food-producing countries, the redirection of food crops to produce biofuels, and speculation on commodity financial markets in a climate where many market participants expected global growth and commodity demand to remain relatively robust. Price rises were also supported by strong capital inflows into many of these economies as a result of high global liquidity, interest rate differentials with the developed economies, and relatively healthy growth prospects. These

7 Yilmaz Akyüz, "Export dependence and sustainability of growth in China", *China & World Economy*, vol. 19, No. 1, pp. 1-23 (Institute of World Economics and Politics, Chinese Academy of Social Sciences, 2011).

8 See *Asia-Pacific Trade and Investment Report 2011* (United Nations publication, Sales No. E.11.II.F.8.), Chap 1, p 12.

capital inflows contributed to substantial rises in asset markets, such as equities and property. High inflationary pressures especially high food and fuel prices have significant poverty impacts rolling back the hard-won development gains of many years. ESCAP estimated that rising prices of food and fuel could lead to 42 million additional people in poverty in 2011, joining the 19 million already affected in 2010.[9]

In economies where domestic demand plays a major role, price rises due to global food and oil prices were supplemented by demand-side forces. Some economies in South Asia, such as India, were especially affected by consumption-demand-led price increases. China and Viet Nam, on the other hand, were particularly impacted by investment-demand-led price increases, with prices increasing beyond the target level of policymakers as investment was spurred by strong credit growth.

As growth prospects for exporting economies move downwards, the trade-off with inflation has assumed increasing importance

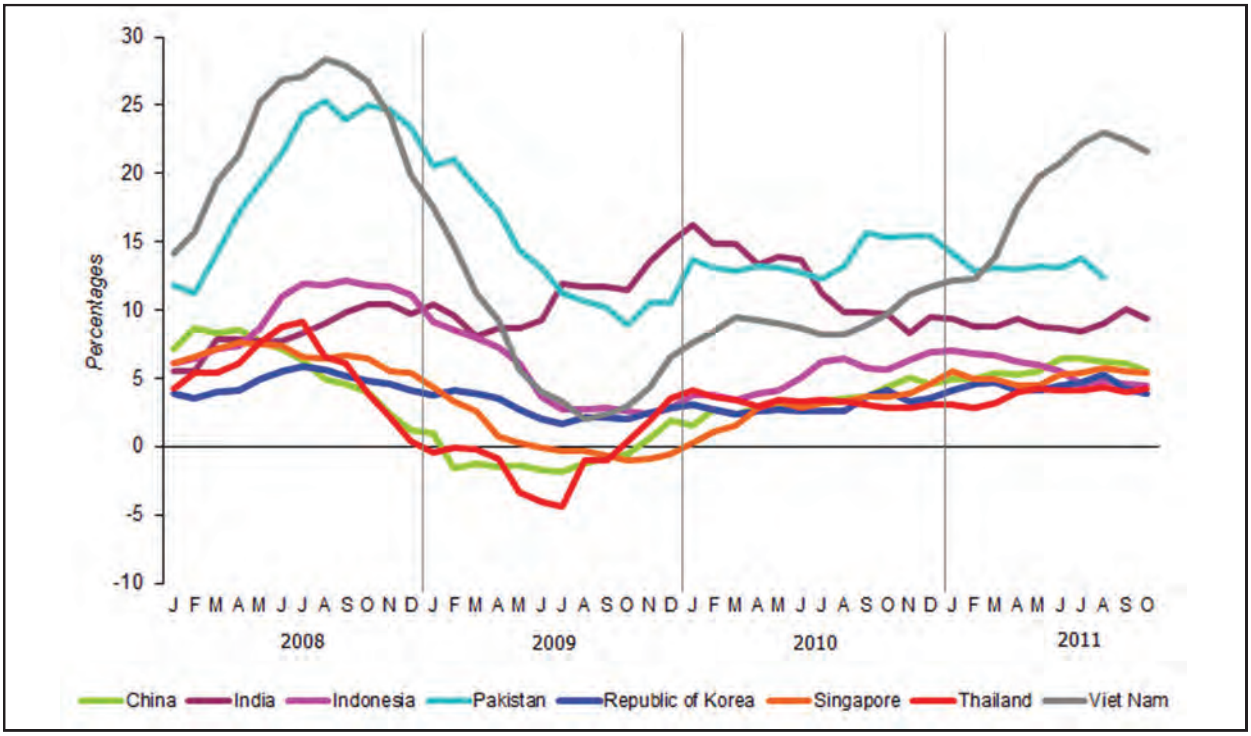
Economies across the region reacted to rising prices by enacting monetary policy tightening over successive steps since 2010 (see figure 6). As growth prospects for exporting economies have moved downwards in line with the global environment, the trade-off with growth has assumed increasing importance. The impact of monetary tightening in past months, coupled with lower commodity prices, has also led to some stabilization in inflation rates across some economies in the region (see figure 4). China, for instance, witnessed a reduction in inflation for three consecutive months as of October 2011. In India, inflation has continued to remain high despite the Reserve Bank of India increasing the policy rates 13 times over the past 19 months, while the tight monetary policy has affected the country's growth momentum. Concerns regarding growth prospects, as well as the somewhat more positive inflationary forecast, have in recent months led some economies to hold off on further monetary policy tightening (see figure 6). Indonesia decreased its interest rate in October 2011 and Indonesia and Thailand decreased in November 2011, with other countries signalling possible moves in the near future.

In contrast, economies where growth is significantly due to domestic factors have continued to use monetary policy to dampen demand-side price pressures. Monetary policy and other controls on lending have been tightened throughout 2011 in a number of South Asian economies and China. The downward impact of such measures on growth in these economies has been accepted as necessary in order to manage the threat of insufficient capacity in the economy and to manage robust growth without the build-up of excessive price pressures. Nevertheless, the situation in China is somewhat unique in that both exports and investment exert impact on growth through various channels. Measures to dampen demand-side inflation due to excessive investment at a time of slowing exports would introduce an additional source of pressure on growth in the economy, raising concerns of a "hard landing" for the economy.

The outlook for inflation in coming months has become less certain due to a number of countervailing forces pressing on the region. Normally, slowing global growth would be expected to reduce demand for commodities and therefore substantially lower food and, especially, oil prices. However, these prices are dependent on a number of factors other than global demand. On the supply side, there are ever-present risks of supply disruptions given weather conditions and continuing instability in the Middle East. On the demand side, the interaction of food and oil through biofuels and high global liquidity spurring speculation in commodity markets may continue

