ADB

# ASIAN DEVELOPMENT Outlook 2012 Update

## Services and Asia's Future Growth

Asian Development Bank

ADB

# ASIAN DEVELOPMENT Outlook 2012 Update

## Services and Asia's Future Growth

Asian Development Bank

ISBN 978-92-9092-862-1 (Print), 978-92-9092-863-8 (PDF)
ISSN 1655-4809
Publication Stock No. FLS125028

Cataloging-in-Publication Data

Asian Development Bank.
Asian development outlook 2012 update. Services and Asia's future growth.
Mandaluyong City, Philippines: Asian Development Bank, 2012.

1. Economics. 2. Finance. 3. Asia. I. Asian Development Bank.

The annual *Asian Development Outlook* provides a comprehensive economic analysis of 45 economies in developing Asia and the Pacific.



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

For orders, please contact:
Department of External Relations
Fax +63 2 636 2648
adbpub@adb.org

Printed on recycled paper.

# Contents

# Foreword

The clouds engulfing global growth prospects are thickening. Compared with the expectations underlying *Asian Development Outlook 2012* forecasts published in April, the feeling that sustained recovery may soon get underway are much more muted. The United States economy has yet to return to its potential, and the euro area is in recession while grappling with its sovereign debt and banking crises.

The major industrial economies of the United States, the euro area, and Japan are collectively expected to expand by only about 1% this year and next. The malaise in advanced economies is weighing heavily on global prospects. As a result, this *Update* sees developing Asia's growth tailing off more rapidly than previously forecast. The region is slowing from its 7.2% growth pace in 2011 to 6.1% in 2012 and 6.7% next year.

But the regional slowdown is not entirely down to outside factors. Rather than seeing domestic demand pickup to compensate for the weak external environment, the two economic powerhouses—the People's Republic of China (PRC) and India—have experienced slowing investment and consumption. The *Update* forecasts sharp decelerations in both economies, from 9.3% in 2011 to 7.7% this year in the PRC and from 6.5% to 5.6% in India.

Although continued growth is evident elsewhere in Asia, weakening momentum in the PRC and India is already affecting on the growth outlook for the rest of the region. This is because the two regional giants stand as important sources of export demand for many other Asian economies.

Much uneasiness remains, as the ongoing sovereign debt crisis in the euro area and the looming fiscal cliff in the United States pose major risks to the outlook. This is despite the stabilizing and confidence-building effect of recent announcements from monetary authorities there.

The only silver lining to the growth slowdown is the likely easing of inflation, which is seen falling from 5.9% in 2011 to 4.2% in both 2012 and 2013. This assumes there are no serious supply disturbances that could cause international food or fuel prices to spike.

Continuing weakness in the external environment and decelerating growth in the region's two most robust economies strongly suggest that developing Asia must prepare itself for a period of moderate, rather than high, growth. The heady days of double-digit growth in gross domestic product may be a thing of the past. This new reality should provide the region with the incentive and impetus to get serious about rebalancing economic structures, stimulating domestic demand, and improving productivity. These reforms are critical if the giant strides in poverty reduction witnessed in Asia in recent decades are to continue.

As the region's middle class grows and external markets remain weak, developing a vibrant service sector can be an important component of this rebalancing. In fact, the service sector in Asia is already large, providing almost half of the region's gross domestic product in 2010 and employing about 34% of all workers that year. Further, services tend to be labor-intensive, so stimulating this sector promotes inclusive growth and helps to reduce poverty.

But unleashing the potential of services to boost growth requires investment in appropriate infrastructure and education, along with comprehensive regulatory reform to promote a more competitive services industry.

H. Kuroda

Haruhiko Kuroda
President
Asian Development Bank

# Acknowledgments

The *Asian Development Outlook 2012 Update* was prepared by the staff of the Asian Development Bank (ADB) from the Central and West Asia Department, East Asia Department, Pacific Department, South Asia Department, Southeast Asia Department, Economics and Research Department, as well as the resident missions. Representatives from these departments and the Office of Regional Economic Integration constituted a Regional Economic Outlook Task Force, which met regularly and coordinated closely to develop consistent forecasts for the region.

The authors who contributed the sections are bylined in each chapter. The subregional coordinators were Tatsuji Hayakawa for Central and West Asia; Yolanda Fernandez Lommen for East Asia; Yoko Niimi for South Asia; Joven Balbosa for Southeast Asia; and Christopher Edmonds for the Pacific.

A team of economists from the Economics and Research Department, led by Joseph E. Zveglich, Jr., Assistant Chief Economist, Macroeconomics and Finance Research Division, assisted by Edith Laviña, coordinated the overall production of the publication. Technical and research support was provided by Arnelyn May Abdon, Shiela Camingue, Cindy Castillejos-Petalcorin, Gemma Esther Estrada, Nedelyn Magtibay-Ramos, Pilipinas Quising, Aleli Rosario and Lea Sumulong. Robert Boumphrey, Richard Niebuhr and Anthony Patrick as the editorial economic advisors made substantive contributions to the country chapters and regional outlook. Stella Quimbo provided editorial advice on the theme chapter.

Peter Fredenburg did the style and manuscript editing. Alfredo de Jesus was responsible for typesetting, as well as graphics generation in which he was assisted by Maria Susan Torres. Art direction of the cover design was by Anthony Victoria, with artwork from Design Muscle. Critical support for the printing and publishing of the report was provided by the Logistics Management Unit of the Office of Administrative Services. Fermirelyn Cruz, Elenita Pura, and Rhia Bautista provided administrative and secretarial support.

The Department of External Relations, led by Ann Quon, Omana Nair, and Sean Crowley, planned and coordinated the dissemination of the *ADO 2012 Update*.

C Rhee

Changyong Rhee
Chief Economist
Economics and Research Department

# Definitions

The economies discussed in the *Asian Development Outlook 2012 Update* (*ADO 2012 Update*) are classified by major analytic or geographic groupings. For purposes of *ADO 2012 Update*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to the 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member.
- **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 Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **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.
- Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars.

*ADO 2012 Update* is generally based on data available up to **12 September 2012**.

# Acronyms and abbreviations

| | |
|---|---|
| ADB | Asian Development Bank |
| ASEAN | Association of Southeast Asian Nations |
| BPO | business process outsourcing |
| CPI | consumer price index |
| ECB | European Central Bank |
| EU | European Union |
| FDI | foreign direct investment |
| FY | fiscal year |
| GDP | gross domestic product |
| IMF | International Monetary Fund |
| ICT | information and communication technology |
| OECD | Organisation for Economic Co-operation and Development |
| OPEC | Organization of the Petroleum Exporting Countries |
| PRC | People's Republic of China |
| US | United States |

# *ADO 2012 Update—Highlights*

**Dimming global growth prospects and soft domestic demand in the region's two largest economies are slowing the pace of developing Asia's expansion. Growth is now expected to slide from 7.2% in 2011 to 6.1% in 2012, with a bounce back to 6.7% in 2013.**

**The possibility of a shock emanating from the unresolved euro area sovereign debt crisis or a sharp fiscal contraction in the United States pose the biggest downside risks to the economy. Fortunately, most developing Asian economies have room to counteract such shocks with fiscal and monetary policy. However, there is currently no regionwide need for countercyclical policy intervention.**

**In the medium term, continued weakness in external demand and moderated growth in the People's Republic of China and India mean economies in the region must diversify their growth drivers. Service sector development is poised to play a critical role in the region's future growth.**

## Key messages

- Developing Asia's growth is slowing more than anticipated in the *Asian Development Outlook 2012* (*ADO 2012*). The region is projected to expand by 6.1% in 2012 and by 6.7% in 2013, down significantly from 7.2% in 2011. Deceleration in the region's two giants—the People's Republic of China (PRC) and India—and in other major exporting economies is tempering earlier optimism.

- The PRC is forecast to grow by 7.7% this year and by 8.1% in 2013, considerably more slowly than the robust 9.3% growth of 2011. While weak external demand is dragging down the PRC and the export-oriented East Asian economies, internal factors are contributing too. Slowing investment and stagnating consumption are holding back gross domestic product (GDP) expansion in the PRC, with knock-on effects for East Asia's outlook through diminished demand for intraregional exports.

- India will not accelerate this year from the 6.5% recorded in 2011 but, rather, see GDP growth slow to 5.6% in 2012 and bounce back to 6.7% in 2013. Tepid consumption has been insufficient to make up for declining investment and export demand. A large fiscal deficit and persistently high inflation have limited the scope for fiscal and monetary policy to stimulate the economy.

- Weakening growth momentum will temper price pressures, pushing inflation in the region down from 5.9% in 2011 to 4.2% in both 2012 and 2013. International food and fuel prices were quite volatile in the first half of 2012. The surge in food and oil prices in the second half of 2012 is a concern, raising the specter of the 2008 price spikes.

- The ongoing sovereign debt crisis in the euro area and the looming fiscal cliff in the United States (US) pose major risks to the outlook despite the stabilizing effect of announcements by monetary authorities in Europe and the US.

- Regional capital markets have not shown excessive volatility, but recent experience shows that drops in global investor confidence can trigger rapid reversals in capital flows. Improving macroprudential policies should have priority on the reform agenda.

- Developing Asia has no widespread, urgent need at the moment for countercyclical policy intervention. Most Asian countries, except those with deepening deficits or persistently high inflation, can mobilize monetary and fiscal policies should a major shock materialize.

- Protracted weakness in major industrial economies bodes ill for a myopic focus on exports. As growth in maturing economies slows, countries will have to rely more on enhancing productivity and efficiency to secure future prosperity. Service sector development can play a critical part in this process.

- Developing Asia's large and expanding service sector already contributes significantly to the region's growth. That role will broaden further as economies that graduated from agriculture to industry evolve further into service economies.

- The service sector still fixates, however, on traditional services with low productivity. A key challenge is to raise service sector dynamism by moving toward high-value modern services, such as information and communication technology, finance, and professional business services.

- A vibrant service sector would have broad economic benefits. Synergies between services and industry could improve overall productivity. The service sector tends to be more effective in job creation, in particular for women, thus supporting inclusive growth. Modern services meet domestic demand for high-end services and, because they are increasingly tradable, provide new export opportunities.

- Lack of human capital and inadequate infrastructure are major bottlenecks for developing the modern service sector. But above all, restrictive government regulations that stifle competition and innovation must yield to policies that promote services:

    - Ramp up investment in services-relevant infrastructure that has broad spillover effects, such as information and communication technology and broadband services.
    - Ease the shortage of highly skilled workers through education reform, in particular reforming tertiary education for business services.
    - Relieve the regulatory burden on new players by exerting strong political commitment to reduce excessive restrictions and strengthen competition law, toward creating more competitive service markets, which hold the key to productivity growth.

## Dimming global growth prospects

### *Developing Asia's outlook*

- **Asia's growth is cooling more rapidly than forecast in April in the *ADO 2012*.** Growth in developing Asia's GDP will slow from 7.2% in 2011 to 6.1% in 2012 before picking up somewhat to 6.7% in 2013.

  » The *Update* forecasts for GDP growth revise down *ADO 2012* estimates by 0.8 percentage points in 2012 (from 6.9%) and by 0.6 percentage points in 2013 (from 7.3%) because of pressure from the weak external environment.

  » Economic activity in the major industrial economies remains weak. The US economy has failed to build strong growth momentum, and the euro area is continuing to contract mildly. Japan began 2012 well, but its growth prospects are nevertheless subdued for the rest of the year by sluggishness in the US and the euro area.

- **The slowdown is manifest in the region's two giants.** Growth this year in the PRC is forecast to decelerate to 7.7% from 9.3% in 2011, and in India to 5.6% from 6.5% last year. External and internal factors combined to weaken their growth prospects.

  » Export growth in these two economies declined significantly. In the PRC, it decelerated to 9.2% in the first half of 2012 from 24.0% in the same period of last year, while in India exports contracted by 6.7% in the first 5 months of fiscal year 2012. The lagged impact of monetary tightening, the normalization of fiscal policy in both economies, and delayed reforms in India have contributed to falling investment and consumption, particularly in real estate and infrastructure.

  » Projections were also downgraded in the other export-oriented economies in East Asia as they have had to contend with weak demand from the major industrial economies and the PRC.

  » However, growth in the other subregions is forecast to remain resilient this year. In fact, average growth in developing Asia excluding East Asia and India is projected to increase to 5.2% in 2012 from 4.9% in 2011.

- **Sluggish growth prospects are keeping price pressures in check**. Average inflation in developing Asia is expected to moderate to 4.2% in both 2012 and 2013, improving on the 5.9% recorded last year. International food and fuel prices were quite volatile in the first half of 2012. The surge in food and oil prices in the second half of 2012 is a concern.

- **The weakening momentum of growth in the PRC and India will exacerbate the growth outlook for the rest of Asia.** The rising importance of the two Asian giants is evident in the greater influence their economies have on regional and international business cycles. Because import demand from the PRC and India amount to significant shares of global trade, spillovers from them into Southeast Asian countries and the major industrial economies are significant. External forces play a large role in the PRC's slowdown, explaining about two-thirds of it, while internal factors are dominant in India's.

### *Risks to the outlook*

- **The unresolved euro crisis and the threatened US fiscal cliff pose the biggest downside risks to the outlook.** Intensified financial market stress in Europe may deepen the recession, with disastrous spillovers to the rest of the world. Further, failure in the US to extend important fiscal policy measures into 2013 would further erode private demand.

  - » The most open economies in developing Asia are particularly vulnerable. Spillover analyses suggest that a negative shock from industrialized countries would have substantial impact on the region's growth. The adverse effects of the US fiscal cliff could have a larger impact on Asia than bad news of the same magnitude from Europe.
  - » Recent supportive announcements from the European Central Bank and the US Federal Reserve diminish—but do not eliminate—the potential of these risks to undermine the global outlook.

- **The possibility of sudden capital flow reversals is a continuing concern.** While the region's financial markets have been relatively resilient, the deleveraging of large banks in advanced economies could, together with heightened global uncertainty, cause investor confidence to ebb and sharply reverse capital inflows to developing Asia, as happened in 2008 and 2010.

### *Policy response in the face of uncertain prospects*

- **Developing Asia currently has no urgent regionwide need to pursue countercyclical macroeconomic policies**. The output gap in many regional economies is not large. Core inflation shows signs of moderating as domestic demand eases.

- **Most economies in the region have ample room to use monetary and fiscal policy tools if needed.** Nevertheless, future countercyclical policy must support inclusive growth while ensuring long-term sustainability. Some countries with large structural fiscal deficits or high and persistent inflation need to implement fiscal consolidation and prioritize the imposition of macroprudential policies to regain market confidence.

- **Weakness in major industrial countries and decelerating growth in the region's two giants point to a less-favorable future growth environment.** Economies in the region must adapt by speeding up the rebalancing process, improving productivity, and enhancing efficiency. Developing a vibrant service sector in the region can supplement growth.

## Outlook by subregion

- **Developing Asia's growth is slowing on account of weaker growth in the region's two giants and in the other highly open East Asian economies.** Other developing Asian economies, however, appear to be resilient.

- **East Asia is still the fastest-growing subregion, but its deceleration is manifest.** Weak external demand from major industrialized economies is having a severe impact on East Asia's exports. The subregion's growth prospect is dimming—now forecast at 6.5% in 2012 (lower than the 6.8% of 2009 after the Lehman shock) and at 7.1% in 2013. In the PRC, domestic factors such as the pullback in real estate investment and the reduced pace of infrastructure development have reinforced the growth slowdown. The rest of East Asia has to contend with the twin blows arising from the weak global environment and the PRC's growth deceleration, and will also see slower growth. Inflation pressures will be contained as a result and are expected to moderate at 3.1% and 3.3% in the next 2 years.

- **South Asia will slow sharply while still combating inflation.** Downward revision for India slows the forecast for South Asia's growth from 6.6% to 5.5% in 2012 and from 7.1% to 6.4% in 2013. India's domestic economy is weakening as investment continues to be subdued, consumer confidence wanes, and deficient monsoon rains weigh in. The outlook for most other South Asian economies appears to be generally stable. Inflation continues to be the big concern for the subregion, limiting latitude for easing monetary policy to stimulate demand and counter the slowdown in economic growth. All in all, South Asia's inflation is forecast to average 8.6% in 2012 before calming to 7.4% in 2013.

- **Southeast Asia maintains resilience as inflation pressure abates.** Growth in Southeast Asia is expected to quicken to just over 5% in 2012. This partly reflects recovery in Thailand from severe flooding in 2011. Higher government spending has contributed to Malaysia and the Philippines achieving stronger growth than forecast in April. Investment and private consumption generally are buoyant in this subregion. However, exports have been eroded by the weak global environment, so GDP growth forecasts for this year and next are pared for Indonesia, Singapore, Thailand, and Viet Nam. Viet Nam's finance sector is under worsening stress from the slowdown in economic activity, falling asset prices, and the high ratio of nonperforming loans. In 2013, growth in Southeast Asia as a whole is seen edging up to 5.5% (though this forecast is trimmed from the *ADO 2012*). Inflationary pressures have abated such that the projection for 2012 is revised down to 3.9% and for 2013 to 4.0%.

- **Central Asia is softening as the oil price stabilizes and the external environment moderates.** Economic activity during the first half of 2012 fell short of the April forecast. The subregion's growth is forecast to decelerate to 5.7% in 2012, revised down from the 6.1% forecast in April, before edging up to 6.0% in 2013. The economy of the Kyrgyz Republic in particular is expected to stagnate this year because of slower gold production, before recovering in 2013. Growth prospects in Azerbaijan and Kazakhstan are likewise marked down because of weaker growth in the subregion's main trading partners, particularly the euro area and the PRC, as well as lower oil prices. The *Update* lowers the inflation projections of the *ADO 2012* for Central Asia from 7.2% to 6.4% in 2012 and from 7.3% to 6.7% in 2013.

- **Resource-rich Pacific economies continue to insulate this subregion from external headwinds.** GDP for the Pacific is still expected to expand by 6.0% this year, driven by Papua New Guinea, Solomon Islands, and Timor-Leste, where growth forecasts are unchanged as they push ahead with the development of infrastructure and resource projects. Growth prospects for Fiji have improved from April, but forecasts for some smaller economies are lowered. In 2013, aggregate growth is expected to moderate to 4.2%, mainly a result of major projects reaching completion. The forecast for inflation in the Pacific is trimmed to 6.3% this year and kept at 5.4% in 2013.

## Special theme: Services and Asia's future growth

### *Rising importance of services in Asia*

- **Services play a critical role in developing Asia's growth.** The sector is already large, accounting for almost half of the region's GDP in 2010. Services contribute substantially to economic growth across Asia, providing 66% of India's growth from 2000 to 2010 and 43% of growth in the manufacturing-oriented PRC in the same period.

- **Structural changes in the region's economies will further expand the role of services.** Developing Asia is following the same path travelled in the past by the advanced economies, with agriculture's dominance giving way to industry, and then industry being supplanted by services. Rising incomes and rapid urbanization are boosting demand for services domestically. As manufacturing sees wages rise and labor intensity fall, Asia will look even more to services to create jobs for the millions who join the workforce every year.

- **A vibrant service sector has broad benefits for the economy.** Four key factors highlight the urgent need to foster the development of the service sector:

    - » **Positive spillovers to other sectors.** Vibrant business services, such as information and communication technology (ICT), industrial design, and marketing, may facilitate investment and the development of new products. The cross-benefits work both ways, as a dynamic industry sector creates demand for more business services. This synergy between services and industry can raise the productivity of the economy as a whole.
    - » **Support for greater inclusiveness.** Job creation is central to inclusive growth, and services tend to be labor-intensive. The sector's share of total employment in the region is large—employing 34% of all workers in 2009—and growing. Empirical evidence suggests that service sector growth helps reduce poverty. More directly, services such as health care and education enable individuals to be more productive and enhance their quality of life.
    - » **Diversified production for stability.** The extended slowdown in the major industrial countries is weighing heavily on merchandise exports from the region. Developing the service sector can diversify the production base, which will enhance the resilience of the economy and boost its growth momentum.
    - » **New opportunities for foreign trade.** Technological progress has enabled the rise of cross-border trade in services. For example, the advent of ICT has catalyzed the global exchange of outsourced business processes. India and the Philippines have established themselves as world leaders in the export of such services. Asia accounts for a large share of this trade already, but greater openness can support a more competitive and productive service sector.

*Trapped in traditional services*

- **Labor productivity in developing Asia's service sector lags far behind that of advanced economies.** For most economies in the region, labor productivity is less than 20% of the figure in advanced economies. It languishes at around 10% in the PRC and India. In the worst cases, it may take up to 30 years to reach 20%.

- **Low productivity partly reflects the dominant role of traditional service industries.** These services—such as wholesale and retail trade, real estate, transport, personal services, and public administration—still account for the bulk of the sector's output. In contrast, modern services such as ICT, finance, and professional business services occupy less than 10% of Asia's service economy, well below the 20%–25% in advanced economies.

- **Enabling the shift to modern services and modernizing traditional services are essential to close the productivity gap with advanced economies.** Modern services enjoy higher productivity, have greater potential for synergies with other sectors, and are more amenable to cross-border trade. They also strengthen the link between services and inclusive growth by generating high-quality, high-wage jobs. Traditional services too can reap considerable productivity gains by updating their practices using modern tools.

- **Regulatory, infrastructure, and human capital bottlenecks are holding back service sector productivity.** Infrastructure for services, such as ICT, still lags advanced economies. The highly skilled workers that are required for modern services, such as scientists and bankers, are in short supply. And above all, excessive regulation that protects incumbent firms and other vested interests keeps markets less competitive and thus undercuts prospects for improved productivity and efficiency.

*Policy priorities for competitive services*

- **Regulatory reform is needed to foster a more competitive service sector.** The burden of heavy regulation is the single tightest bottleneck constraining the sector. A slew of regulations and restrictions currently protect incumbent firms, stifling competition and innovation in services. In India, for instance, a staggering 13 official bodies regulate higher education. Trade barriers in the PRC, the Philippines, Thailand, and others are higher than those in countries with similar incomes. International experience shows that regulatory reform can catalyze competition and deliver significant economic benefits. It must be a top priority for policy makers.

- **Investment in infrastructure for services needs to be ramped up**. ICT infrastructure, for example, has large positive spillover effects for the whole economy. Examples of the benefits of such investments are the world-class Indian and Philippine service industries in ICT and outsourced business processes. While Asia has invested in ICT infrastructure at a furious pace, it still lags advanced economies.

- **Education reform is vital to easing the shortage of highly skilled workers.** While education attainment has risen rapidly in Asia overall, the region still suffers acute shortages of some skills. Modern high-productivity services require highly skilled workers. The shortage is especially evident in professional groups: accountants, business managers, engineers, lawyers, medical doctors, scientists, and software specialists.

- **The region must improve its collection and publication of service sector data.** The lack of high-quality and timely data on services limits understanding of the sector, which constrains the ability of Asia's policy makers to formulate and implement appropriate policies. To foster evidence-based policy analysis, the strengthening of service sector statistics needs to be pursued in tandem with other reforms.

- **Policy makers must create a more competitive environment for services.** Regulatory barriers—including domestic obstacles and foreign trade restrictions—protect vested interests from new market entrants. Dismantling such barriers is critical to unleash competition. Easing constraints on infrastructure for services, and training workers in the skills demanded by modern services, will provide the means to move to modern high-productivity services. A more competitive, dynamic service industry can boost overall productivity to support the region's future growth.

**Growth rate of GDP** (% per year)

| Subregion/Economy | 2011 | 2012 | | 2013 | |
|---|---|---|---|---|---|
| | | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| **Central Asia** | **6.6** | **6.1** | **5.7** | **6.2** | **6.0** |
| Azerbaijan | 0.1 | 4.1 | 3.0 | 3.5 | 3.5 |
| Kazakhstan | 7.5 | 6.0 | 5.8 | 6.5 | 6.3 |
| **East Asia** | **8.1** | **7.4** | **6.5** | **7.7** | **7.1** |
| China, People's Rep. of | 9.3 | 8.5 | 7.7 | 8.7 | 8.1 |
| Hong Kong, China | 4.9 | 3.0 | 1.6 | 4.5 | 3.9 |
| Korea, Rep. of | 3.6 | 3.4 | 2.7 | 4.0 | 3.4 |
| Taipei,China | 4.0 | 3.4 | 1.7 | 4.6 | 3.8 |
| **South Asia** | **6.2** | **6.6** | **5.5** | **7.1** | **6.4** |
| Bangladesh | 6.7 | 6.2 | 6.3 | 6.0 | 6.0 |
| India | 6.5 | 7.0 | 5.6 | 7.5 | 6.7 |
| Pakistan | 3.0 | 3.6 | 3.7 | 4.0 | 3.7 |
| Sri Lanka | 8.3 | 7.0 | 6.5 | 8.0 | 7.0 |
| **Southeast Asia** | **4.6** | **5.2** | **5.2** | **5.7** | **5.5** |
| Indonesia | 6.5 | 6.4 | 6.3 | 6.7 | 6.6 |
| Malaysia | 5.1 | 4.0 | 4.6 | 5.0 | 4.8 |
| Philippines | 3.9 | 4.8 | 5.5 | 5.0 | 5.0 |
| Singapore | 4.9 | 2.8 | 2.2 | 4.5 | 3.8 |
| Thailand | 0.1 | 5.5 | 5.2 | 5.5 | 5.0 |
| Viet Nam | 5.9 | 5.7 | 5.1 | 6.2 | 5.7 |
| **The Pacific** | **7.0** | **6.0** | **6.0** | **4.1** | **4.2** |
| Fiji | 2.0 | 1.0 | 1.3 | 1.2 | 1.7 |
| Papua New Guinea | 8.9 | 7.5 | 7.5 | 4.5 | 4.5 |
| **Developing Asia** | **7.2** | **6.9** | **6.1** | **7.3** | **6.7** |

*Notes*: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member. East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam. South Asia comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Central Asia comprises

*(continued on the next page)*

**Inflation** (% per year)

| Subregion/Economy | 2011 | 2012 | | 2013 | |
|---|---|---|---|---|---|
| | | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| **Central Asia** | **8.9** | **7.2** | **6.4** | **7.3** | **6.7** |
| Azerbaijan | 7.9 | 9.0 | 6.5 | 8.5 | 6.0 |
| Kazakhstan | 8.3 | 6.5 | 6.0 | 6.8 | 6.3 |
| **East Asia** | **5.0** | **3.7** | **3.1** | **3.7** | **3.3** |
| China, People's Rep. of | 5.4 | 4.0 | 3.2 | 4.0 | 3.5 |
| Hong Kong, China | 5.3 | 3.8 | 3.8 | 3.3 | 3.3 |
| Korea, Rep. of | 4.0 | 3.0 | 2.7 | 3.0 | 2.9 |
| Taipei,China | 1.4 | 1.5 | 1.9 | 1.6 | 1.8 |
| **South Asia** | **9.4** | **7.7** | **8.6** | **6.9** | **7.4** |
| Bangladesh | 8.8 | 11.0 | 10.6 | 8.5 | 8.5 |
| India | 8.9 | 7.0 | 8.2 | 6.5 | 7.0 |
| Pakistan | 13.7 | 12.0 | 11.0 | 10.0 | 10.0 |
| Sri Lanka | 6.7 | 8.0 | 8.5 | 7.0 | 7.5 |
| **Southeast Asia** | **5.5** | **4.4** | **3.9** | **4.4** | **4.0** |
| Indonesia | 5.4 | 5.5 | 4.4 | 5.0 | 4.5 |
| Malaysia | 3.2 | 2.4 | 1.9 | 2.8 | 2.5 |
| Philippines | 4.6 | 3.7 | 3.5 | 4.1 | 4.1 |
| Singapore | 5.3 | 3.0 | 4.1 | 2.5 | 3.0 |
| Thailand | 3.8 | 3.4 | 3.0 | 3.3 | 3.2 |
| Viet Nam | 18.7 | 9.5 | 9.1 | 11.5 | 8.6 |
| **The Pacific** | **8.6** | **6.6** | **6.3** | **5.4** | **5.4** |
| Fiji | 8.7 | 5.1 | 4.7 | 3.0 | 3.0 |
| Papua New Guinea | 8.7 | 7.0 | 6.5 | 6.0 | 6.0 |
| **Developing Asia** | **5.9** | **4.6** | **4.2** | **4.4** | **4.2** |

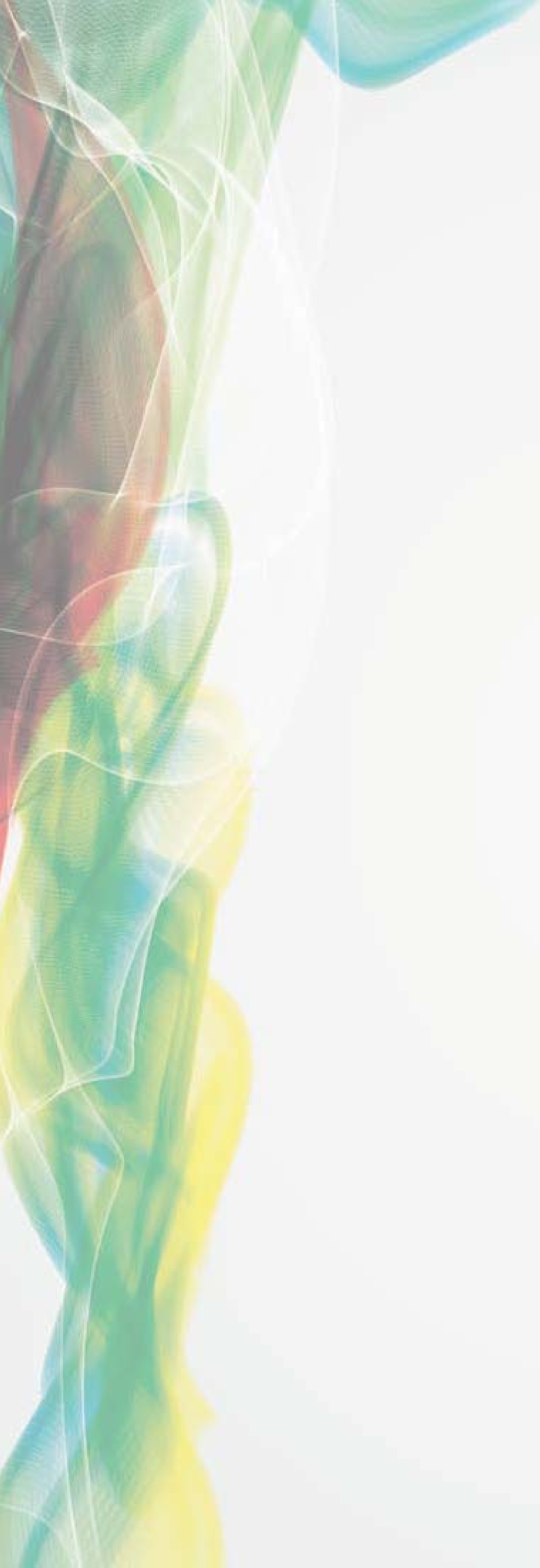
*(continued from the previous page)*

Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

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

# Dimming global growth prospects

# 1



# Dimming global growth prospects

The global economic slowdown has proved more tenacious than it appeared in April 2012, when the *Asian Development Outlook 2012* (*ADO 2012*) published its forecasts. Most forecasts for gross domestic product (GDP) growth in this *Update* are therefore downward revisions to take into account the unexpectedly weak performance in the first half of 2012 and diminished prospects for recovery in the near term.

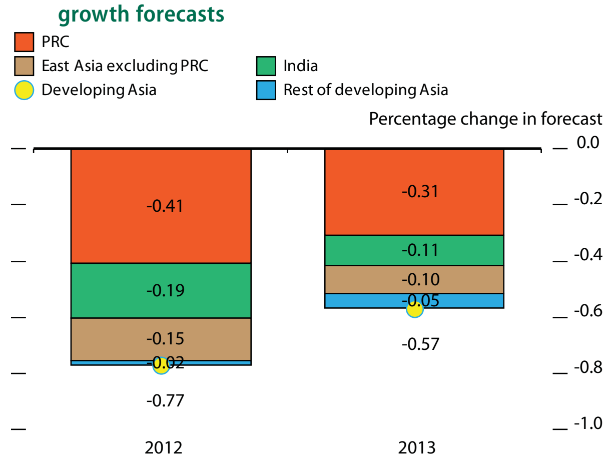
The main cause of the continued slackening of growth in developing Asia is unrelenting weakness in the region's main export markets, the industrial economies of the euro area, Japan, and the United States (US). But external factors are not entirely to blame for the steeper slide in the region's growth.