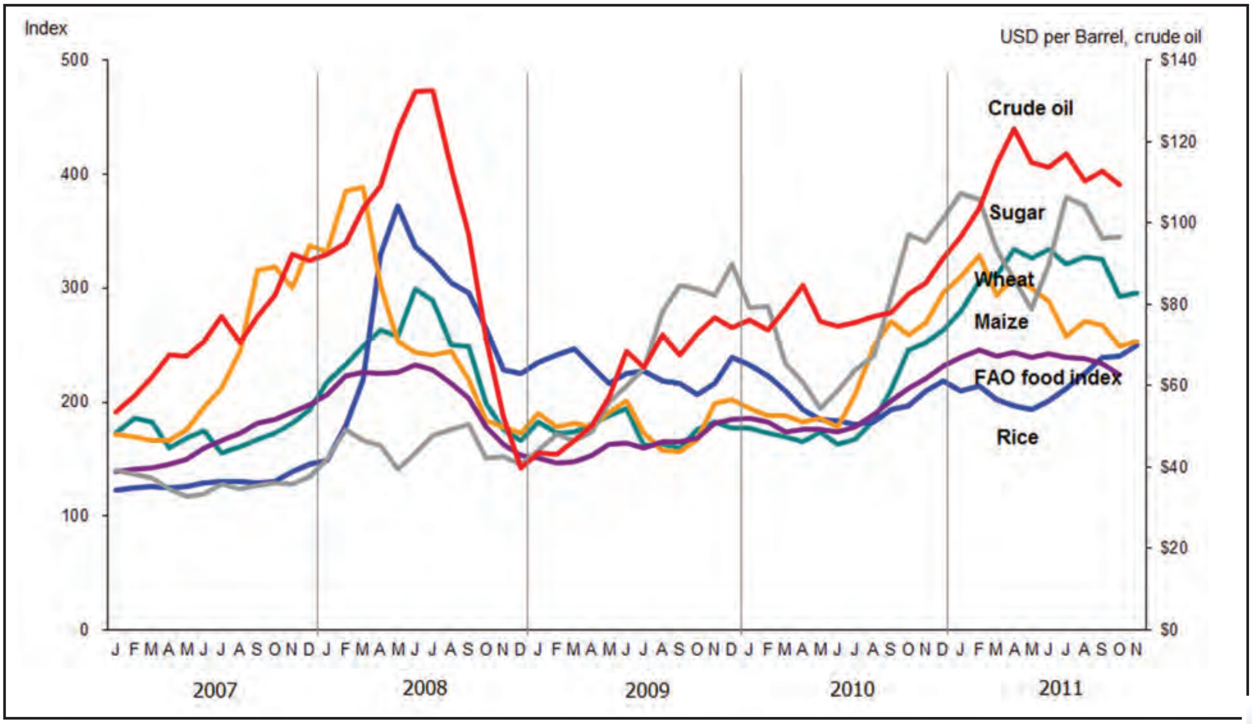
9 *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2), Chap. 1, p 24.

Figure 4. Consumer price inflation, year-on-year, in selected developing ESCAP economies, 2008-2011



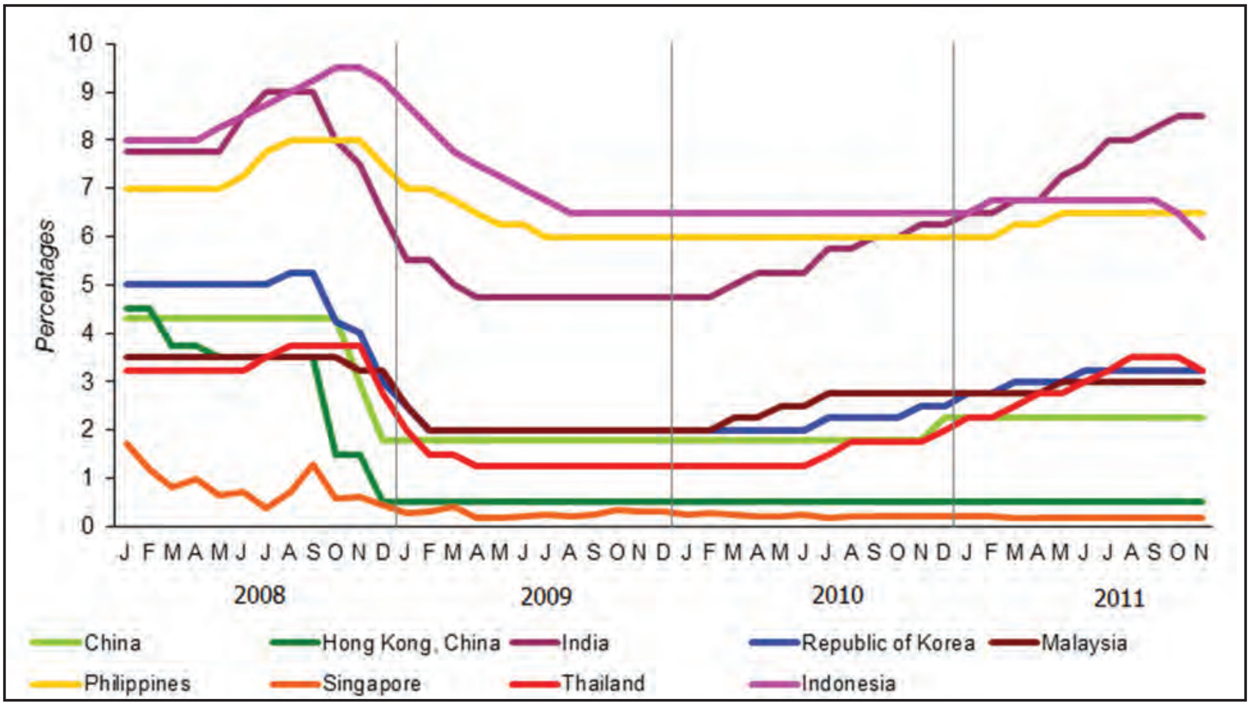
Source: ESCAP, based on data extracted from CEIC Data Company Limited (as of 30 November 2011).

Figure 5. Oil price, FAO food price index and selected food prices (index 1998-2000 = 100), 2007-2011



Sources: Food and Agriculture Organization, http://www.fao.org/es/esc/prices/PricesServlet.jsp? lang=en; United States Energy Information Administration, http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm; and IMF Primary Commodities Price, http://www.imf.org/external/np/res/commod/index.aspx (accessed 24 November 2011).

Figure 6. Policy rates in major Asian developing economies, 2008-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 25 November 2011).
Notes: The policy rates for each country include the rediscount rate for China; the discount window base rate for Hong Kong, China; the Reserve Bank of India repo rate for India; Bank of Korea base rate for the Republic of Korea; the overnight policy rate for Malaysia; the repurchase rate for the Philippines; the overnight repo rate for Singapore and the 1-day bilateral repurchase rate for Thailand.

to exert upward pressure on prices. There is concern that measures which may be adopted by the developed economies to support growth through maintaining accommodative monetary policies, and possibly engaging in a further round of quantitative easing, would introduce considerable new liquidity into global financial markets. While speculation is on the basis of beliefs about real supply and demand, there may always emerge lines of argument that logically indicate real causes for increases in oil and food prices, even at a time of slow global growth.

Speculation in commodity markets exaggerates the price volatility that stems from supply and demand factors

The main concern about speculation in commodity markets is that any price volatility due to real supply and demand factors would be exaggerated by the addition of speculative money. Furthermore, at a time of slow global growth and concerns about safe assets, commodities may be viewed as a reasonably dependable investment class. This is because they are real goods the supply of which is finite and the demand for which is intrinsic and increasing in the long term due to increasing wealth in developing economies. Such financial investment in commodity markets would present the problem that the prices of these key commodities would be rising, remaining stable or at least not falling significantly at a time of slowing growth. For non-commodity-producing economies in the region, the implication of such a scenario would be the dilemma of attempting to support growth at a time when price pressures through the commodities channel have not completely abated.