Increasingly evident economic weakness in the two giants of Asia, the People's Republic of China (PRC) and India, tamp down the growth prospects of the region as whole (Figure 1.1.1). That weakening export growth fails to fully explain the slowdowns in the PRC and India suggests that domestic structural problems contribute to their difficulties. Most of Southeast Asia has stayed relatively buoyant, despite suffering a similar deceleration in export growth, on the strength of continuingly robust domestic demand. There is little change in the forecast for Central Asia, the Pacific, or South Asian countries other than India.

Analysis shows that economic shocks emerging from the US have greater spillover into developing Asia and impact on regional economic growth than do shocks of the same magnitude from the euro area. Spillover from Japan is even more consequential in this region than spillover from the US. Open economies like most of those in East and Southeast Asia are more susceptible to external shocks than are less-open economies like India. Meanwhile, the rising profiles of the PRC and India on the global economic stage mean that they now cast their shadows across developing Asia and even the main industrial countries, increasingly influencing their growth prospects.

Although weak, the current environment does not require a massive regionwide countercyclical policy response. Policy makers, however, should stay vigilant in the event of further turmoil from potential industrial country shocks.

**1.1.1 Contributions to revisions in developing Asia's growth forecasts**




PRC = People's Republic of China.

*Source:* ADB estimates using data from *Asian Development Outlook* database; World Bank, World Development Indicators and Global Development Finance database. http://databank.worldbank.org/ddp/home.do

This chapter was written by Martin Bodenstein, Arief Ramayandi, and Akiko Terada-Hagiwara of the Economics and Research Department. Background materials from Peter Elliot, Shikha Jha, Douglas Laxton, and Pilipinas Quising are gratefully acknowledged.

# Growth flagging as momentum fades

The weak external environment is slowing growth in developing Asia. The *ADO 2012* noted this in its forecasts published in April, but since then the prospects for major industrial economies have proved to be more subdued than previously anticipated (Box 1.1.1). Further, domestic demand in the region, which was expected to mitigate weakness from abroad, is slipping. In particular, the two largest economies—the PRC and India—have disappointed earlier expectations.

### 1.1.1 Industrial economies sluggish

Lacking a strong rebound in private domestic demand, GDP growth in the major industrial economies is now expected to languish at 1.1% in 2012 and 1.5% in 2013—unchanged from the *ADO 2012* forecast for 2012 but 0.2 percentage points weaker for 2013 (Box table). This deterioration mostly reflects developments in the euro area and the US and occurs despite upward revision for Japan's growth.

**Baseline assumptions on the international economy, 2011–2012 (%)**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| | Actual | | *Update* projection (*ADO 2012* in brackets) | |
| **Gross domestic product growth (%)** | | | | |
| Major industrial economies | 2.6 | 1.2 | 1.1 (1.1) | 1.5 (1.7) |
| United States | 2.4 | 1.8 | 1.9 (2.0) | 2.1 (2.3) |
| Euro area | 2.0 | 1.5 | -0.6 (-0.5) | 0.5 (1.0) |
| Japan | 4.5 | -0.8 | 2.3 (1.9) | 1.6 (1.5) |

*Note:* More details in Annex table A1.1.

*Sources:* US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp (all accessed 21 September 2012); ADB estimates.

The sovereign debt crisis in the euro area continues to weigh down economic activity in the currency union. Fiscal consolidation and rising interest rates for public and private borrowers have deepened the recession in southern Europe, most notably in Italy and Spain. Whereas the euro area as a whole contracted only mildly over the first half of the year because of relatively strong growth in Germany, economic growth is expected to contract considerably over the remainder of the year, indicating annual GDP contraction of 0.6% year on year. For 2013, a mild recovery is expected with GDP growing by 0.5%.

Although the European Central Bank managed to calm financial markets in September with its decision to resume large interventions in sovereign debt markets on behalf of affected member countries, a solution to the structural shortcomings of the currency union has not yet been brokered. Whether the central bank's efforts can buy enough time to draft a credible fiscal and banking union will depend on the willingness of the German government to support this course and to keep Deutsche Bundesbank opposition under control without violating the German central bank's independence. Absent a powerful alternative strategy that would keep interest rates at manageable levels for all euro area members, not intervening in financial markets carries the risk of massive financial market turmoil in Europe strongly reminiscent of the 2008–2009 global financial crisis.

Unlike in the euro area, monetary policy makers in the US have indisputably supported economic growth in recent years. In early September, the Federal Reserve announced another round of quantitative easing to keep the economy from slowing further and to revive a dragging labor market. Although considerably stronger than the euro area, the US is still experiencing only tepid GDP growth and is projected to grow at 1.9% in 2012 and at 2.1% in 2013. The major uncertainty for the US economy is the looming "fiscal cliff." Although US policy makers are likely to agree to extend some of the temporary tax cuts into 2013, fiscal tightening equal to about 1.7% of GDP will almost certainly be implemented, as reflected in the forecast for US growth in this *Update*. Failure to prevent all temporary fiscal measures from expiring would create fiscal tightening of about 4% of GDP and push the US economy back into recession in 2013.

Japan has been the only major industrial economy to steer clear of new problems. The Japanese economy started 2012 well and is forecast to expand by 2.3% this year before slowing to 1.6% in 2013. Concerns over the health of the global economy are reflected in Japan's plunging business investment and slowing exports. Monetary policy will remain highly accommodative.

## Regional economic outlook revised

This *Update* revises growth projections for the region's GDP down from the April estimates. The new projections lop 0.8 percentage points off 2012 and 0.6 points off 2013. GDP growth for developing Asia is now forecast to moderate from 7.2% in 2011 to 6.1% in 2012 (Figure 1.1.2), significantly lower than the April forecast of 6.9%. Growth is seen accelerating to 6.7% in 2013 but still falling short of the projection in the *ADO 2012*.

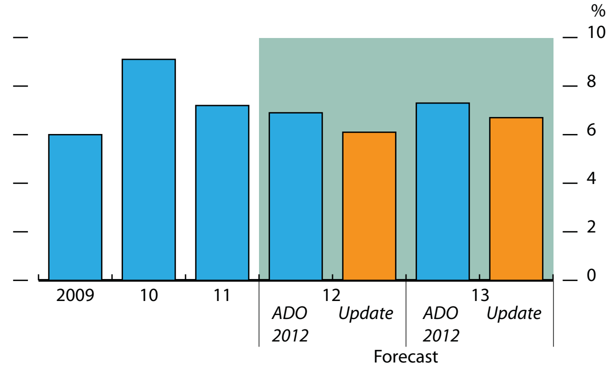
The momentum displayed in the first quarter of 2012 could not be maintained. Second quarter outturns came in below expectations because of external weakness and, in some cases, domestic developments. Weak economic activity in the year to date leaves big gaps for the rest of the year to fill before meeting April forecasts (Figure 1.1.3). The recovery in the external environment in the second half of this year is not expected to be uniform across the major industrial economies. Moreover, its strength and timing are uncertain. The external environment is expected to recover as the euro area picks up next year but perhaps not as strongly as anticipated in April. Although weaker-than-anticipated economic activity in the US and euro area appears to be responsible for the significant downward revision in GDP growth in 2012, Asia's internal weakness also plays a key role (Box 1.1.2).

The downward revision is largest in East and South Asia, at almost 1 whole percentage point, mainly because of weak performance in the PRC and India. The slowdown in the PRC reflects, in addition to soft demand for the country's exports, previous policy tightening. Lower growth in India stems from weakening external demand, a tight monetary policy aimed at persistently high inflation, and difficulties in obtaining consensus on measures to tackle impediments to growth.

Outside of these two large economies, performance varies depending on exposure to external conditions and the strength of domestic demand. Because of its openness, East Asia is feeling strong external headwinds from within the region and beyond. No economy in East Asia is expected to meet the April forecasts for either 2012 or 2013, as subregional growth is now forecast to decelerate to 6.5% this year—which is below even the 6.8% growth rate recorded in the wake of the Lehman shock in 2009. As South Asia's economies are less open than those in East Asia and so relatively insulated from the external environment, this *Update* makes only minimal downward revisions to the growth forecasts of most of them. Significant downward revision for the South Asian subregion as a whole, to 5.5% in 2012 and to 6.4% in 2013, is almost entirely from weakness in India (Figure 1.1.4).

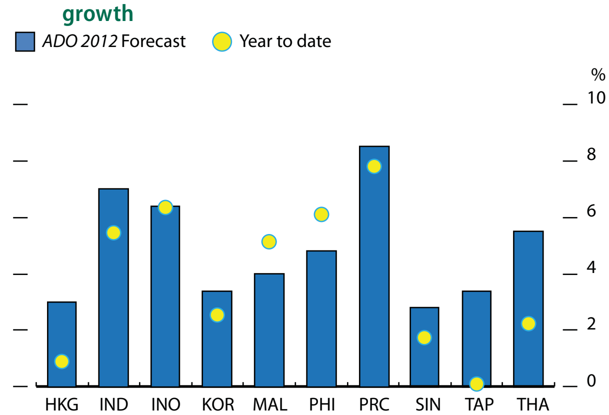
Excluding East Asia and India, growth prospects for the rest of developing Asia are almost unchanged, revised down

**1.1.2 Revised GDP growth forecasts, 2012 and 2013**




*Source: Asian Development Outlook* database.

**1.1.3 GDP growth, *ADO 2012* forecast versus year-to-date growth**

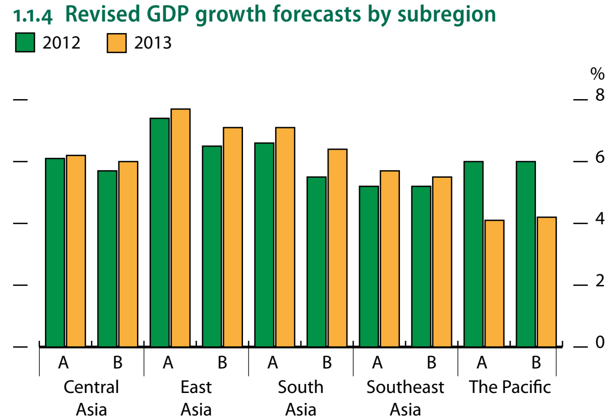



HKG = Hong Kong, China, IND = India, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, PHI = Philippines, PRC = People's Republic of China, SIN = Singapore, TAP = Taipei,China, THA = Thailand.

*Note:* Data for India refer to GDP at factor cost. Components do not add up to total. Latest data for India is Q1 FY2012.

*Source:* CEIC Data Company (accessed 3 September 2012).

**1.1.4 Revised GDP growth forecasts by subregion**




A = *ADO 2012* forecast, B = *ADO 2012 Update* forecast.

*Source: Asian Development Outlook* database.

### 1.1.2 Factors underlying growth projection revisions

Starting with the *ADO 2011* in April of that year, GDP growth projections for 2012 in emerging Asia (comprising 10 economies) have been consistently revised downward—from 8.1% (*ADO 2011*) to 7.7% (*ADO 2011 Update*), 7.0% (*ADO 2012*), and 6.2% in this *Update*. While the projections for the global economy, particularly for the euro area, have been sharply revised downward, from 1.6% in the *ADO 2011* to –0.6% in this *Update*, other factors came into play over the same period.

The global projection model GPM6Commodities, described in detail in Carabenciov et al. (2008), is used to analyze the sources of the downward revisions to the ADO projections. The model has six country blocks: the US, the euro area, Japan, emerging Asia, Latin America, and a rest-of-the-world block of mostly developed European economies that are not part of the euro area. The emerging Asia block of the GPM6Commodities consists of the PRC; India; the Republic of Korea; Indonesia; Taipei,China; Thailand; Malaysia; Hong Kong, China; the Philippines; and Singapore. These economies account for 92% of developing Asia's GDP in purchasing power parity terms. The aggregated GDP growth forecast of these 10 economies was reduced by nearly 2 percentage points.

The model appeals to features that policy makers and academics alike have found relevant in business cycle analysis, such as nominal rigidities, rationality, linkages for trade in goods, services, financial assets, and oil. Most importantly, model policy is described explicitly through Taylor-type interest rate rules.

Starting with *ADO 2011* projections, shocks arising from six blocks—the US, the euro area, Japan, Latin America, the rest of the world, and commodity prices—are added one by one to gauge the effects attributed to each block. The shocks from a regional block arise from several factors: demand, supply, markup, policy, finance, and others. The commodity price block includes all global food and oil demand and supply shocks.

For 2012, the shocks emanating from the now contracting euro area and the still elevated oil price appear to be the key external drags on the region, with the euro area subtracting 0.3 percentage points and oil 0.6 percentage points from the April 2011 forecast. This downward drag is partly offset by upward revision for Japan over this period, adding 0.1 percentage point. All in all, external shocks account for just about half of the revision from the *ADO 2011*. The other half seems to come from a regional or domestic factor within emerging Asia.

**Contributions of shocks to emerging Asia from 6 global projection model blocks**

| Item | 2012 |
|---|---|
| April 2011 (*ADO 2011*) GDP growth projections (%) | 8.1 |
| October 2012 (*ADO 2012 Update*) GDP growth projections (%) | 6.2 |
| Difference between April 2011 and October 2012 projections (percentage points) | -1.8 |
| **Effects of foreign shocks (percentage points)** | |
| From emerging Asia | -0.9 |
| From United States | -0.1 |
| From euro area | -0.3 |
| From Japan | 0.1 |
| From the rest of the world | 0.1 |
| From Latin America | -0.1 |
| From commodities | -0.6 |

*Note:* For this exercise, the developing Asia block comprises the People's Republic of China and the nine economies of emerging Asia: Hong Kong, China; India; the Republic of Korea; Indonesia; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand.

*Source:* ADB estimates.

by only 0.1 percentage point. Economies in Central Asia have experienced softening to a lesser extent than have East and South Asia. Growth prospects in that subregion are now projected slightly lower at 5.7% in 2012 and at 6.0% for 2013, largely reflecting weaker demand from the euro area and the PRC for energy exports. In contrast, growth in Southeast Asia is riding resilient domestic demand, allowing the April forecasts to stand almost unchanged at 5.2% for 2012 and 5.5% for 2013. Similarly, the Pacific is expected to meet the April forecasts of 6.0% this year and 4.2% next year, as robust expansion in the larger, resource-rich economies statistically overpowers the weakening economies of smaller Pacific island states.

## Domestic demand sustaining growth for some

Private domestic demand contributed to growth in the first 3 months of the year before subsequently slipping and thus failing to fill the gap left by diminished export demand. Slipping domestic demand has also weakened imports.

Subregional variation is significant (Figure 1.1.5). In Southeast Asia domestic demand showed resilience in the first half of 2012 in the face of relatively weak exports. In particular, Indonesia and Malaysia have maintained strong consumption and investment. Thailand has recovered strongly from the floods of last year. The Philippine economy has also rebounded with sound consumption and investment, though imports in the first half of 2012 fell short of the forecast. Singapore is the exception in Southeast Asia. Plagued by domestic inflation and adverse external factors, the economy followed the pattern of the other newly industrialized economies—the Republic of Korea; Taipei,China; and Hong Kong, China—in which deteriorating external demand undermined confidence, drove down domestic demand, and stalled investment. In India, fixed investment made virtually no contribution to growth in a clearly weaker economy.

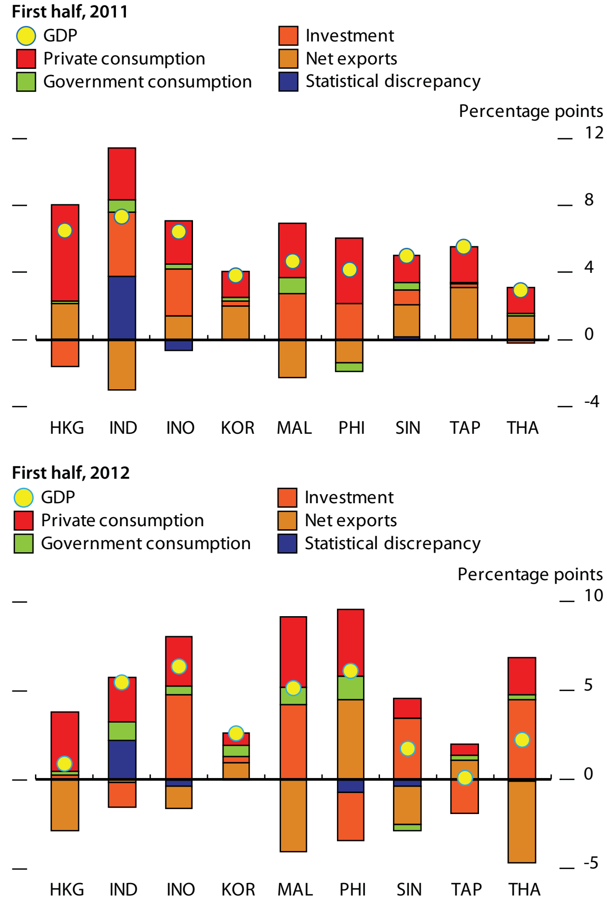
Export growth to date is far slower than forecast in April for 2012 as a whole (Figure 1.1.6). Exports are contracting across the region, particularly affecting machinery and semiconductors, and causing exports from the Republic of Korea and Taipei,China to falter. In the PRC exports plunged in the second quarter.