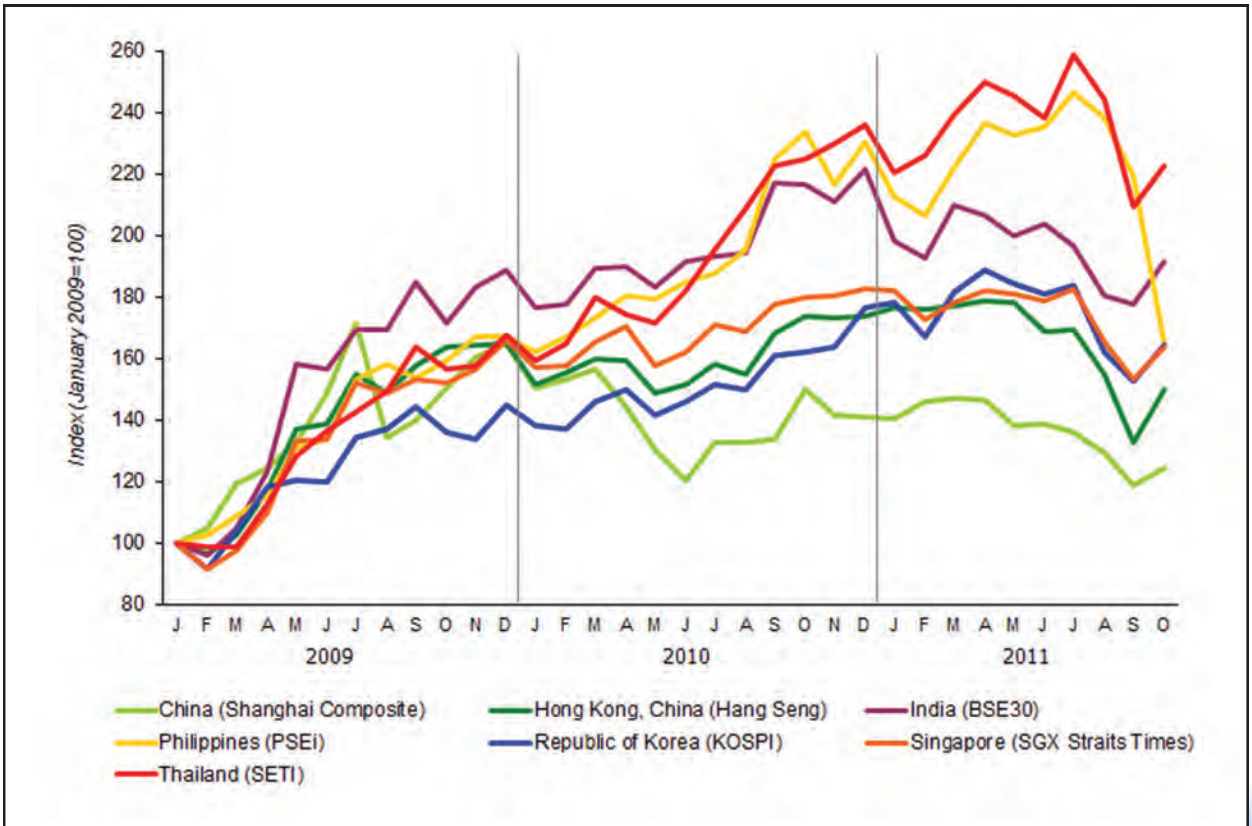
Increased volatility in financial markets

The financial markets in the region are faced with a period of considerable volatility as investors attempt to insulate themselves against a perceived increase in the risks facing both the global and the Asia-Pacific economies. Asset prices and exchange rates in the region are likely to face both periods of capital outflows and inflows in response to global liquidity and financial conditions as well as major news events. Policymakers will have to be prepared for periodic bouts of volatility which will complicate their macroeconomic planning.

Policymakers will have to be prepared for bouts of financial market volatility which will complicate their macroeconomic planning

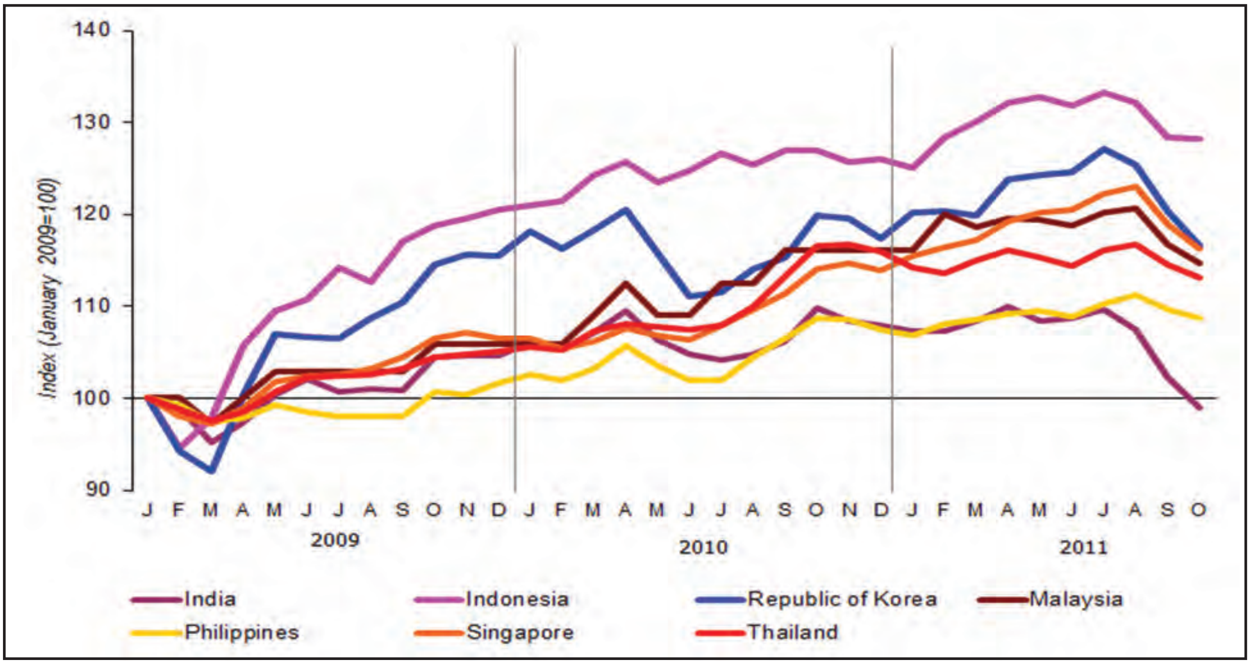
The Asia-Pacific region has recently experienced periods of substantial capital outflows as investors have realized that slowing growth in the global economy will inevitably affect the export-led growth model of many economies in the region. Consequently, growth projections for enterprises have been scaled downwards, thereby having a negative impact on equity markets (see figure 7). Furthermore, the reduced likelihood of monetary policy tightening in an environment of constrained growth has lowered former assumptions of interest rate levels, thereby affecting bond markets. At a more general level, at times of perceived global economic uncertainty, the region is also affected by the standard reaction of a "flight to safety""—a retreat to assets that are perceived to be safe. Thus, despite the sovereign debt concerns in the United States and the loss of its Standard & Poor's AAA rating, investors have retreated once again to United States Treasury bills in large numbers. These capital outflows have led, in recent months, to marked regional depreciations in exchange rates against major currencies (see figure 8).

Figure 7. Equity market performance in major Asian developing economies, 2009-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 24 November 2011).
Note: The equity market of each country/area is noted in parentheses in the legend.

Figure 8. Exchange rate movements in selected developing economies against the United States dollar, 2009-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from http://ceicdata.com/ (accessed 24 November 2011).
Note: A positive trend represents appreciation and vice versa.

Fundamental factors will result in periods of continued capital inflows to the region

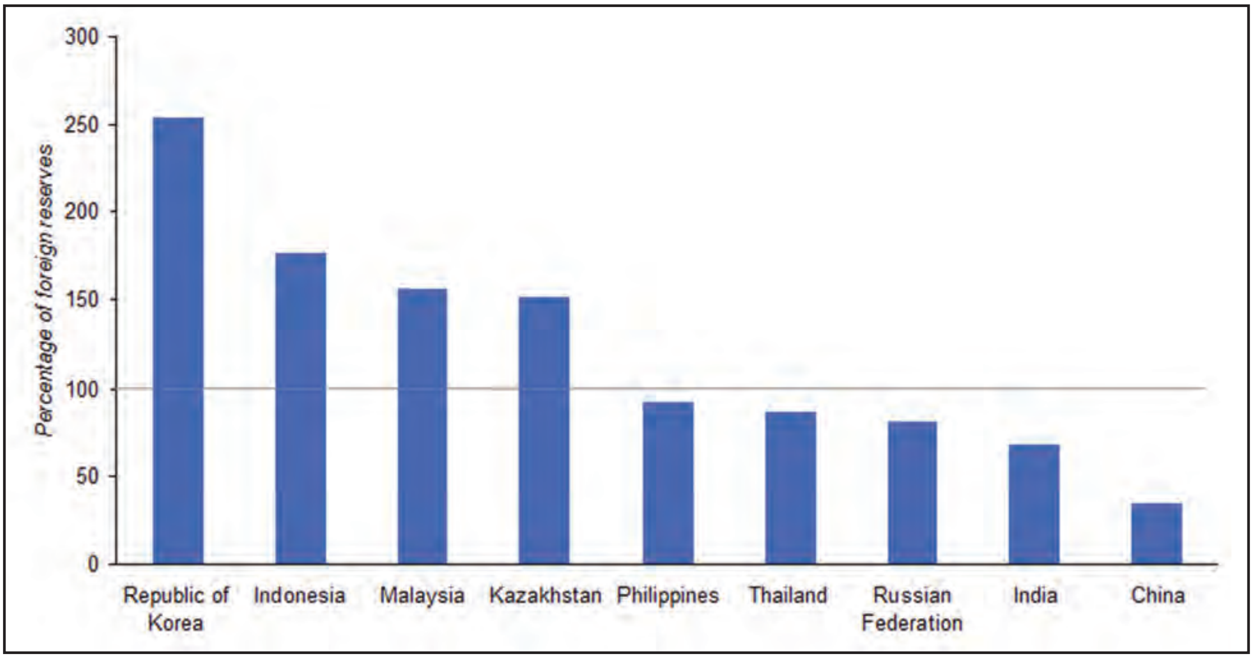
There are reasons, however, to believe that fundamental factors will result in periods of continued financial inflows to the region. Despite the growth slowdown in the region, economies continue to experience far more robust growth than the developed economies, therefore supporting the performance of equity and property markets. Interest rates, while less likely to rise in many economies than they have in recent months, remain at far higher levels than the near-zero levels of the developed economies, thus maintaining foreign interest in the region's bonds and other assets. It may also be argued that investors have an increasingly nuanced view of risk, with a gradual altering in the perception that, in times of uncertainty one should withdraw en masse from emerging markets to developed markets. While, in the short term, Treasury bills in the United States, for instance, remain popular, in the long term, Treasury bills may come to be regarded as more risky assets as the willingness and ability of the United States to continue to finance such debt is increasingly called into question following the difficulties in the debt ceiling negotiations witnessed in recent months.

In an environment of both negative and positive factors influencing capital flows to the region, economies should be prepared for volatility in such flows. There is, therefore, the risk that macroeconomic stability will be impacted through substantial movements in exchange rates and asset values. Exchange rate movements would affect inflation, export performance, and domestic financial sector stability, while asset value changes create the risk of a further build-up of asset price bubbles and an eventual bursting of such bubbles.

Economies in the region have traditionally managed the risk of exchange rate volatility by building up foreign exchange reserves, although it is not clear that this approach provides sufficient protection. Economies have accumulated reserves both to protect currencies in case of sudden capital outflow, and as a by-product of management of exchange rates to maintain export competitiveness. The ESCAP foreign reserves vulnerability index, however, indicates that, in a number of cases, it is not evident that reserves are adequate to protect exchange rates, and thus macroeconomic stability, in the case of substantial capital outflows (see figure 9). If the worst-case global scenario results in a renewed banking crisis sparked, for instance, by sovereign debt defaults and bank collapses in the euro zone, then a number of economies in the region could be at significant risk of exchange rate pressure. The mechanism may be a flight to safe assets by investors, triggering a sudden exit of short-term capital flows. The economies which would be at most risk would be those who have deep, highly open and relatively sophisticated financial markets that have seen substantial inflows over the past few years, and where there is the possibility that reserves do not fully take into account the scale of possible capital outflows. As at the outset of the crisis in 2008, countries are acknowledging such risks by arranging for other sources of foreign exchange support. In 2008, the Republic of Korea entered into a precautionary arrangement with the United States Federal Reserve and, in October 2011, increased the amount of its currency swap arrangement with Japan from $13 billion to $70 billion.

In the worst-case global scenario a number of economies in the region could be at significant risk of exchange rate pressure

Figure 9. Vulnerability yardstick as a percentage of foreign reserves in selected developing economies, latest data available



Sources: ESCAP calculations based on data from IMF, International Financial Statistics CD-ROM, July 2011;World Bank, Quarterly External Debt Statistics databases, accessed September 2011; and CEIC Data Company Limited (accessed on September 2011).

Notes: The vulnerability yardstick is the sum of short-term debt, imports of the last quarter of the year and stock of equity and debt portfolio capital.

Even if reserves are adequate, the use of such reserves does not assist in dealing with the issue of asset price declines in the case of outflows. However, in the case of capital inflows, the use of reserves does not prevent an undesired excessive increase in domestic asset values. Interest rate rises, a common tool for dealing with the inflationary consequences of capital inflows, are self-defeating to some degree as they inevitably attract more capital. If capital inflows to the region are expected to be a long-term trend, then the continued use of foreign exchange reserves as the primary tool for managing the consequences presents a host of difficulties. Other than the efficacy of using reserves, an ever-present and increasingly important issue is the cost of holding them. Declines in the value of the United States dollar and the euro have reduced the value of holdings in local currencies substantially, and these currencies may well depreciate further in the medium term. An additional cost is the interest rate differential between holding European or United States bonds at close to zero interest rates, as compared to the comparatively high domestic interest rates which have to be paid to mop up the inflation created by the injection of local currency.

Economies in the region have increasingly turned to capital controls to deal with volatile inflows