Weak domestic demand has driven down imports in many parts of developing Asia, generally far below forecasts made in April for the first half of 2012 (Figure 1.1.7). Actual imports were much lower than anticipated in East Asia and the Philippines. Import demand remains lethargic in the PRC because of softening demand for raw materials and capital goods. Southeast Asia stands out as import demand remained resilient, causing net exports to subtract from growth in light of slow export growth. This situation contrasts with 2011, when net exports generally contributed to growth.

As a result, current account surpluses in Southeast Asia will narrow more than projected, from 4.4% of GDP to 3.0%, which is below their value in 2008. In other subregions, except the Pacific, external balances are roughly in line with the April forecasts. In the region as a whole, the current account balance as a percentage of GDP is now expected to shrink to 1.7% in 2012, down from the 1.9% forecast in April. The forecast for 2013 is trimmed to 1.5% (Figure 1.1.8).

Improvements in labor markets are tapering off, with unemployment rates above pre-2008 levels and diminishing income prospects. Consumer confidence, already weak,

**1.1.5 Contributions to growth, by demand components**

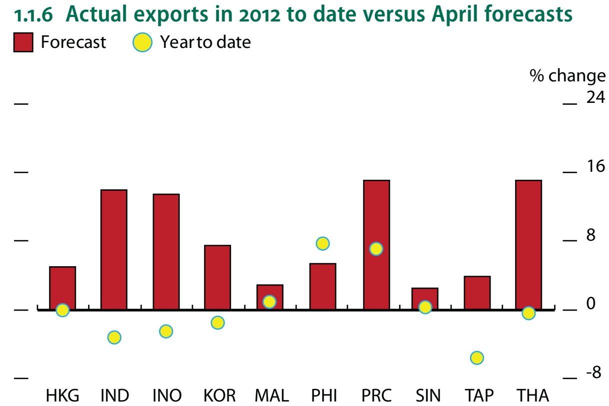



GDP = gross domestic product, HKG = Hong Kong, China, IND = India, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, PHI = Philippines, SIN = Singapore, TAP = Taipei,China, THA = Thailand.

*Note:* India data fo 2012 are as of the first quarter of FY2012.

*Source:* CEIC Data Company (accessed 3 September 2012).

**1.1.6 Actual exports in 2012 to date versus April forecasts**




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

*Note:* Data for PRC, IND, KOR, SIN, and TAP are as of August 2012, for HKG, INO, MAL, PHI, and THA as of July.

*Source:* CEIC Data Company (accessed 17 September 2012).

appears to have deteriorated further in recent months (Figure 1.1.9), reflected in sharply decelerating retail sales growth, particularly in the PRC and the newly industrialized economies (Figure 1.1.10). Likewise, some economies in South Asia have seen domestic demand deteriorate. Similar concerns may apply to Central Asia, though the outlook for the subregion's major guest worker host nation, the Russian Federation, is stable at this time.

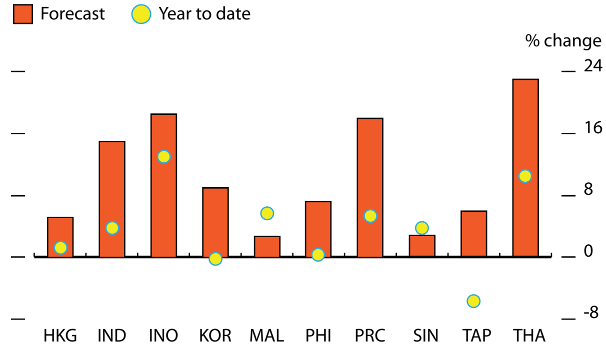
## Causes and effects as Asia's giants decelerate

The PRC and India may still be achieving enviable GDP growth rates, but the pace of economic expansion in both countries now falls short of the high rates achieved in the years preceding the global financial crisis. This weakening in the PRC and India exacerbates the growth outlook for the rest of Asia, as the two countries have gained greater influence on regional and international business cycles because of their size and global roles as importers.

Slowing growth momentum in the PRC and India reveals itself in several indicators. Growth rates of production-related indicators such as the industrial production index and electricity generation fell sharply in the year to date (Figure 1.1.11).

Fixed investment, exports, and retail sales have also slowed (Figure 1.1.12). Real estate investment has been affected the most, but a moderation of investment in infrastructure and manufacturing has added to the slowdown. Exports barely grew in the first half of 2012—nose diving from the 20%–30% annual growth recorded last year. Unsurprisingly, consumer and business confidence have eroded in recent months.

**1.1.7 Actual imports in 2012 to date versus April forecasts**

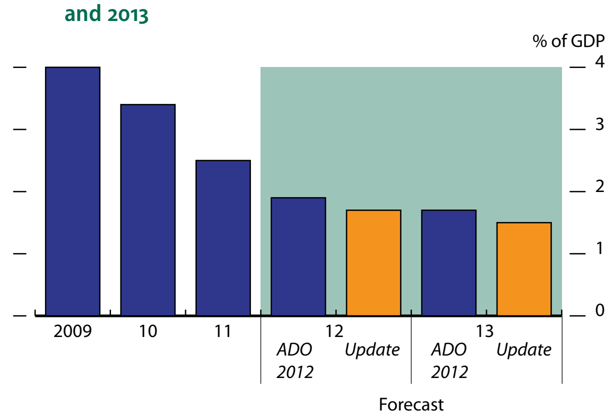



HKG = Hong Kong, China, IND = India, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, PHI = Philippines, PRC = People's Republic of China, SIN = Singapore, TAP = Taipei,China, THA = Thailand.

*Note:* Data are as of August 2012 except as of July for HKG, INO, MAL, and THA, and as of June for PHI.

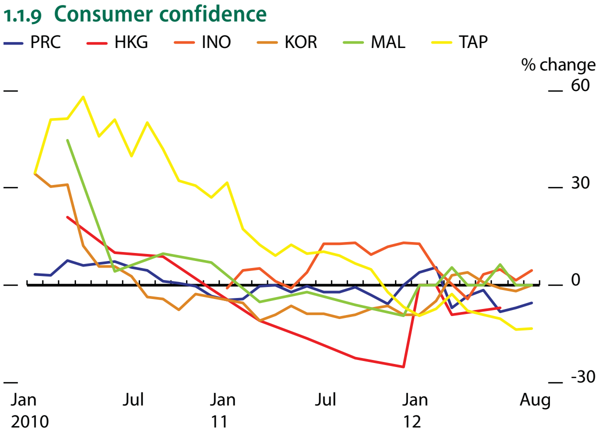
*Source:* CEIC Data Company (accessed 17 September 2012).

**1.1.8 Revised current account balance forecasts, 2012 and 2013**




*Source: Asian Development Outlook* database.

**1.1.9 Consumer confidence**

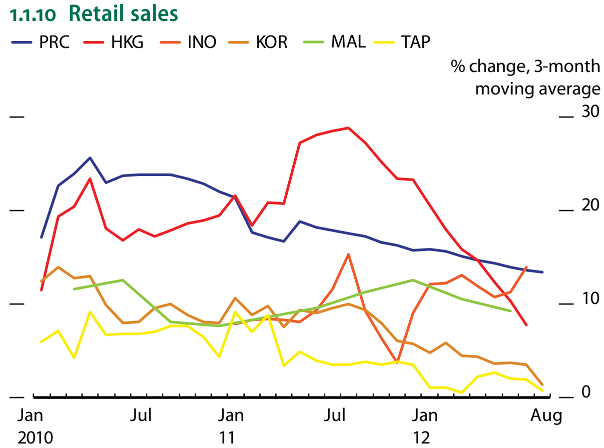



HKG = Hong Kong, China, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, PRC = People's Republic of China, TAP = Taipei,China.

*Note:* Data for Hong Kong, China is on a quarterly basis.

*Source:* CEIC Data Company (accessed 12 September 2012).

**1.1.10 Retail sales**

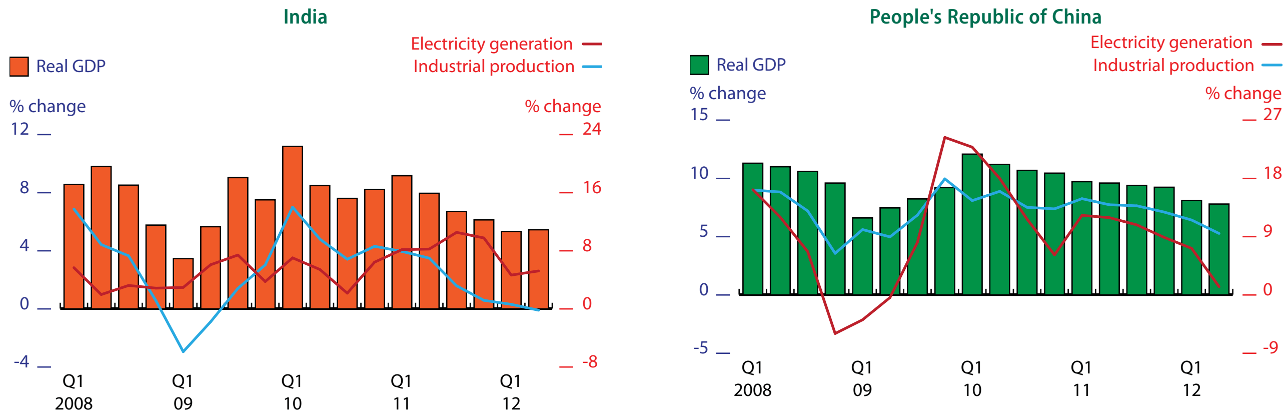



HKG = Hong Kong, China, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, PRC = People's Republic of China, TAP = Taipei,China.

*Note:* Data for Malaysia is on a quarterly basis.

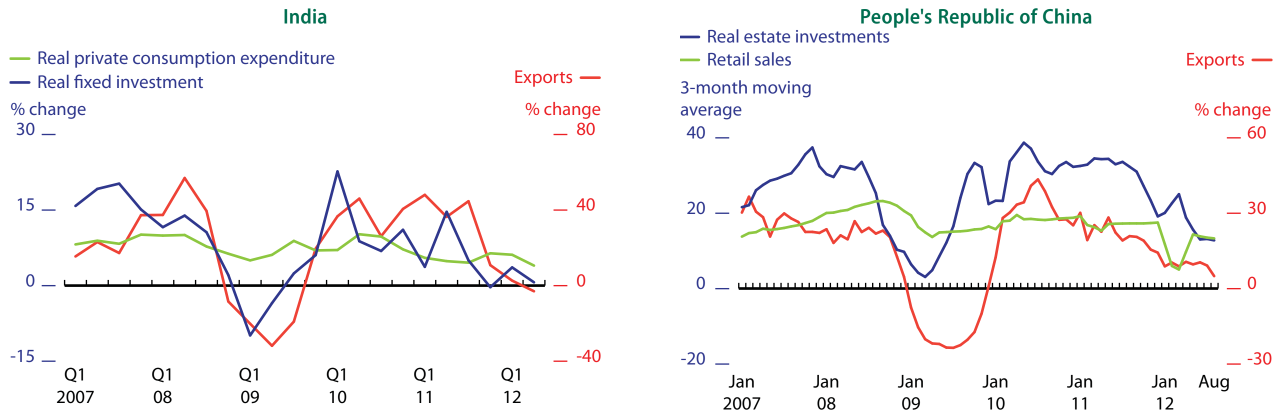
*Source:* CEIC Data Company (accessed 12 September 2012).

**1.1.11 GDP, industrial production index, and electricity generation**




*Source:* CEIC Data Company (17 September 2012).

**1.1.12 Fixed investment, exports, and retail sales in India and the People's Republic of China**




*Source:* CEIC Data Company (accessed 18 September 2012).

The PRC and India both see their exports and economic activity in general dragged down by financial distress, uncertainty, and sluggish recovery in the major industrialized economies. However, the additional internal factors weighing on GDP growth differ between the two countries. In India, institutional weakness that delays routine regulatory clearance and the liberalization of rules for foreign investment holds back investment. In the PRC, policy makers imposed restrictive policies to prevent possible overheating in the real estate sector. Monetary tightening in the PRC reinforced the success of these policy choices.

Policy makers in the Asian giants and other economies of emerging Asia need to understand the relative role of internal and external factors. This understanding will guide appropriate policy responses. For example, fiscal and monetary policy may effectively address declining investment demand if it is caused by external demand weakness, but such fiscal stimulus will do little to resolve a bottleneck caused by poor regulation.

The various sectors of an economy interact in complex ways—with, for example, a decline in export demand lowering demand for fixed investment in manufacturing. Similarly, shocks spill over into trade partners' economies with variable force; for example, shocks to economic activity in the PRC and India have weaker spillovers to other Asian economies than do shocks originating in the major industrial economies. A global vector autoregressive model, described in Box 1.1.3, imposes sufficient discipline to shed light on the relative importance of internal and external shocks. The model can also estimate the strength of international spillovers between trading partners.

## Spillovers into developing Asia

The spillover-analysis model measures the effect of a shock in recipient countries as fractions of the shock's effect in its home economy. Figure 1.1.13 plots the cumulative decline in a country's GDP over 1 year, relative to a baseline forecast, caused by a negative shock from abroad that reduces the source country's GDP by 1% relative to the baseline. It shows the impact that a shock to GDP in the US, the euro area, or Japan has, within a year after impulse, on India, the PRC, and an aggregate of the Association of Southeast Asian Nations (ASEAN) countries. A shock is a drop in GDP of the source country.

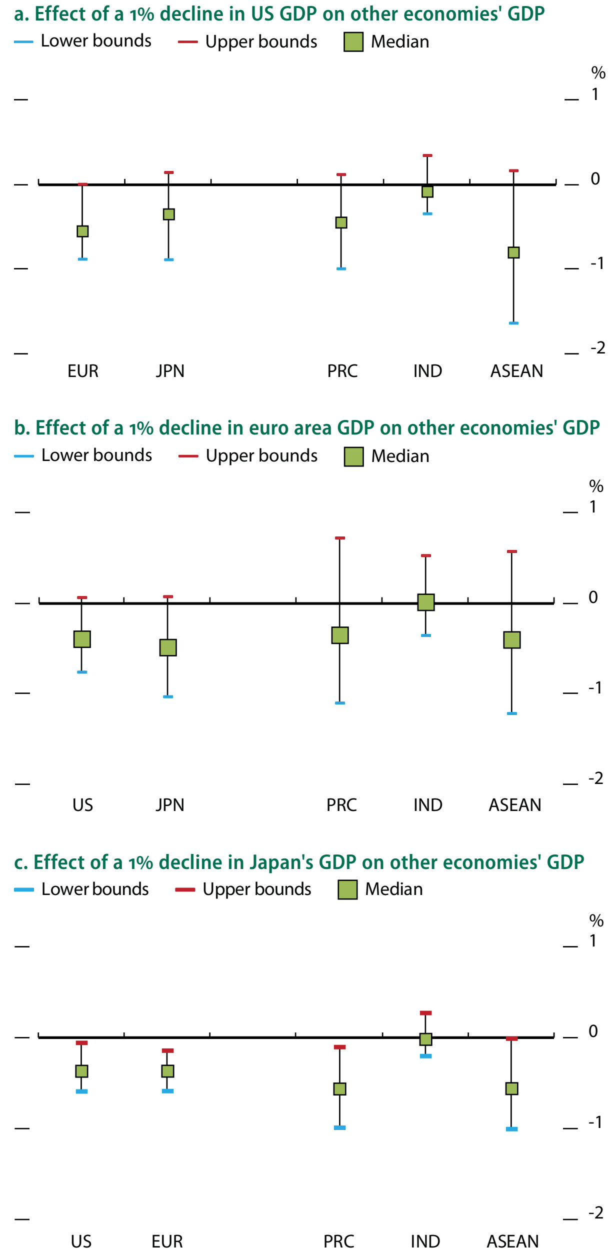
Spillovers from industrialized countries are substantial, particularly into the more open economies of developing Asia. A shock in Europe tends to have smaller impact on Asia than does a shock of the same magnitude in the US or Japan.