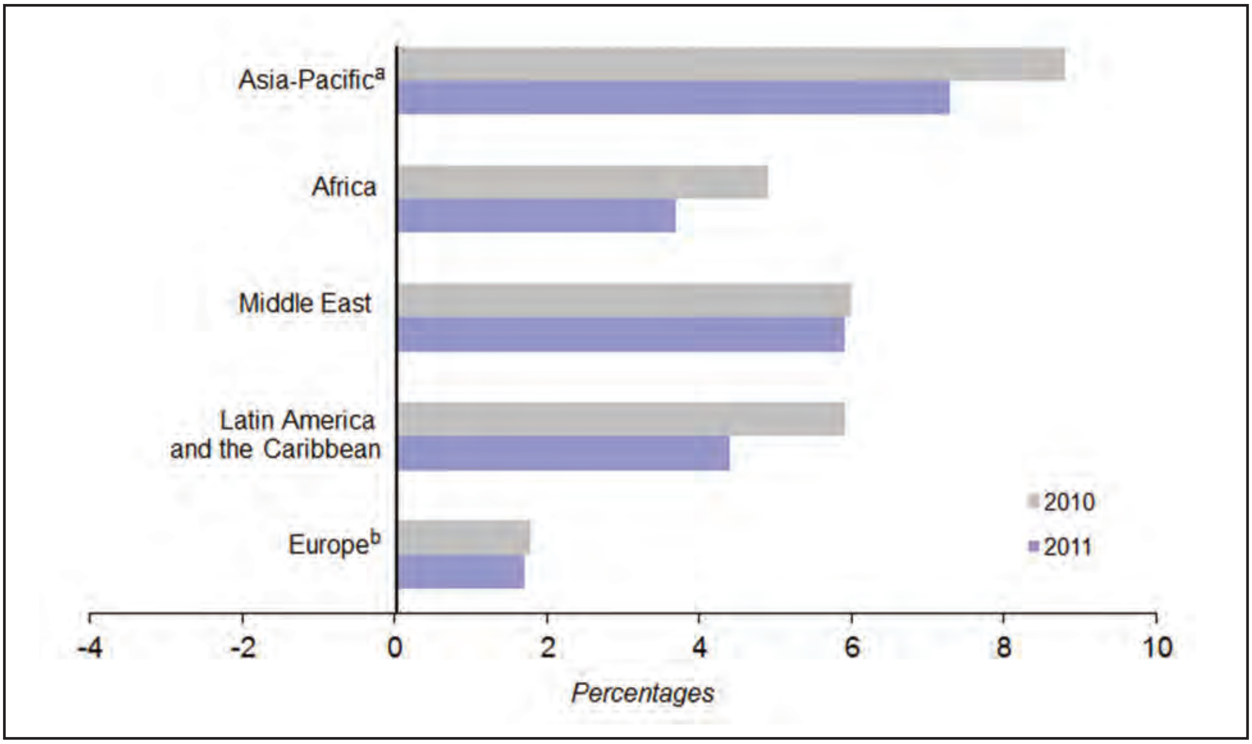
Given the disadvantages of using reserves accumulation as the main instrument for dealing with capital inflows, economies in the region have increasingly turned to capital controls as an additional measure, as previously recommended by ESCAP. Over the past year, Indonesia, the Republic of Korea, Thailand and Taiwan Province of China have imposed various controls. Measures have included limits on foreign exchange and the external debt exposure of domestic banks (Republic of Korea, Indonesia), limits on foreign holdings of domestic assets (Republic of Korea, Indonesia, Taiwan Province of China), restrictions on the maturity of foreign holdings of assets (Indonesia, Republic of Korea, Taiwan Province of China), and taxes on foreign holdings of assets (Republic of Korea, Thailand).

Outlook for 2012

The key downward pressure on growth performance for economies in the region in 2012 will come from continued sluggishness in the growth recovery of the developed economies, with aggregate growth for developing ESCAP economies slowing from an expected 7.2 per cent in 2011 to a forecast 6.6 per cent in 2012. This pressure will be greatest on the export-dependent economies of the region. This will not necessarily imply drastic reductions in growth performance, as many governments will be able to call on significant fiscal and monetary policy flexibility due to strong macroeconomic fundamentals. Growth in the region is consequently forecast to remain, by far, the highest among the regions of the world, as it was in 2011 (see figure 10).

While the environment for exports will not be as great a concern for domestic-demand-led economies, the impact from the global situation will come in terms of possible reductions and instability in financial flows which impact growth performance. However, a number of domestic-demand-led economies also have internal pressures on growth deriving from uncomfortably high levels of inflation leading to a restrictive monetary policy stance.

Figure 10. Real GDP growth by region, 2010-2011



Sources: ESCAP calculations based on data from the United Nations regional commissions.

Notes:

[a] Only developing economies in the ESCAP region (excluding countries of the Commonwealth of Independent States)

[b] Developed and developing member countries of the Economic Commission for Europe.

A significant slowdown occurred in 2011 due to the base effect and the problems in the developed economies

Most of the major exporting economies of East Asia and South-East Asia are predicted to see growth in 2012 at levels broadly similar to that of 2011 (see table 1). A significant slowdown in growth occurred in 2011 in relation to the previous year. This was due partly to the base effect of very robust growth in 2010 as the region emerged from the initial shock of the crisis, and partly due to the spillovers from slowing growth in the developed economies in 2011. In East Asia, the Republic of Korea and Hong Kong, China, are forecast to see growth in 2012 of 3.5 per cent and 4.3 per cent, respectively, as compared to the 3.9 per cent and 5 per cent expected for 2011. In South-East Asia, Singapore and Malaysia are forecast to see growth of 3 per cent and 5 per cent, respectively, in 2012, as compared to an expected 5 per cent in 2011. While the contribution of the export sector will be constrained in 2012, domestic components will contribute to keeping growth fairly steady, through the operation of accommodative fiscal and monetary policies. Thailand is expected to witness a much sharper fall in growth in 2011 to 2 per cent due to its particular circumstances, having been severely impacted by flooding in late 2011. However, the resulting reconstruction and resumption of normal economic activities is forecast to result in growth of 4.5 percent in 2012.

Growth in a number of economies where domestic demand plays an important role is forecast to remain robust in 2012. However, growth was constrained somewhat in a number of these economies in 2011, the result of tight monetary policies meant to manage inflation. China and India are forecast to see growth of 8.5 per cent and

Table1. Rates of economic growth in selected developing Asian economies, 2010-2012

	2010	2011		2012
Country or area		April 2011	Current estimate	Forecast
Bangladesh	6.1	6.4	6.7	6.5
China	10.4	9.5	9.3	8.5
India	8.5	8.7	7.5	7.8
Indonesia	6.1	6.5	6.5	6.5
Kazakhstan	7.0	6.2	6.5	5.6
Malaysia	7.2	5.2	5.0	5.0
Pakistan	3.8	2.8	2.4	3.7
Philippines	7.3	5.2	4.4	5.1
Republic of Korea	6.1	4.5	3.9	3.5
Singapore	14.5	5.0	5.2	3.0
Thailand	7.8	4.5	2.0	4.5
Hong Kong, China	7.0	4.9	5.0	4.3
Developing ESCAP economies	8.9	7.3	7.2	6.6

Sources: ESCAP, based on national sources; IMF, International Financial Statistics database (Washington, D.C., August 2011); ADB, *Key Indicators for Asia and the Pacific 2011* (Manila, 2011); CEIC Data Company Limited accessed on 28 November 2011; ESCAP estimates and ESCAP, *Economic and Social Survey of Asia and the Pacific 2011* (United Nations pubilcation, Sales No. E.11.II.F.2).

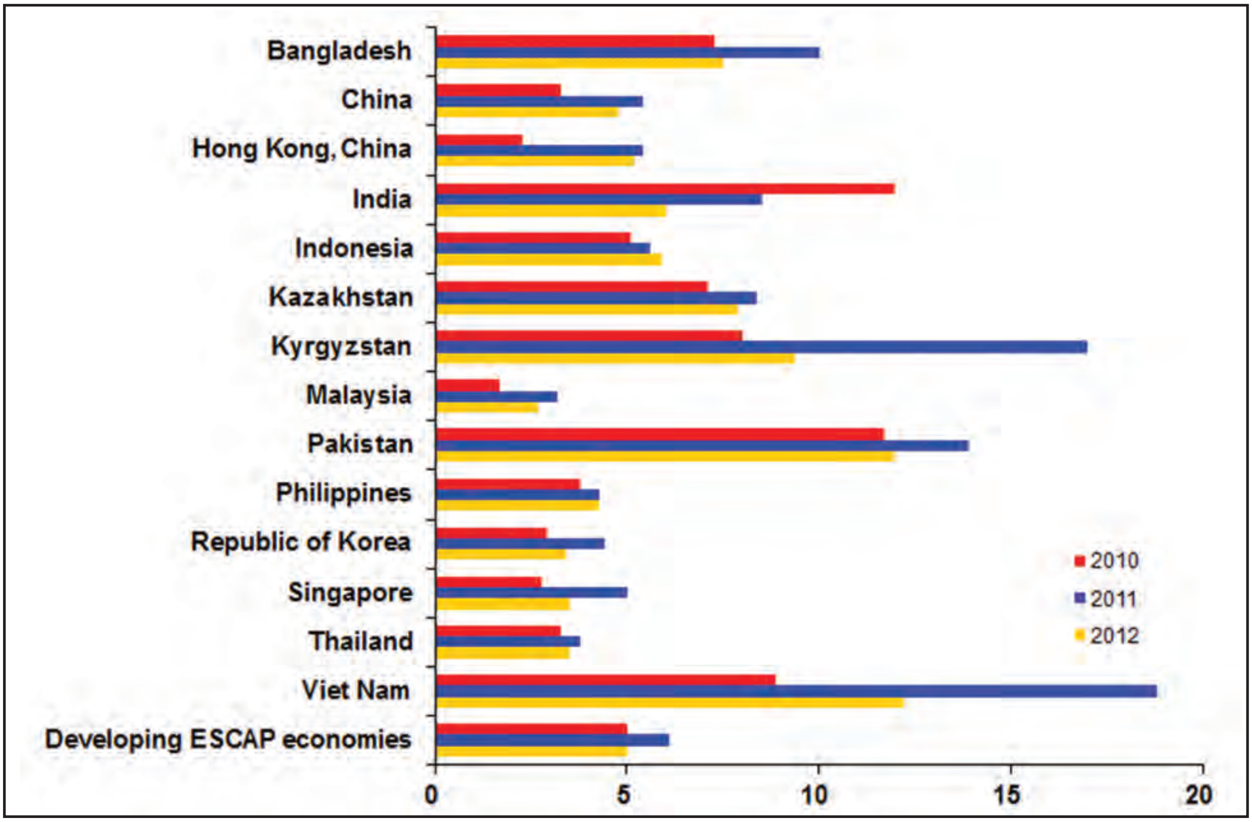
Notes: Rates of real GDP growth for 2011 are estimates and those for 2012 are forecasts. Developing ESCAP economies comprise 37 economies (excluding the Central Asian countries) and the calculations are based on the weighted average of GDP figures in United States dollars in 2010 (at 2000 prices).

7.8 per cent, respectively, in 2012, as compared to 9.3 per cent and 7.5 per cent that is expected for 2011. Pressures on growth for the two economies will continue to be present due to lingering inflation, with the global situation also affecting the important export sector for China and foreign financing of Indian enterprises. Indonesia will be well placed to sustain growth in 2012 at a forecast 6.5 per cent, similar to the expected rate in 2011, aided by the economy's relatively favourable inflation outlook, which would permit a relaxation of the monetary stance.

The level of commodity prices remains very high in many economies and is a cause of significant hardship

Inflation is predicted to improve in 2012, after a substantial rise and subsequent decline in some economies in 2011, leading to high overall values for 2011 as a whole (see figure 11). Inflation is forecast to decline in 2012 in export-led economies due to a reduction in demand emanating from the sluggish global environment. Imported inflation from commodity prices also declined in severity during the course of 2011 due to declining global demand. However, the level of commodity prices remains very high in many cases and is a cause of significant hardship to those in the affected economies. A continuation of these economic trends is forecast to reduce inflationary pressures in 2012. In some major economies where domestic demand is more important, particularly India, China and Viet Nam, inflation has remained at fairly elevated levels by historical standards. Commodity price rises in these economies, especially for food, have remained high due to domestic factors. Contractionary monetary policies during the course of 2011 have somewhat moderated the pace of the increase in inflation in 2011, with the efforts forecast to bear greater fruit in 2012.

Figure 11. Consumer price inflation of selected developing economies in the ESCAP region, 2010-2012



Sources: ESCAP, based on national sources; IMF, International Financial Statistics databases (Washington, D.C., August 2011); ADB, *Key Indicators for Asia and the Pacific 2011* (Manila, 2011); CEIC Data Company Limited and ESCAP estimates.

Notes: Rates of inflation for 2011 are estimates and those for 2012 are forecasts. Developing economies of the region comprise 37 economies (exlcuidng the Central Asian countries) and the calculation of the regional rate is based on the weighted average of GDP figures in United States dollars in 2010 (at 2000 prices).

Policy challenges and options

Navigating the growth and inflation balance

While growth in many countries in the region will come under pressure in the difficult current global climate, there is considerable scope for supporting growth through government policy. Most countries in the region retain substantial fiscal space to be able to increase government spending. Interest rates, which are currently at relatively high levels across the region, can also be kept on hold or even decreased if necessary, which could greatly stimulate lending across the region. While fiscal balances have moved downwards due to the stimulus policies enacted at the start of the financial crisis, subsequent strong growth performance and the phasing out of such measures boosted government finances in 2010 compared to the previous year (see table 2). However, there are significant disparities in fiscal policy performance among Asia-Pacific economies, with South Asian economies recording relatively high fiscal deficits while East Asian and South-East Asian economies showed strong fiscal consolidations in 2010.

Table 2. Fiscal balance for selected Asia-Pacific developing economies, 2006-2010

	(Percentage of GDP)				
Country/area	**2006**	**2007**	**2008**	**2009**	**2010**
Bangladesh	-3.3	-2.8	-6.2	-3.9	-3.7
China	-0.8	0.6	-0.4	-2.3	-1.6
Fiji	-2.9	-2.1	0.5	-4.1	-3.6
Hong Kong, China	4.0	7.7	0.2	1.6	4.1
India	-3.3	-2.5	-6.4	-6.8	-5.1
Indonesia	-0.9	-1.3	-0.1	-1.6	-0.7
Kazakhstan	0.8	-1.7	-2.1	-2.9	-2.4
Malaysia	-3.3	-3.2	-4.8	-7.0	-5.6
Pakistan	-4.3	-4.4	-7.6	-5.3	-6.3
Papua New Guinea	3.2	2.4	-2.2	-0.1	0.7
Philippines	-1.0	-0.2	-0.9	-3.7	-3.5
Republic of Korea	0.4	0.7	-1.1	-4.1	-1.1
Samoa	-0.5	0.7	-1.5	-4.2	-9.7
Singapore	6.3	11.3	7.8	-0.3	-0.1
Sri Lanka	-7.0	-6.9	-7.0	-9.9	-7.9
Taiwan, Province of China	-0.2	-0.2	-0.8	-3.6	-3.2
Thailand	-0.3	-1.3	-0.6	-4.2	-2.5
Viet Nam	1.3	-1.0	0.7	-6.6	-4.7
Developing Asia-Pacific	-0.8	0.2	-1.4	-3.3	-2.2