Historically, reducing the US GDP by 1% diminishes GDP in the euro area, Japan, and the three large economic blocks in Asia over its first year. ASEAN economies are affected the most, as their combined GDP drops by about 4/5 the magnitude of initial drop in the US. Spillover into the PRC is about 1/2 as large as into ASEAN, a bit more than into Japan and a bit less than into the euro area. Spillover into India is much lower, at less than 1/10 (Figure 1.1.13a)

A negative shock originating in the euro area also causes GDP in its major trading partners to contract. In this case, spillover into the PRC, ASEAN, and the US is of similar magnitude, about 2/5, and into Japan slightly larger (Figure 1.1.13b). When the shock to economic activity stems from Japan, the PRC and ASEAN see a reduction at nearly 1/2 of the original shock to Japanese GDP, whereas the US and the euro area experience smaller declines of only 1/3 (Figure 1.1.13c).

Indian GDP experiences only limited spillover from the US and almost none from Japan or the euro area. These findings reflect the country's low integration in world trade (Box 1.1.4).

**1.1.13 Spillovers from large industrial economies, GDP effect after 1 year**




ASEAN = Association of Southeast Asian Nations, EUR = Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, and Spain, GDP = gross domestic product, IND = India, JPN = Japan, PRC = People's Republic of China, US = United States.

*Note:* Lower bound refers to the 5th percentile of the distribution. Upper bound refers to the 95th percentile of the distribution.

*Source:* ADB estimates.

## Spillovers from Asia's giants

The PRC and India produce growing shares of world GDP and have become more integrated into international goods and factor trade. As

### 1.1.3 Measuring cross-border effects of shocks

A global vector autoregressive (GVAR) model provides a compact statistical view of the world economy. The specifications of the GVAR follow Dees et al. (2007). The model uses time series data of six macroeconomic variables (real GDP, inflation, real exchange rate, real equity price, and nominal short-term and long-term interest rates) for 33 countries and is estimated over a 30-year period from the second quarter of 1979 to the fourth quarter of 2009 using the GVAR Toolbox 1.1 (Smith and Galesi 2011).The present application of the model focuses on the relationships involving the three major industrial economies—the euro area, Japan, and the US—and developing Asia economies defined as the PRC, India, and an aggregate of the five largest economies in the Association of Southeast Asian Nations: Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

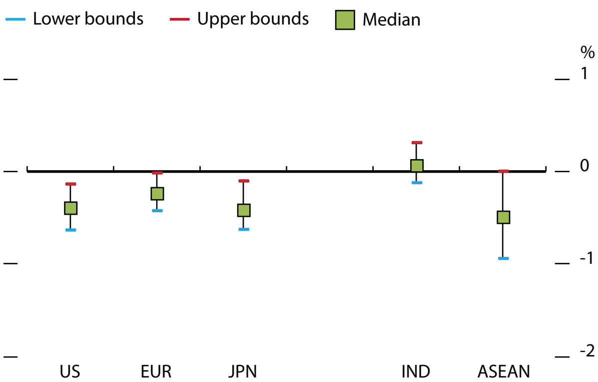
Spillovers from one economy to another are assessed through generalized impulse response functions (Pesaran and Shin 1998), which consider shocks to all the equations in the GVAR system and takes into account the estimated historical correlation between shocks. The resulting complexity of dynamics comes at the cost of structural identification. The methodology cannot distinguish between the underlying structural features of the economy that generated an impulse felt in the global economy. While this shortcoming inhibits the use of GVAR models to generate policy counterfactuals, these models are adequate for measuring international linkages.

The generalized impulses can also be used to derive a generalized forecast error variance decomposition, which allows for correlated shocks but accounts for them appropriately using historically observed distribution of the residuals. The normalized decomposition informs about the relative importance of the various shocks in explaining an economy’s output fluctuations. Similar treatment can be found in Diebold and Yilmaz (2012).

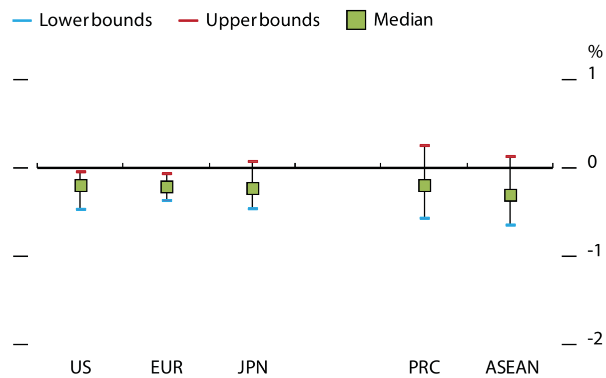
The results are derived from time series data over the past 30 years and take as given the policies implemented over those years. As international trade has expanded over the sample period, current spillovers may be larger than those estimated using historical data.

**1.1.14 Spillovers from Asian giants, real GDP effect after 1 year**

**a. Effect of a 1% decline in the PRC's GDP on other economies' GDP**




**b. Effect of a 1% decline in India's GDP on other economies' GDP**




ASEAN = Association of Southeast Asian Nations, EUR = Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, and Spain, GDP = gross domestic product, IND = India, JPN = Japan, PRC = People's Republic of China, US = United States.

*Note:* Lower bound refers to the 5th percentile of the distribution. Upper bound refers to the 95th percentile of the distribution.

*Source:* ADB estimates.

this trend continues, economic activity in the two Asian giants will shape regional and international business cycles. Already, spillovers from the PRC into ASEAN and the major industrial economies are not negligible. Figure 1.1.14 summarizes the spillovers from the PRC and India into other economies, following the same analytical method.

An internally caused fall in the PRC's GDP drags down growth in the three major industrial economies. Spillovers into the US and Japan are

### 1.1.4 India's trade structure and impulse resistance

India has become increasingly integrated into the global economy since the 1990s, when major reforms were initiated in response to a severe crisis in its balance of payments. However, the country's openness to trade still lags that of other economies in developing Asia (Box table). India's lesser openness to trade, and the dominating role of domestic demand, explain why India is barely affected by external shocks, compared with the PRC or ASEAN economies.

In line with India's opening to trade, its exports have risen over the past 2 decades. Relative to GDP, however, exports remain small, averaging about 11% in the 2000s and less than 16% by 2011. About 40% of total exports are primary products with little added value and limited spillover to the rest of the domestic economy.

India's trade with the major industrial economies and the PRC are modest slices of a small pie. Its exports to the US and the euro area each averaged less than 2% of India's GDP in the 2000s. In the same period, exports to Japan averaged only 0.3% of GDP, and those to the PRC 0.6%. These minuscule contributions to India's GDP explain the relatively negligible spillovers into India from shocks in any of the major industrial economies or the PRC.

**Measures of trade openness (total trade as % of GDP)**

| Decade | PRC | Indonesia | Malaysia | Philippines | Thailand | India |
|---|---|---|---|---|---|---|
| 1970s | 9.2 | 34.6 | 79.1 | 33.8 | 36.1 | 9.8 |
| 1980s | 24.7 | 38.6 | 96.2 | 34.8 | 47.9 | 11.9 |
| 1990s | 36.6 | 49.4 | 156.5 | 58.2 | 73.5 | 16.3 |
| 2000s | 52.3 | 51.3 | 172.6 | 80.3 | 116.1 | 27.1 |

PRC = People's Republic of China.
*Source*: ADB estimates based on the UN Comtrade data.

of similar magnitude, at 2/5 of the original shock in the PRC, and the effect on the euro area is 1/5. ASEAN is more strongly affected, its GDP falling by 1/2 of the magnitude of the original shock in the PRC. India, again, is not significantly affected (Figure 1.1.14a).

Although India is hardly affected by external events, it can affect others. The three major industrial economies, ASEAN, and the PRC all suffer GDP declines roughly 1/4 the size of the original decline in Indian GDP (Figure 1.1.14b).

## Weighed effects from within and without

The preceding analysis suggests that external factors may play dissimilar roles in recent slowdowns in the PRC and India. One way of illustrating this difference is through the following calculations derived from forecast errors and revisions between the *ADO 2011 Update* and the *ADO 2012 Update* (Table 1.1.1). Realized GDP growth in 2011 turned out to be weaker by 1.0% in the US, 0.2% in the euro area, 0.3% in Japan, and 1.4% in India than forecast in the *ADO 2011 Update*. Similarly, growth expectations for 2012 have been revised downward since the *ADO 2011 Update*.

Interpreting the differences between the realized and the predicted growth rates for 2011 as negative shocks to GDP in the US, the euro area, Japan, and India, and invoking the estimated spillovers, provides an

**1.1.1 Comparison of forecasts in the *ADO 2011 Update* and the *ADO 2012 Update***

| Economy | Differences between actual and predicted growth for 2011 | Projected growth for 2012 (*ADOU 2011*) | Projected growth for 2012 (*ADOU 2012*) |
|---|---|---|---|
| US | -1.0 | 2.2 | 1.9 |
| Euro area | -0.2 | 1.3 | -0.6 |
| Japan | -0.3 | 2.8 | 2.3 |
| India | -1.4 | 8.3 | 5.6 |
| PRC | 0.0 | 9.1 | 7.7 |

PRC = People's Republic of China, US = United States.
*Source: Asian Development Outlook* database.

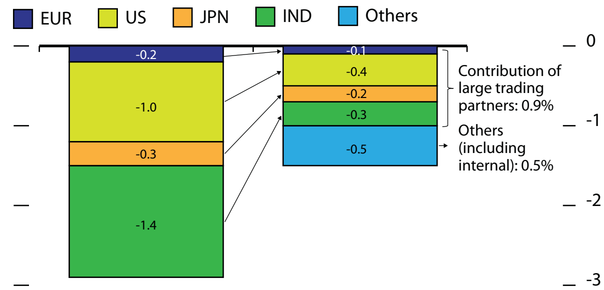
illustrative measure of the relative importance of internal and external factors in driving the slowdown in the two Asian giants.

As international spillovers into India are weak, internal factors account for most of India's slowdown. For the PRC, however, external spillovers are sizable. The negative shocks in the PRC's large trading partners may cause the PRC's GDP to contract by about 0.9% in 2012. External factors can be seen as accounting for 2/3 of the forecast revision in PRC's GDP growth between the two *ADO Updates* (Figure 1.1.15).

This illustration of cross-country spillovers in recent developments in India and the PRC does not inform about the relative importance of domestic and foreign shocks in explaining output volatility in general.

External and internal shocks commingle in causing output fluctuations. Decomposing the historical output variations in the Asian giants based on their geographic origin suggests that internal factors are important drivers of output fluctuations in both the PRC and India, albeit to varying degrees (Box 1.1.5). Shocks originating from Europe and the US play significantly lesser roles.

**1.1.15 Spillover effects into the PRC**




EUR = Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, and Spain, GDP = gross domestic product, IND = India, JPN = Japan, PRC = People's Republic of China, US = United States.

*Note:* Numbers may not sum precisely because of rounding.

*Source:* ADB estimates.

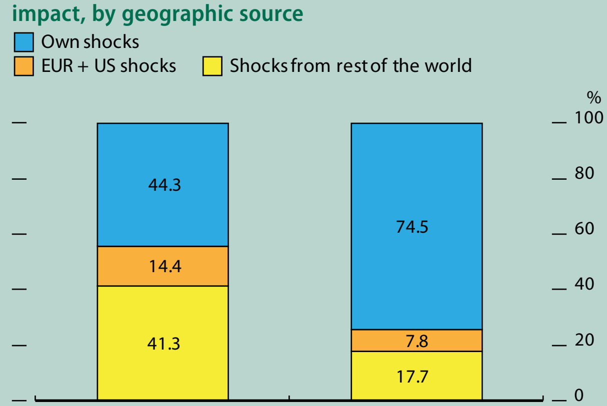
## 1.1.5 Relative importance of internal and external shocks to Asia's giants

The box figure shows the relative contributions of shocks from different geographic sources to the volatility of output in the PRC and India for a horizon of 4 quarters after impact. Shocks sum all types of disruption—financial, GDP, price, and others—as summarized by Dees et al. (2007).

A large share of GDP fluctuation in the two giants is explained by domestic shocks. Although external shocks have some bearing on GDP volatility in India, domestic shocks account for 75% of variation in output. In the PRC, internal shocks are less dominant but still account for more than 40% of variation.

This observation reinforces two messages. The first message is that countries that are more open, like the PRC, are more susceptible to external developments than less-open countries like India. A favorable external environment with buoyant global demand for exports accelerates GDP growth more in open economies than others. Conversely, when gloomy prospects in the global economy weaken export demand, limited openness shields countries. The second message is that the degree to which domestic factors drive GDP fluctuations in the two giants hints at the need for economic reform, not least to the service sector.

**Relative contributions of shocks to GDP change 1 year after impact, by geographic source**




EUR = Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, and Spain, GDP = gross domestic product, IND = India, PRC = People's Republic of China, US = United States.

*Source:* ADB estimates.

# Risks to the outlook

The outlook in this *Update* assumes soft demand from the US and Europe for the region's exports and weakening growth momentum in the PRC and India. However, even this gloomy view may turn out to be too optimistic.

Both Europe and the US harbor powerful risks that could drag down growth in emerging Asia's GDP further through diminished demand for the region's exports. New stress emanating from sovereign debt markets could deepen the recession in the euro area. Failure in the US to extend expiring fiscal programs into 2013 could further erode private demand and cause the US economy to contract. The damage to emerging Asia from such negative developments could be amplified by volatility in capital flows. Even without a major global event, capital flows may turn volatile as investors change their perception about economic prospects in the euro area or the US.

## Risks from a major global shock

To quantify the implications of a major global event on emerging Asia, two scenarios are derived from the global projection model GPM6Commodities (see Box 1.1.2). The first scenario considers the effects of severe financial market stress in the euro area. The second studies a large fiscal contraction in the US.

### Shock from a systemic euro event

As in 2011, the European sovereign debt crisis has continued to upset global financial markets in 2012. A plethora of European and global summits has spurred some promising action, such as a road map to full banking union and changes in the rules of the European Stability Mechanism. However, no definite plan that would remove the underlying structural problems of the currency union has been adopted. Even the decision by the European Central Bank (ECB) to intervene directly in sovereign debt markets with the goal of keeping interest rates for affected countries manageable will bring only temporary relief. If the highly indebted economies of southern Europe fail to implement market-oriented reforms that can raise long-term growth prospects, financial market participants may continue to invest elsewhere or demand higher risk premiums. Although the ECB left the volume and duration of its interventions unspecified to bolster the effectiveness of its plan, opposition to ECB activities, particularly in Germany, limits the window of opportunity for European policy makers to shape the future of the euro area.

Against this backdrop, the first scenario plays out the consequences of major tensions in the European banking sector. The scenario assumes that the ECB cannot prevent the crisis through market interventions because of political resistance in northern Europe, the risk composition of its balance sheet, or the sheer magnitude of the event. Financial market stress in Europe is assumed to reach by the end of 2012 the intensity seen during the Lehman crisis in 2008, and then to ebb gradually in 2013.

In contrast to 2008, when financial market stress in the US spilled massively into Japan and Europe through undermined confidence, direct financial spillovers in the present scenario are assumed to be more limited because financial markets in Europe are dominated by Europeans and the current crisis has evolved slowly enough to allow banks to realign their portfolios to limit spillovers. Severe deterioration in financial conditions drives the euro area into a deep and prolonged recession. Table 1.2.1 summarizes the effects on GDP growth in major economic regions in 2012 and 2013.

Euro area GDP growth drops by 0.4 percentage points in 2012 and by a whopping 1.7 percentage points in 2013 relative to the baseline forecast. As the US and Japan have close financial and trade links with Europe, the economic prospects of these two countries are severely affected. In addition, steep euro depreciation further weakens the competitiveness of the US and Japan against exports from the euro area. The transmission of the shock through financial and goods markets is reinforced by the assumed erosion of investor and consumer confidence. Relative to the baseline, GDP growth in the US and Japan declines by 0.3 percentage points in 2012 and by about 1 percentage point in 2013.