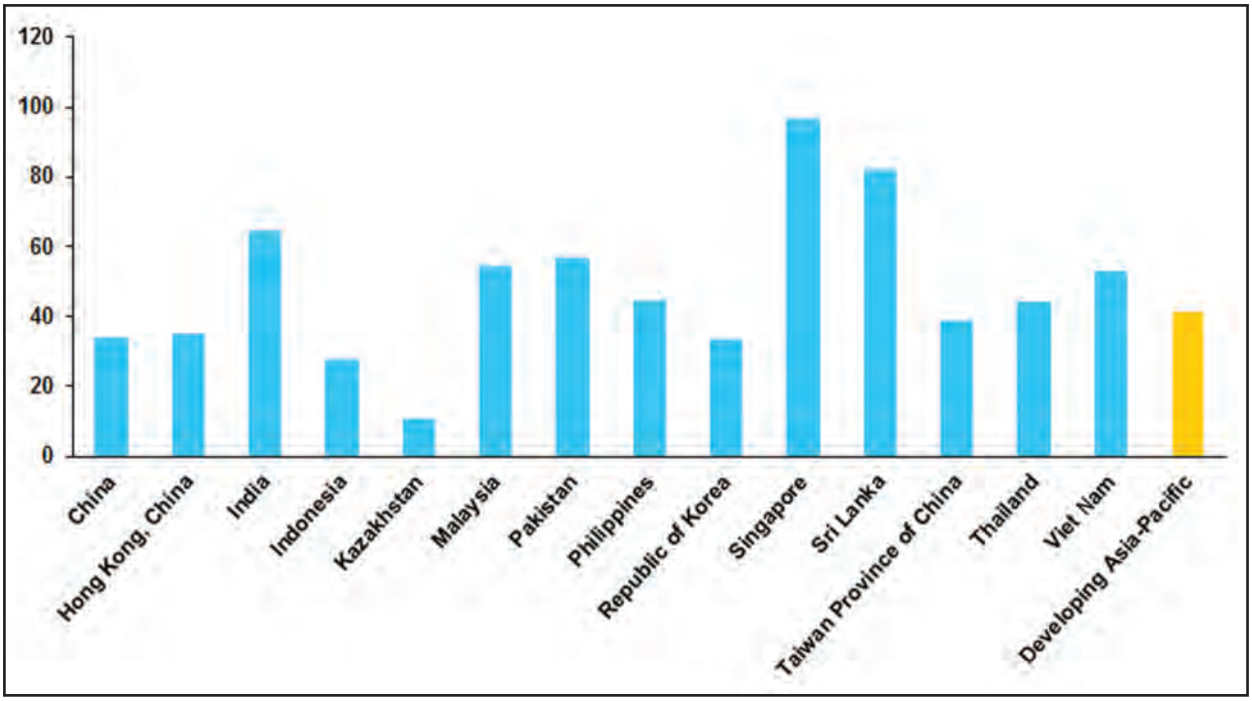
Source: ESCAP based on national sources and ADB, *Asian Development Outlook 2011* (Manila, 2011).

There is scope for fiscal stimulus in most of the economies which may be most affected by a growth downturn

There is scope for fiscal stimulus in most of the economies which may be most affected by a growth downturn. Fiscal deficits and levels of public debt (see figure 12) are relatively low in many export-oriented economies of the region, though they are somewhat high in a few, such as Malaysia. In terms of overall fiscal sustainability in the region, developing Asia-Pacific economies have relatively low public debt levels at an average of 41 per cent of GDP as of 2010, well below that of developed economies. Therefore, enacting further stimulus policies, if required, would not impose excessive burdens on budgets and would not increase public debt to unsustainable levels in the economies most likely to be hit by a slowdown in exports. Public debt levels are high in a number of economies, such as some in South Asia, but these economies are largely domestic-demand-led and, hence, their overall growth is less affected by slackening global demand.

A number of governments have already announced fiscal stimulus programmes in recent months in response to the deteriorating economic environment. In October 2011, Malaysia announced a $1.9 billion package and the Philippines announced a $1.7 billion package. Both packages included support to infrastructure development. In addition, Malaysia provided a cash grant to poor households and the Philippines directed funds to poverty alleviation. India also announced a package of $1.7 billion in tax credits to assist the export sector affected adversely by the slowdown of

Figure12. Gross public debt as a percentage of GDP in selected Asia-Pacific developing economies, 2010



Source: ESCAP based on CEIC data company limmited (October 2011) and IMF, World Economic Outlook Database, September 2011.

Note: Singapore's high public debt to GDP should be considered as an exceptional case as most of the public debt is intra-government holdings by the Central Provident Fund and not accumulated as a result of government deficits.

the global economy. The measures already adopted by various countries in the region are among the possible options for fiscal policy for other economies in the region - tax reduction, cash assistance for low-income households and increases in infrastructure spending. Other methods may include targeted one-off subsidies, such as consumption vouchers and cash handouts.

The concern with renewed stimulus measures in the region is the impact that such measures have on inflation, which, despite having moderated in recent months, remains high in many economies. It is possible that external causes of inflation will continue to be less pressing in coming months, with the downturn in the global economy reducing demand for commodities and consequently their prices. Furthermore, capital inflows to the region, which have also stoked inflation, may be curtailed in a risk-averse global environment. Nevertheless, the global price drivers for food, a key element of inflation in the region, may be less influenced by the difficult global environment. Food demand does not move as greatly in response to global growth. Weather-related factors and financial speculation remain more important causes of short-term food volatility.

The region must therefore be prepared for the risk that external price pressures, primarily through food but possibly through oil also, will stay high despite slowing domestic growth. While many of the causes of inflation are external—for example the global rise in food and oil prices as well as inflows of foreign capital—rises in the prices of these items have fed through to core inflation through rising input prices and the second-round effects of higher wage demands. Therefore, restricting demand through monetary policy would have some effect on controlling prices. Monetary policy is, however, a blunt tool, one that implies restricting demand to control price increases which are external or supply-led and not due to overheating domestic demand. Demand in the economy, which is already under pressure due to slowing exports, would be further impacted by a contractionary monetary policy. Measures to directly impact the high price of commodities, such as tax and tariff policy, should be an integral part of inflation-fighting measures. Capital controls are another useful tool for restricting the inflow of foreign capital to local asset markets. However, in cases where substantial price increases in the general economy feed into heightened inflationary expectations, monetary policy may remain the most effective tool, although one with significant growth implications. The question then becomes: What level of inflation should be regarded as acceptable in the short term at a time when growth concerns have again come to the fore?

It is necessary to consider both the growth and inflation impacts of monetary policy

The overriding importance given to keeping inflation at relatively low levels in economies facing external and supply-led inflation is excessive where the associated measures may, in themselves, cause hardship to the population through the loss of jobs or income. Considering both the growth and inflation impacts of monetary policy may be more appropriate, with a rethinking of the necessity of meeting short-term inflation targets at any given moment despite a clouded outlook for growth. A number of economies in the region have inflation targeting regimes for setting monetary policy enacted after the 1997 Asian crisis, including Indonesia, the Philippines, the Republic of Korea and Thailand. One option is for inflation targets to be revised upwards or for inflation targets to be considered over a longer time frame. Another option is for precise targets to be removed and for monetary policy decisions to be taken at every point in time through a considered appraisal of the overall economic environment and the impact of monetary policy on areas other than inflation.

For a number of more domestic-demand-led economies, such as some in South Asia which are witnessing high inflation, the course of action is clearer. Since in these cases robust domestic demand has been one of the factors driving price rises, monetary policy measures that dampen demand will still have to be considered. This will have the effect of reducing growth to more sustainable levels. India, for instance, is unlikely to see growth accelerate because policymakers continue to tighten interest rates as price rises remain at near double-digit levels. Fiscal stimulus would also prove more difficult for the economy, as debt levels are relatively high. India has this in common with some neighbouring economies, such as Sri Lanka and Pakistan.

China is unique in the region as it is export-oriented but still has substantial demand-led inflation. However, China's approach to any further stimulus in the event of a substantial slowdown in growth will be key to the performance of the exporting economies of the region. Any substantial growth in the economy will help cushion the export blow from the developed economies. China will require a different set of measures to sustain growth and manage inflation as compared to the economies which are either primarily led by exports or by domestic demand. The economy is substantially impacted by the global slowdown, but is experiencing inflation influenced by robust domestic demand, primarily through investment supported by the creation of credit. While dampening domestic investment through monetary policy is a rational measure for reducing inflation, enacting such measures at a time of weakness in other growth drivers of the economy while avoiding an excessive slowdown or "hard landing" will be a difficult balancing act. It will be important to carefully monitor short-term developments in growth and price performance in the economy to ensure the correct timing and scale of any measures.

Coping with capital flows

The region is still striving to arrive at the appropriate policies to deal with excessive short-term capital flows

The region is still striving to arrive at the appropriate policies to deal with the pressing issue of exposure to excessive short-term capital flows. The current policy mix of currency intervention, foreign exchange reserves accumulation, prudential measures related to foreign exposure and limited capital controls have not proved sufficient to manage the impact of such inflows and the risks from sudden outflows. As discussed earlier, intervention as the primary method of reducing the risks from capital inflows and outflows suffers from numerous disadvantages. The increasingly accepted supplementary option across the region is to impose capital controls that attempt to deal with the problem of capital inflows at the source rather than taking remedial measures, such as intervention, after inflows have taken place. However, the adoption of capital control measures to address inflows in the region so far have been limited and may not be sufficient, in their current guise, to deal sufficiently with the challenge and further modifications may be required.

The recent controls in the region have been designed to reduce the attractiveness of certain types of inflows, such as foreign bank borrowing and short-term bonds. These sectors have been viewed as the most attractive for investors in particular country cases. The intention of the controls is to move investors towards long-term holdings of assets in these sectors. However, there remains the risk that volatility will not decline as a large quantum of reversible capital flows will continue to be attracted to these countries in spite of the controls. Therefore, it is possible that the current controls being applied in the region will induce investors to redirect their investments to reversible holdings in sectors not covered by the controls. The latter course of action is the finding of numerous assessments of controls imposed by other economies in the past,[10] and ESCAP analysis of recent capital controls in the region support that conclusion. In Indonesia, a one-month holding period requirement of central bank paper (SBIs) was introduced in June 2010. The measure resulted in foreign investors moving into longer-tenure SBIs, producing lower market volatility. However, after a short period of time, non-resident participation increased in the government bond markets, where the holding period requirements did not apply. In response to the continuing inflows, the authorities announced a series of further measures, including hikes in the reserve requirements on foreign currency deposits, the re-imposition of a cap on short-term external borrowing by banks, and the further extension of the minimum holding period requirement to six months.

In the future, economies may have to design controls which deal with the possible challenge of a "new normal" of long-term pressure for entry of short-term capital into the region. One of the criticisms traditionally offered regarding capital controls is that periods of short-term capital inflows are temporary, and therefore the long-term efficiency costs of imposing controls outweigh the benefits of dealing with a transient issue. However, the new global environment presents a sea-change

10 See, for example, Gregorio, Edwards and Valdes, "Controls on capital inflows: Do they work?" Journal of Development Economics, Elsevier, vol. 63, No. 1, pp. 59-83, October 2000.

in the behaviour of portfolio capital, with funds being attracted to the region for an extended period due to the inherent attractiveness of the region as seen from medium-term projections of growth and interest rate differentials with the developed world.

The next steps that may be required by economies seeking to avoid the adverse impacts of volatile capital inflows would be to impose more widespread quantitative restrictions on foreign portfolio and other short-term investments and bank non-productive investment lending. While a strong measure, it may be justified due to the long-term pressure that some developing economies face vis-à-vis the developed world. The guiding principle may be to have free entry of foreign investment in the real sector, such as FDI, corporate and bank project lending and corporate equity and bond new issues, while carefully managing the entry of capital for existing portfolio and other assets. Such discrimination between uses of capital would be difficult to optimize. There would be leakages or a reduction in the potential amount of foreign funds available for real investment. However, this consideration may not be critical, as most developing economies which are being impacted by the inflow of capital are arguably either not in significant need of foreign funds for their investment or present such attractive investment stories that foreign capital will continue to enter regardless of the restrictions in place.

Rebalancing amid external pressures

The medium-term need for the region continues to be to redirect its growth drivers from extraregional demand to intraregional and domestic demand

The medium-term need for the region in order to maintain its growth momentum continues to be to redirect its growth drivers from extraregional demand to intraregional and domestic demand. Economies in the region differ in their rebalancing needs, with one set of economies, principally China, needing more consumption and another set of economies, especially those in South-East Asia, needing more investment. However, the rebalancing challenge is complicated, in the short-term, by the slowdown in extraregional demand due to the global environment. This is because some of the possible measures to aid in this redirection may have a negative short-term impact on growth, which would add to current growth difficulties. For example, export-led economies with upward pressure on their exchange rates could implement a coordinated exchange rate appreciation against developed economy currencies. This would support domestic investment and consumption, while not affecting intraregional exports. However, while assisting in making imported goods cheaper for investment and consumption in economies, as well as reducing imported inflation, such a policy would further damage export competitiveness in extraregional markets, risk unemployment and exert downward pressure on wage levels in the export sector. The example of China noted here illustrates that, at times of external difficulty, government policies which impinge on existing growth drivers may prove unpalatable.

A more acceptable way to continue the medium-term task of rebalancing economies towards domestic and regional demand is to implement a set of measures to support future growth drivers without an unduly unfavourable impact on the current ones. One such set of policies would be to continue the process of establishing social protection systems, such as public provision of health and unemployment insurance as well as pensions and enhanced public spending on health care and education.

This would increase the ability of people to consume by reducing the need for precautionary savings without exerting any undue downward pressure on other components of growth. In terms of aiding investment in those economies where it remains relatively low, spending on infrastructure is a clear area for improvement. Governments have ample room to boost investment in their own infrastructure and that of their neighbours with less fiscal ability, with investments that offer both good returns and substantial indirect benefits by increasing intraregional integration and trade. The removal of impediments to intraregional investments was, for instance, one of the commitments of SAARC leaders made at their Summit in November 2011 as part of their overarching objective of increasing intercountry linkages.[11] Investment can be supported by the creation of a regional financial architecture for development financing, which would include a system of intermediation between its large savings and its unmet investment needs, as proposed by ESCAP.[12]

A key policy for fostering rebalancing is to support the development of the agricultural sector

Another key policy for fostering rebalancing is to support the development of the agricultural sector in the region. In Asia and the Pacific, the majority of poor people live in rural areas and derive most of their income from agriculture. Apart from the moral imperative to improve their lives and reduce poverty, increasing agricultural growth and therefore rural incomes will also increase domestic and regional consumption. As the region aims for more balanced economic growth, it needs a second, more knowledge-intensive green revolution that will reverse the relative neglect of the agricultural sector in public policy management and overseas aid priorities over recent decades. Promoting higher agricultural productivity is the key policy response, especially in the context of rising food prices, with public resources needing to be shifted from subsidizing consumption to boosting agricultural productivity. This requires sustained national programmes of agricultural research, public education and better-designed rural extension plans. International development partnerships and South-South cooperation can also help foster such a green revolution, while also addressing concerns for food security.

11 SAARC, Addu Declaration, available at http://www.saarc-sec.org/2011/11/14/news/ADDU-DECLARATION/79/.

12 *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2), Chap. 3.

The Asia-Pacific region is facing the challenge of coping with a sharp deterioration in the global environment, impacting the region's growth prospects in 2012. As forewarned by ESCAP, the developed economies of the world remain mired in the economic crisis which erupted in 2008. The impact on Asia-Pacific countries at this stage of the crisis will be on the financial markets through capital outflows due to global uncertainty, and more fundamentally on output due to shrinking demand for exports.

A number of countries in the region have also been severely impacted by the effects of floods and other natural disasters, which have taken lives and caused severe distress as well as negatively affected growth prospects and complicated economic management. Some economies in the region continue to grapple with the challenge of high prices, which presents economies with the balancing act of supporting slowing growth while maintaining price stability.

The ***Year-end Update*** of ESCAP's annual flagship publication, ***Economic and Social Survey of Asia and the Pacific 2011,*** considers the implications of these challenges for policymakers in the region. The key message of the ***Update*** is the need for countries in the region to stand ready to enact appropriate supportive measures for their economies in response to global instability. Most countries in the region are well-placed to undertake such actions due to their favourable macroeconomic fundamentals and adequate fiscal space. Furthermore, the medium-term challenge for the region is to sustain its development by continuing to rebalance growth through inclusive policies which boost demand while reducing poverty and inequality.

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