The effects on emerging Asia are also powerful (Figure 1.2.1). As the region depends heavily on US

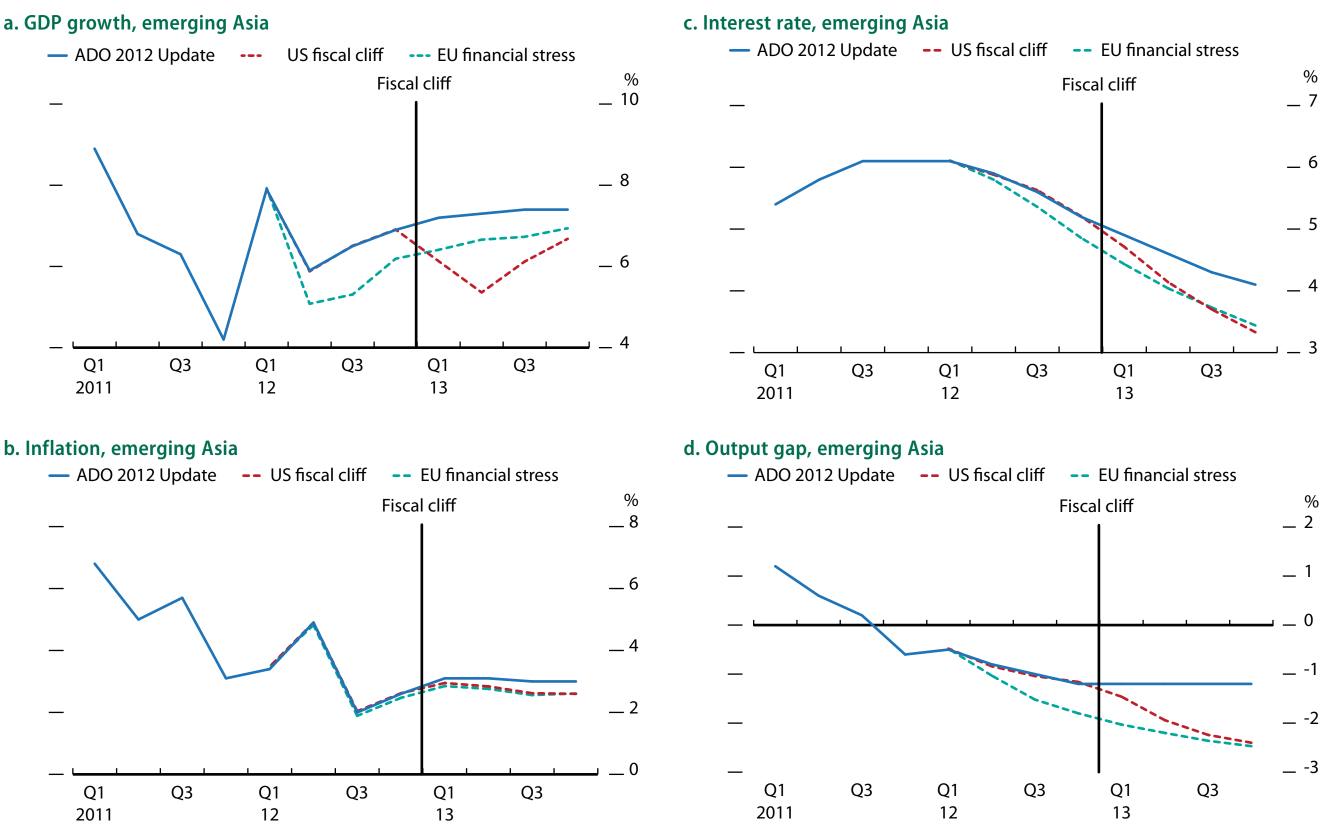
**1.2.1 Alternative scenarios: annual real GDP growth**

| Area | EU financial stress (deviation from baseline) | | United States fiscal cliff (deviation from baseline) | | *ADO 2012* Update baseline | |
|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2013 (w/o QE) | 2013 (w/ QE) | 2012 | 2013 |
| Euro area | -0.4 | -1.7 | -0.3 | -0.3 | -0.6 | 0.5 |
| United States | -0.3 | -0.8 | -2.5 | -2.2 | 1.9 | 2.1 |
| Japan | -0.3 | -1.2 | -0.4 | -0.4 | 2.3 | 1.6 |
| Emerging Asia | -0.4 | -0.8 | -0.8 | -0.9 | 6.3 | 7.0 |
| Latin America | -0.2 | -0.5 | -0.8 | -0.8 | 3.1 | 4.1 |
| Remaining countries | -0.6 | -1.5 | -1.0 | -1.0 | 2.0 | 2.1 |

*ADO* = *Asian Development Outlook*, EU = European Union, QE = quantitative easing, w/ = with, w/o = without.

*Source:* ADB estimates using the global projection model.

**1.2.1 Alternative scenarios: effect on emerging Asia**




*ADO* = *Asian Development Outlook*, EU = European Union, GDP = gross domestic product, US = United States.

Source: ADB estimates using the global projection model.

and European demand for its exports, growth in the region drops by 0.4 percentage points relative to the baseline in 2012 and by 0.8 percentage points in 2013. In this demand-driven scenario, the output gap in emerging Asia turns distinctly negative, moderating inflation in the region below baseline projections. The scenario assumes that monetary and fiscal policies in emerging Asia follow their historical patterns. Interest rates in emerging Asia would be about 1% lower. However, lower inflation would give Asian central banks room to deviate from their historical policy rules and pursue additional monetary easing.

## Shock from the US fiscal cliff

After the financial market turmoil in 2008–2009, US policy makers implemented numerous fiscal programs to soften the impact of the subsequent recession. Many of these temporary measures have been extended over the years but only after prolonged political standoffs. Today, stimulus measures amounting to roughly 4% of the US GDP are scheduled to expire at the beginning of 2013 (Table 1.2.2).

Despite deepening division between the US political parties during this presidential election year, several income tax and unemployment provisions are assumed to be extended. Other measures amounting to 1.7% of GDP, however, are assumed to be eliminated. The baseline GDP growth forecast for the US already reflects this view. However, complete gridlock in Washington cannot be ruled out. Therefore, the second scenario assumes that none of expiring measures will be extended, causing a severe fiscal contraction (the "fiscal cliff"). The results for this scenario are also displayed in Table 1.2.1.

The fiscal contraction is frontloaded in the first half of 2013, causing US GDP growth to drop by 2.5 percentage points, from 2.1% to −0.4%. Relative to the historical performance of the US economy, the effects of the fiscal contraction are amplified by the inability of monetary policy makers to push short-term nominal interest rates below the zero bound.

Weaker US demand transmits to the rest of the world predominantly through lower US imports. Given its export dependence, emerging Asia would see its growth prospects diminished by 0.8 percentage points in 2013. The detailed responses in the region's GDP growth, output gaps, inflation, and interest rates resemble those of the first scenario (Figure 1.2.1).

In contrast to the first scenario, the realization of the US fiscal cliff is felt as strongly in Latin America as in emerging Asia. Although the euro area and Japan see their growth rates cut under the US fiscal cliff scenario, the impact on these industrial countries is only half that on the emerging world.

If the Federal Reserve were to engage in more aggressive quantitative easing to soften the impact of the fiscal contraction, the drop in US growth could be limited to 2.2 percentage points relative to the baseline. Although US trading partners would benefit from this attempt to keep the decline in US activity under control, quantitative easing would bring about dollar depreciation. Consequently, US exporters would become more competitive and put additional pressure on exporters elsewhere. The effects of the fiscal cliff on countries other than the US turn out to be roughly the same with or without quantitative easing.

**1.2.2 Fiscal restraint under current law in 2013**

| Measure | Change in structural budget balance % GDP | Change in structural budget balance $ billion |
|---|---|---|
| Unemployment insurance | 1.4 | 225 |
| Middle class tax relief | 0.5 | 85 |
| Affordable Care Act | 0.1 | 18 |
| Emergency unemployment compensation | 0.2 | 34 |
| Medicare payments | 0.1 | 10 |
| Other expiring provisions | 1.7 | 269 |

*Source:* Congressional Budget Office 2012.

## Risks from capital flow volatility

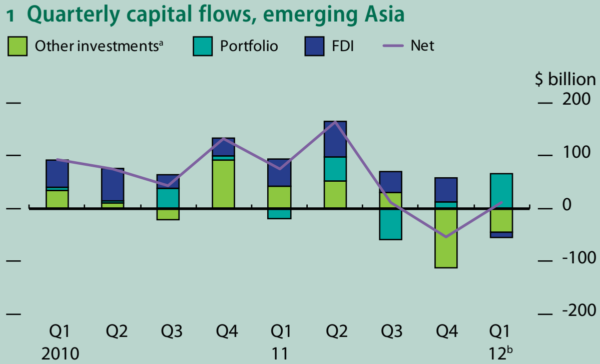
Either a systemic event in the euro area or the realization of the fiscal cliff in the US would affect capital flows to emerging Asia. If investor confidence were to drop and risk premiums to increase, capital might leave the region for conventional safe havens. Deleveraging by banks under balance sheet pressures would further bleed the region financially. Even without a major event in Europe or the US, capital markets in the region remain vulnerable to sudden swings in investor sentiment caused by news from the major industrial economies (Box 1.2.1).

### 1.2.1 Capital flows erratic

A prolonged period of large-scale monetary accommodation in the major industrial economies has accompanied volatile investor sentiment and associated cross-border flows. Asian economies weathered the unprecedented collapse in international capital flows between 2007 and 2009. After a short-lived capital outflow at the height of the 2008 financial crisis, macroeconomic management in the region had to contend with a surge in capital inflows in liquid asset categories. Since then, alternating optimism and pessimism about the strength of economic recovery in Europe and the US have been responsible for the bouncing around of net private capital flows (Box figure 1).

Moves by regional central banks and the European Central Bank toward monetary easing have improved funding conditions for Asia banks, which have been reporting tight credit arising from the situation in Europe. The foreign claims of euro area banks on emerging Asia dropped toward the end of 2011 but have edged up since (Box figure 2). Nonetheless, deleveraging by European or regional banks in response to rising shares of nonperforming assets still poses a potential threat to emerging Asia's macroeconomic stability.

**1 Quarterly capital flows, emerging Asia**




FDI = foreign direct investment.

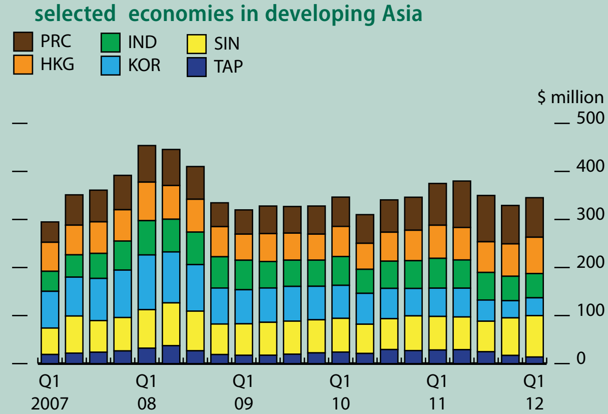
[a] Trade credits, loans, currencies and deposits, and others.

[b] Not including data from the People's Republic of China.

*Note:* Emerging Asia consists of Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; the People's Republic of China; the Philippines; Singapore; Taipei,China; and Thailand.

*Source:* ADB estimates based on data from CEIC Data Company (accessed 10 September 2012).

**2 Foreign claims of reporting banks in the euro area to selected economies in developing Asia**




HKG = Hong Kong, China, IND = India, KOR = Republic of Korea, PRC = People's Republic of China, SIN = Singapore, TAP = Taipei,China.

*Source:* Bank for International Settlements. http://www.bis.org (accessed 3 September 2012).

# Policy options in uncertain times

Most governments in developing Asia enjoy latitude for applying fiscal policy to counter slow growth, as they did in 2008–2009. The best option now for the region as a whole, though, is to wait and see if new shocks materialize to cause further economic deceleration that would warrant such measures. However, policy makers may need to reconsider their assumptions about the efficacy of various fiscal policy options.

Looking ahead, policy makers should also consider the evidence that the days of relatively easy export-led growth are numbered, if not already past. Future growth will need to be better balanced between internal and external sources by, among other strategies, fostering more vibrant service sectors.

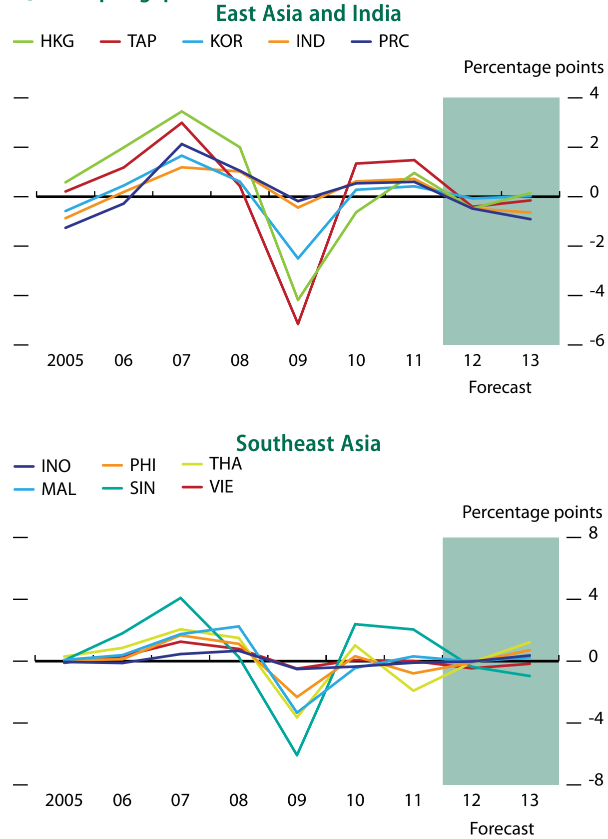
## Policy absent further shocks

Absent major deviations from the *ADO 2012* baseline forecast, developing Asia has no urgent regionwide need to pursue countercyclical macroeconomic policies. Output gaps generally hover around zero, leaving little rationale for propping up demand through policy stimulus. At the same time, inflation has moderated after a spurt in 2011 when prices for food and energy developed strong momentum. For the time being, a wait-and-see strategy is advised—along with some fine-tuning.

Although headline inflation remains high in a few economies, notably in South Asia and Viet Nam, price pressures have eased by more than expected, tracking lower demand pressures and commodity prices (See Annex: Global headwinds unabated). Core inflation data support this view. With output gaps hovering around zero (Figure 1.3.1) and inflation moderating (Figure 1.3.2), policymakers have carefully started easing monetary policy to counter external and domestic headwinds (Figure 1.3.3). Central banks in the PRC, India, and the Republic of Korea have cut interest rates more aggressively than previously expected.

Going forward, inflation is now expected to moderate compared with *ADO 2012* forecasts published in April by 0.3–0.8 percentage points (Figure 1.3.4). Sharp revisions occur in East Asia, where inflation is expected to drop to 3.1% as the PRC cools. By contrast, the inflation forecast for South Asia is revised upward from 7.7% to 8.6%, because of overly expansive fiscal policies, rising domestic fuel and electricity prices, currency depreciation against the US dollar, and bad weather for agriculture. For the region as a whole, inflation is expected to average 4.2% in both 2012 and 2013, down from April's forecast of 4.6% and 4.4% (Figure 1.3.5).

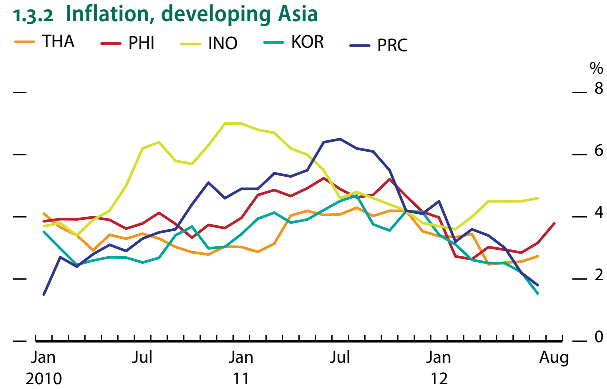
**1.3.1 Output gap**




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

*Source:* ADB estimates.

**1.3.2 Inflation, developing Asia**




INO = Indonesia, KOR = Republic of Korea, PHI = Philippines, PRC = People's Republic of China, THA = Thailand.

*Source:* CEIC Data Company (accessed 3 September 2012).

As long as inflation pressures remain low, highly accommodative monetary policy in Europe and the US may stir little controversy, and the benefits of a stabilized euro area may outweigh these policies' possible costs to the region. However, if high inflation returns, the contentious question of how to manage volatile capital flows may again arise. In that event, policy makers are warned not to neglect the medium-term repercussions of allowing inflation rates to rise too quickly. Leaving policy rates low for fear of attracting unwanted capital inflows is the wrong approach, as prudent regulatory policies are much better suited to deal with them.

Countries with evident vulnerabilities should continue reforming macroprudential policies to build market confidence. India, other economies in South Asia, and Viet Nam have regained control over inflation dynamics, but their inflation rates remain higher than those of other economies in the region. In India, fiscal deficits need to be brought under control to ensure fiscal sustainability in light of the slowing GDP growth. More relevant for the PRC and Viet Nam is the issue of nonperforming loans and their implications for state-owned banks and other nonbank financial institutions, which need to be addressed to bolster macroeconomic stability in these countries.

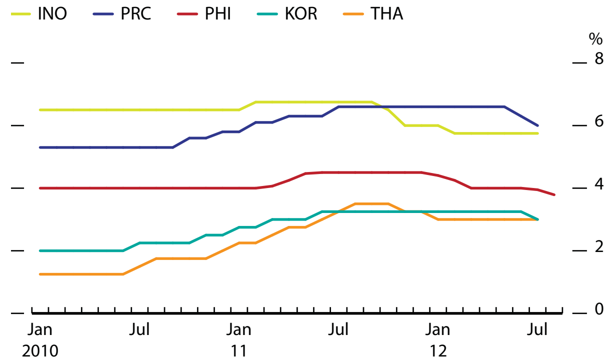
## Policy to contain new turmoil

If major turmoil emerges as in the risk analysis presented above, fiscal and monetary support may be advised, subject to country-specific constraints regarding inflation dynamics, financial market stability, and fiscal space.

The recommendations for monetary policy are straightforward. Major shortfalls in demand from industrial economies would ease inflationary pressures. In particular, prices for food and other commodities would slump, leaving room for interest rate cuts aiming to stimulate the components of GDP consumption and investment sensitive to them. To secure dollar liquidity, Asian countries should negotiate currency swap agreements with the US Federal Reserve or approach the special liquidity facilities of the International Monetary Fund. Further, signatory countries of the Chiang Mai Initiative Multilateralization agreement should be alert and stand by if needed.

Although regional policy makers readily launched fiscal policy programs with the idea of propping up domestic demand in the 2008–2009 global financial crises, it is questionable whether and how fiscal policy should be employed in another severe crisis. Ambitious fiscal policy programs add to the stock of debt and reduce so-called fiscal space. Further, the effectiveness of fiscal policy as measured by fiscal multipliers is not uniformly high across policies and countries with different characteristics.

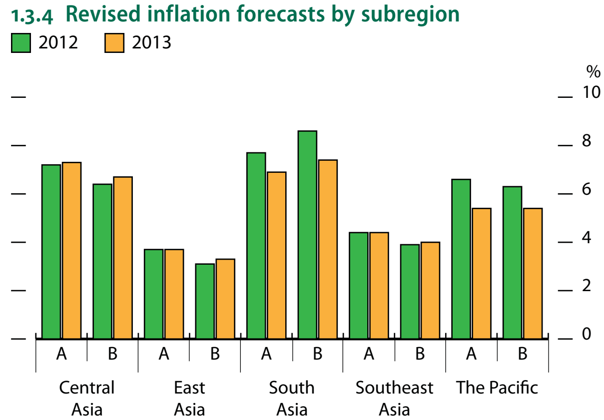
**1.3.3 Benchmark policy rates**




INO = Indonesia, KOR = Republic of Korea, PRC = People's Republic of China, PHI = Philippines, THA = Thailand.

*Source:* CEIC Data Company (accessed 27 August 2012).

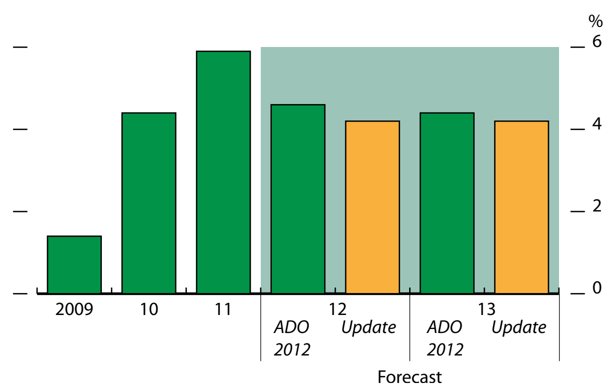
**1.3.4 Revised inflation forecasts by subregion**




A = *ADO 2012*, B = *ADO 2012 Update*.

*Source: Asian Development Outlook* database.

**1.3.5 Revised inflation forecasts for developing Asia, 2012 and 2013**

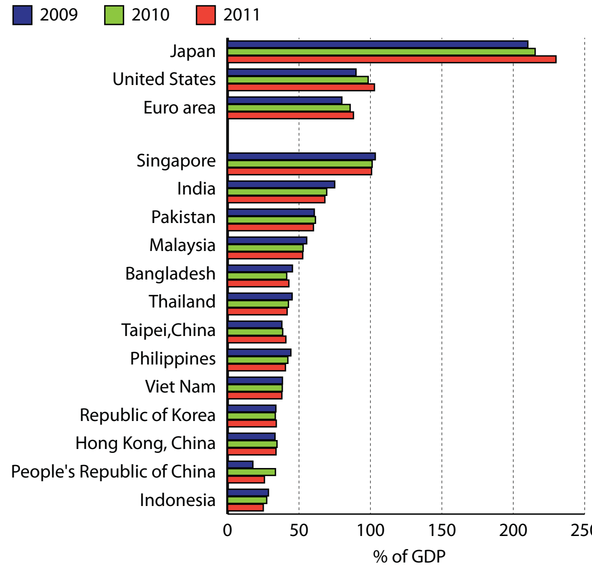



*Source: Asian Development Outlook* database.

The term “fiscal space” is commonly understood as “the degree to which a country has the ability to fund a fiscal stimulus without a sizable increase in the real interest rate” (compare Aizenman and Jinjarak [2011] and Ostry et al. [2010]). Using the crudest interpretation of the term, economists look at the ratio of public debt to GDP. Based on the finding by Reinhart and Rogoff (2009) that, historically, a debt-to-GDP ratio exceeding 90% severely limits a government’s ability to employ fiscal policy to support domestic demand, such ratios are publicly viewed as unsustainable.

With the exception of few outliers, debt-to-GDP ratios in most of developing Asia do not exceed 50% (Figure 1.3.6). International data comparison also reveals that debt-to-GDP ratio is at best an imperfect measure of fiscal space. The Japanese ratio of 229.9% is in a class of its own beyond Portugal’s 106%, Spain’s 68.5%, or Ireland’s 104.9%, yet these European countries are the ones currently lacking room for expansionary fiscal policies, as evidenced by drastic increases in the interest rates they pay.

**1.3.6 Central government gross debt ratio**




*Sources:* International Monetary Fund (IMF). World Economic Outlook database (accessed April 2012); IMF fiscal monitor, July 2012; IMF country reports.

Classical fiscal sustainability analysis offers a starting point for a differentiated approach to the question of fiscal space. Fiscal sustainability refers to whether a government can smoothly finance its budget without generating explosive increases in public debt, under assumptions on differentials in interest rates, GDP growth, and government tax policies. At a bare minimum, fiscal sustainability requires that governments eventually repay their debts. However, in practical terms, such a vague promise may not suffice to guarantee low interest rates, so financial market participants will demand concrete actions from governments to rein in their deficits. Fiscal sustainability is thus intrinsically linked to a government’s ability and willingness to mount fiscal reactions and generate primary surpluses. Taking a country’s historical fiscal reaction function as given, the maximum debt-to-GDP ratio is then defined by its interest rate–growth differential, stock of debt, and primary surpluses, which will be used to pay off the debt. Fiscal space is measured by the difference between this maximum debt-to-GDP ratio and the current and projected debt-to-GDP ratio of a government.

In Asia, the outlook on public debt is generally benign, as argued in Ferrarini, Jha, and Ramayandi (forthcoming). With few exceptions, the last decade has seen tremendous progress in consolidating public finances in the region. After the ambitious stimulus packages in emerging Asia to stem the 2008–2009 global financial crisis, when public debt ratios rose by an average of 5% in 2009, the region’s indebtedness is projected to fall below pre-crisis levels in the near future, given the authors’ assumptions on fiscal policy, interest rates, and GDP growth. Although fiscal space is not formally assessed in that study, economies in Asia are generally viewed as having room to intervene through fiscal policy. Governments in emerging Asia have earned a reputation for fiscal prudence, and their high primary surpluses exist thanks to high growth. However, higher interest rates stemming from prolonged shifts in risk aversion permanently lower growth rates. Large fiscal packages, enacted in the event of a massive global crisis, could quickly squeeze the region's fiscal space.

As ambitious fiscal programs impose high burdens on taxpayers and future generations, assessing the efficacy of conducting demand management through fiscal policy is of utmost importance. The economic literature addresses this question under the term "fiscal multiplier."

In early 2009, governments all around the world boosted spending and cut taxes to cushion the impact of the 2008–2009 global financial crisis, acting with little empirical guidance. Since then, several studies have emerged with somewhat sobering implications for fiscal policy enthusiasts (Box 1.3.1). The studies suggest that demand shortfalls in emerging Asia are most effectively addressed through tax cuts and pure investment spending. Increasing pure government consumption—a very effective tool in highly developed economies—is not recommended. Highly open economies may even choose to refrain from fiscal stimulus altogether to avoid wasting public funds.

### 1.3.1 New evidence on fiscal multipliers

Prior to the 2008–2009 global financial crisis, most studies of fiscal multiplier effects focused on the US. Although the scientific evidence presented in these studies was mixed, US policy makers generally subscribed to the idea that a 1% increase in government spending increases GDP by more than 1%—in other words, that the fiscal multiplier exceeds 1 and actually multiplies. Since then, several studies have poured water on this belief.

Ilzetzki, Mendoza, and Végh (2010) and Ilzetzki (2011) offer an unusually broad analysis of the topic using a panel of 44 developed and developing countries. Corsetti, Meier, and Mueller (2012) derive similar results using only data for countries in the Organisation for Economic Co-operation and Development. Fiscal multipliers are found to be larger in developed economies than in developing economies (Box table 1). Whereas the long-run multiplier effect is 0.8 for the group of developed economies in their sample, it is close to zero for the developing economies.

In line with theoretical models, fiscal multipliers are above 1 for closed economies and negative for very open economies. Countries with fixed exchange rates enjoy more potent fiscal policy, as monetary policy tends to accommodate fiscal policy by adjusting interest rates. The state of public finances also affects the efficacy of fiscal policy. A very high debt-to-GDP ratio is associated with a large negative multiplier.

If the increase in government expenditures is concentrated on public investment, the multipliers are generally higher. For the group of developing countries, the multiplier reaches 0.75 in the long run, compared with 0.18 for increases in government consumption. However, their multiplier is still lower than that of developed economies, for which the multiplier of government investment spending is well above unity.

The results for tax policies stand in stark contrast to the findings for government expenditures. Tax multipliers are significantly larger for developing economies, reaching 0.83 in the long run. In developed economies, the tax multiplier is only 0.28. The only other category of countries for which tax multipliers are large is closed economies.

Studying fiscal and tax multipliers for Indonesia, Malaysia, the Philippines, Singapore, and Thailand, Tang et al. (2010) arrive at largely similar findings. Increases in government spending have little positive effect on the economy—or negative. Changes in tax policies, however, appear to be much more effective.

**Fiscal multipliers**

| | Government consumption | Government investment | Taxes |
|---|---|---|---|
| Developed | 0.80 | 1.15 | 0.28 |
| Developing | 0.18 | 0.75 | 0.83 |
| Fixed exchange rates | 1.50 | 1.40 | 0.03 |
| Flexible exchange rates | -0.41 | 0.16 | -0.15 |
| Closed economies | 1.29 | 0.70 | 1.28 |
| Open economies | -0.75 | -0.51 | -0.31 |
| Highly indebted (60%+) | -2.30 | ... | ... |
| Low debt | 0.41 | ... | ... |

... = data not available.

*Source:* Ilzetzki, Mendoza, and Végh 2010.

## Policy beyond the short term

In addition to adopting a wait-and-see strategy with respect to countercyclical policy measures against external demand shocks from Europe and the US, policy makers may need to revisit their underlying assumptions about the global economy. Market observers increasingly arrive at the conclusion that the external environment for emerging economies will never again be as favorable to export-led growth strategies as in the first decade of the millennium. If this view is correct, overseas demand for the region's exports will be permanently diminished and conventional stimulus tools will fail to deliver long-term results. In addition, growth in important parts of the region is expected to slow as the gains from earlier economic reforms that boosted total factor productivity are reaped. To inject new dynamism, economies in the region must adapt by speeding up the rebalancing process, improving productivity, and enhancing efficiency.

The service sector in particular stands to win from such reform. Despite generating growing contributions to the regional GDP, the service sector is plagued by low labor productivity owing to its focus on traditional services. Retail trade, real estate, transportation, and personal services dominate the sector's output, and more valuable-creating modern services in business and finance are far less present than in advanced economies. The following theme chapter of this report discusses in detail possible directions for productivity-enhancing reforms in the service sector.

# Annex: Global headwinds unabated

Developments in the major industrial economies—the US, the euro area, and Japan—will continue to hold back global economic activity over the forecast horizon. Despite the unleashing of powerful policy tools, the slowdown in the euro area will deepen in the second half of the year, with Germany and France expected to post negative growth. Absent an unexpectedly strong rebound in private domestic demand, GDP growth in the major industrial economies is now forecast to languish at 1.1% in 2012 and 1.5% in 2013—unchanged from the *ADO 2012* forecast for 2012 but 0.2 percentage points weaker for 2013. These changes mostly reflect developments in the euro area and Japan. Against this dim global economic backdrop, world merchandise export growth is expected to slow to 3.0% in 2012 before recovering in 2013 (Table A1.1).

**A1.1 Baseline assumptions on the international economy**

| Item | 2010 Actual | 2011 Actual | 2012 ADO 2012 | 2012 Update | 2013 ADO 2012 | 2013 Update |
|---|---|---|---|---|---|---|
| **GDP growth (%)** | | | | | | |
| Major industrial economies[a] | 2.6 | 1.2 | 1.1 | 1.1 | 1.7 | 1.5 |
| United States | 2.4 | 1.8 | 2.0 | 1.9 | 2.3 | 2.1 |
| Eurozone | 2.0 | 1.5 | -0.5 | -0.6 | 1.0 | 0.5 |
| Japan | 4.5 | -0.8 | 1.9 | 2.3 | 1.5 | 1.6 |
| **World trade (% change)** | | | | | | |
| Merchandise exports | 13.8 | 5.0 | 3.8 | 3.0 | 5.4 | 5.0 |
| **Prices and inflation** | | | | | | |
| Brent crude spot prices (average, $ per barrel) | 79.6 | 110.9 | 111.0 | 111.0 | 106.0 | 106.0 |
| Energy price index (% change from 2005) | 26.4 | 29.9 | 3.1 | -2.5 | -3.1 | -5.3 |
| Food and beverage price index (% change from 2005) | 8.9 | 23.9 | -9.0 | -1.0 | 5.0 | 2.0 |
| Consumer price index inflation (major industrial inconomies' average, %) | 1.2 | 2.4 | 1.6 | 1.8 | 1.8 | 1.3 |
| **Interest rates** | | | | | | |
| United States Federal funds rate (average, %) | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| European Union refinancing rate (average, %) | 1.0 | 1.2 | 1.0 | 0.9 | 1.0 | 0.8 |
| Japan interest rate (average, %) | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| $ Libor[b] (%) | 0.3 | 0.2 | 0.3 | 0.2 | 0.3 | 0.2 |

Libor = London interbank offered rate.

a Average growth rates are weighed by gross national income using Atlas method.

b Average interbank quotations on 1-month loans.

*Sources:* US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp; World Trade Organization, http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary Fund, Primary Commodity Prices, http://www.imf.org; World Bank, Global Commodity Markets, http://www.worldbank.org (all accessed 21 September 2012); ADB estimates.

# Major industrial economy update

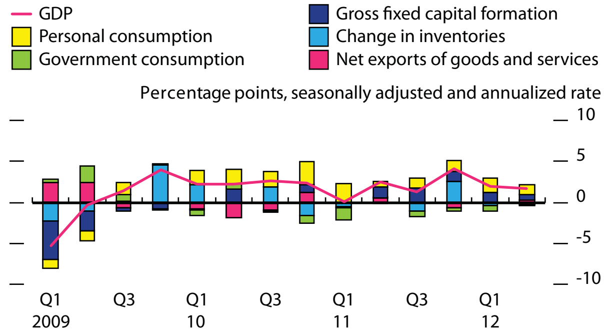
## United States

As data for the first half of 2012 disappointed, the US growth forecast has been lowered from 2.0% to 1.9% in 2012. GDP growth—at a quarter-on-quarter, seasonally adjusted annualized rate—reached 2.0% in the first quarter of 2012 and slowed to 1.3% in the second quarter (Figure A1.1). The modest gains in GDP growth stem from consumption and investment demand. Cuts in government consumption continue to drag on the economy but by no means as much as in 2011. After showing some weakness at the beginning of the year, retail sales and industrial production have resumed their gradual rise (Figure A1.2). Consumer confidence took a noticeable hit over the first 6 months of 2012 but has been more ambivalent since the end of June, leaving some hope that the US economy will be stronger in the second half.

Beyond uncertainty originating from outside the country, the state and direction of fiscal policy and the high unemployment rate pose major challenges. The labor market continues to be the key weakness of the US economy, with the seasonally adjusted unemployment rate remaining elevated at 8.1% in August as the private sector fails to create a sufficient number of new jobs and the public sector continues to shed jobs. Legal requirements for balanced budgets in many US states have thrown many employees of state and local governments out of work.

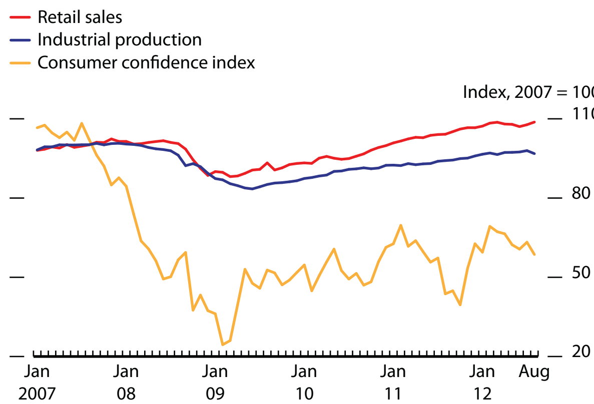
Inflation remains well under control, as the global economy lacks steam (Figure A1.3). Given low and stable price inflation (not exceeding 2.0% over the forecast horizon), monetary policy is expected to continue to support recovery, with target Federal Funds rates unchanged within 0.00%–0.25% at least until mid-2013 and slowly tightened after that. To support the ailing job market, the Federal Reserve launched a new round of quantitative easing in September 2012.

**A1.1 Contributions to GDP growth, United States**




*Source:* US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 18 September 2012).

**A1.2 Business activities and consumer confidence indicators, United States**



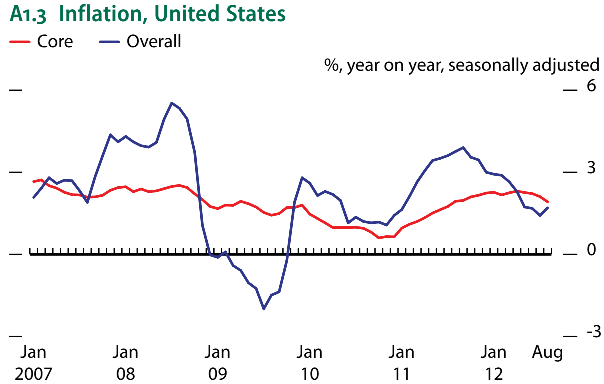

*Source:* CEIC Data Company (accessed 18 September 2012).

## Euro area

The sovereign debt crisis in the euro area continues to weigh on economic activity in the currency union. Fiscal consolidation measures and rising interest costs for private and public borrowers have deepened the recession in southern European countries, most notably Italy and Spain. Whereas the euro area contracted only mildly over the first half of the year, owing to Germany's relatively strong performance, economic growth is believed to be contracting considerably over the remainder of the year, foretelling GDP contraction of 0.6% in 2012. A mild recovery is expected in 2013 with GDP growing by 0.5%.

The first half of the year was a continuation of 2011. Growth in many countries in the euro area dropped further, pushing many into recession. Germany continued to post positive

**A1.3 Inflation, United States**




*Note:* Core inflation excludes food and energy.

*Source:* CEIC Data Company (accessed 18 September 2012).

growth rates but may slip into negative territory in the second half as exports to southern Europe plummet.

Throughout 2011 and the first half of 2012, net exports remained the key contributor to GDP growth (Figure A1.4). The EU's trade with the rest of the world continued recovering from the 2009 contraction. Official numbers for 2012 suggest that all other contributors to GDP have turned negative. In the first quarter of 2012, fixed capital formation and private consumption dragged down GDP. Retail trade remains weak.

By mid-year, the unemployment rate had risen above 11%. The social repercussions are turning increasingly severe in Spain, where the unemployment rate now stands at 25% and disproportionately affects young people. Germany, the Netherlands, and Austria, by contrast, still post unemployment rates of about 5%.

Consumer price inflation was 2.4% in July 2012, down from its peak of 3.0% in April 2011 (Figure A1.5). Core price inflation, which excludes food and energy, is down to 1.6%. Low and stable inflation is a condition required for the European Central Bank to pursue its policy of monetary accommodation, which started with longer-term refinancing operations in the fall of 2011 and has recently been augmented with short-term sovereign debt purchases in secondary markets (Annex box).

### Japan

Japan started 2012 well, and the Japanese economy is forecast to expand by 2.1% in 2012 before slowing to 1.6% in 2013. However, concerns over the health of the global economy are reflected in the plunge in business investment and slowing exports. Monetary policy will therefore remain highly accommodative.

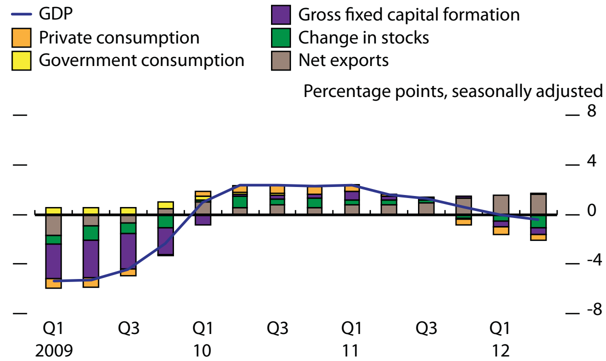
After very strong GDP growth of 5.5% in the first quarter, the economy slowed to 1.4% in the second (Figure A1.6). Private consumption was the main driver of growth, with government consumption contributing only modestly to economic expansion. Industrial production has fallen since the beginning of the year but has held up well considering the increasingly adverse external environment.

Despite the strong performance so far, deflation has resumed, with Japan's consumer prices falling slightly in July. Core prices have fallen each month since the start of the global financial crisis, though the pace has slowed since mid-2011 (Figure A1.7). As will the other two major central banks, the Bank of Japan will continue its highly accommodative policies, despite the expanding cost.

## Commodity price update

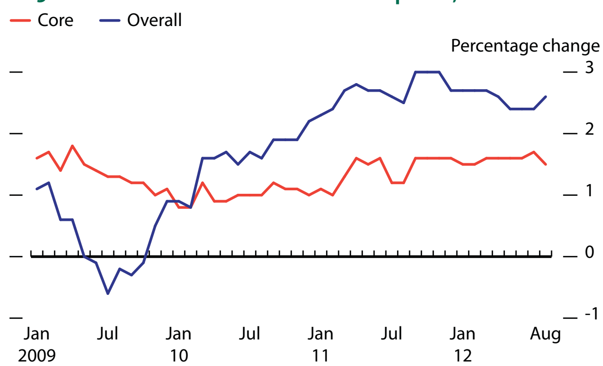
International food and fuel prices showed big movements in the first half of 2012. Concerns over geopolitically induced supply disruption and developments in euro area rescue plans were the major factors driving the swings.

**A1.4 Contributions to GDP growth, euro area**




*Source:* European Central Bank. Statistical Data Warehouse. http://sdw.ecb.europa.eu (accessed 18 September 2012).

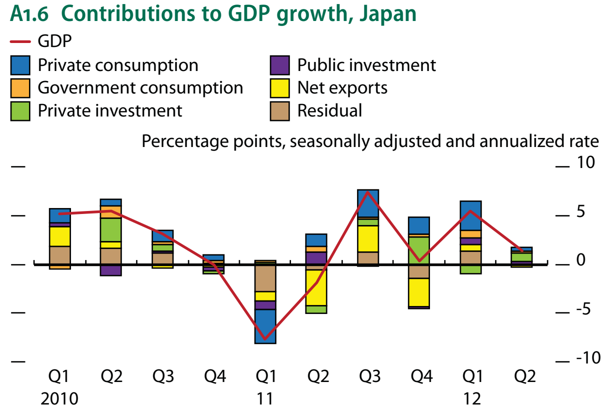
**A1.5 Harmonized indexes of consumer prices, euro area**




*Note:* Core inflation excludes food and energy.

*Source:* European Central Bank. Statistical Data Warehouse. http://sdw.ecb.europa.eu (accessed 18 September 2012).

**A1.6 Contributions to GDP growth, Japan**




*Source:* Economics and Social Research Institute, Cabinet Office, Government of Japan. http://www.esri.cao.go.jp/en (accessed 18 September 2012).

### A1.1 Euro crisis response and reaction

The box figure shows a timeline tracking government bond spreads from the German benchmark as European authorities have labored to contain their sovereign debt crisis. At the conclusion of its September meeting, the European Central Bank (ECB) announced modalities for purchasing euro area sovereign debt in secondary markets through outright monetary transactions (OMTs). The official justification for this move was to guarantee the proper functioning of the monetary transmission mechanism within the currency union, as the direct funding of a government through the ECB is ruled out by its legal framework. The technical features of OMTs are as follows:

i. **Conditionality.** The only debt that qualifies is that of euro area members who are under a full or precautionary European Stability Mechanism or European Financial Stabilization Mechanism program with possible primary market purchases.
ii. **Timing.** Purchases will continue until success has been established or the country under consideration violates the conditionality in accordance with the ECB's mandate for price stability.
iii. **Type of debt.** Only debt maturing in 1–3 years qualifies.
iv. **Volume limits.** None apply.
v. **Creditor treatment.** The ECB has waived its preferred creditor status.
vi. **Sterilization.** As purchases will be fully sterilized, the composition of the balance sheet will be affected but not its size.
vii. **Transparency.** Holdings, market values, and breakdown by country will be published.
viii. **Securities Markets Program.** This predecessor to the OMT will be terminated.

Although the ECB decision has calmed financial markets, a solution to the structural shortcomings of the currency union has not been brokered. Whether the activities of the ECB can buy sufficient time to draft a credible fiscal and banking union will depend on the willingness of the Government of Germany to support this course and keep opposition from the Deutsche Bundesbank under control without violating the independence of the German central bank. In ruling on the constitutionality of the European Stability Mechanism treaty, the German supreme court barred ECB intervention in primary markets, ECB purchases from the ESM, or a banking license for the ESM. Without a powerful alternative strategy that would keep interest rates manageable for all euro area members, not intervening in financial markets carries the risk of massive financial market turmoil in Europe not unlike during the 2008–2009 global financial crisis.

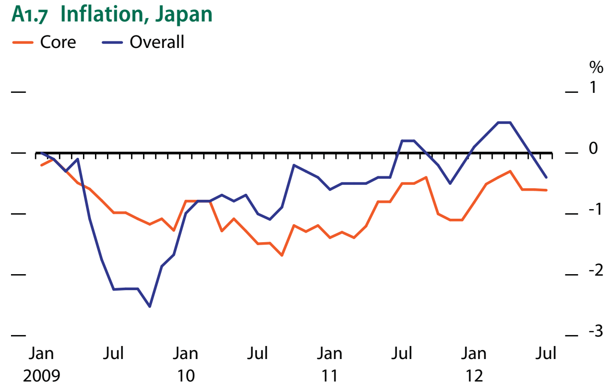
## Oil contained by weak demand

From its peak of $128 earlier this year, Brent crude fell by 30% to $89 in June before subsequently rebounding to well above $100 (Figure A1.8). The average price of Brent crude in the year to date is $113 per barrel (bbl).

The price is expected to average $111/bbl in 2012 assuming no supply disruptions. Although global oil demand is expected to pick up slightly next year as the global economy regains momentum, the rise is now expected to be slower than previously forecast. The price of crude is forecast to soften further to $106/bbl next year on account of better supply side conditions. Oil shale development in the US is a factor, as are possible increases in oil production in Brazil, Kazakhstan, and the Russian Federation. Production in the Organization of the Oil Exporting Countries (OPEC) is expected to average 35 million bbl/day in 2012 and 2013. Lower production in Iran will be partly offset by increases in other OPEC countries: Iraq, the United Arab Emirates, Libya, and Angola.

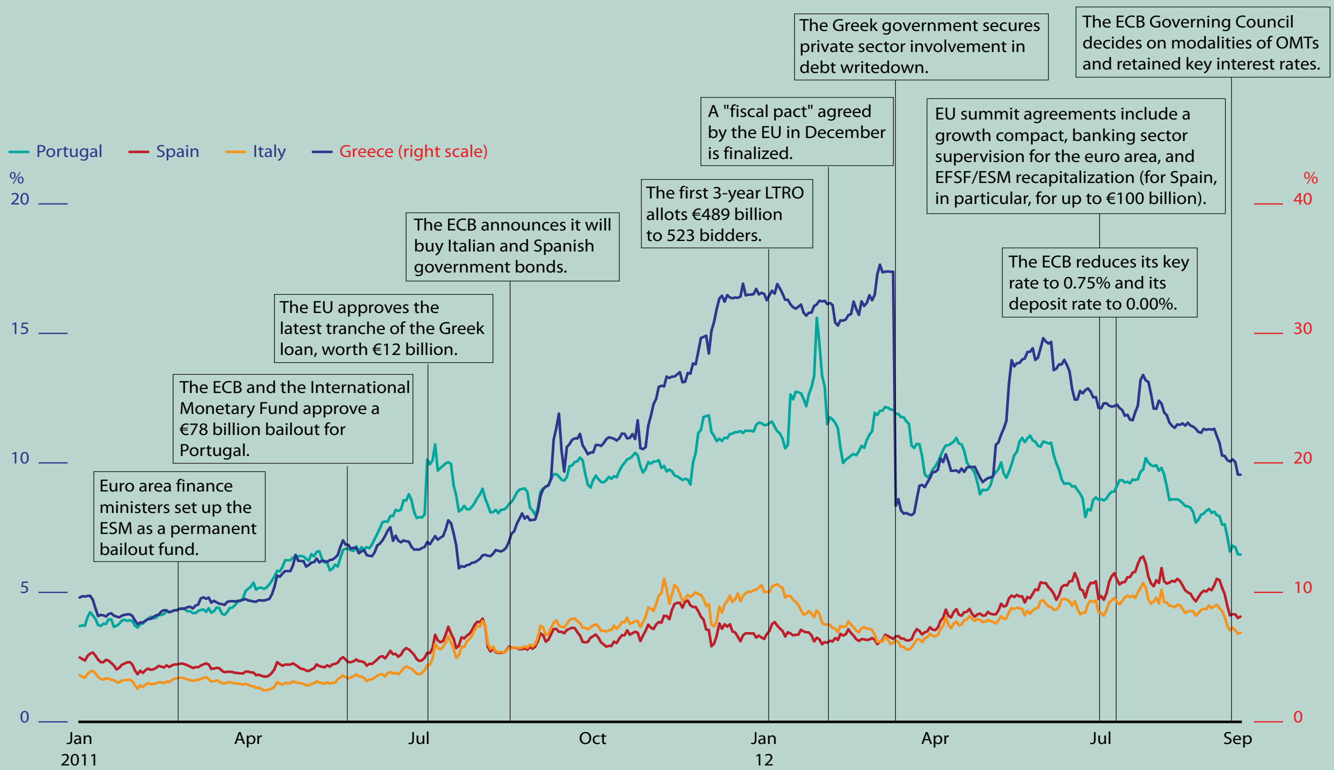
Oil prices will react to perceptions of deeper crises, both economic and geopolitical. The geopolitical risk emanating

A1.7 Inflation, Japan




*Note:* Core inflation excludes food and energy.
*Source:* CEIC Data Company (accessed 18 September 2012).

**A1.1 Euro crisis response and reaction *(continued)***




ECB = European Central Bank, EFSF = European Financial Stabilization Mechanism, ESM = European Stability Mechanism, EU = European Union, LTRO = long-term refinancing operation, OMT = outright monetary transaction.

*Note:* The government bond spread is the difference between the yield of the charted government bond and that of Germany.

*Sources:* Bloomberg (accessed 13 September 2012); Institute of International Finance. 2012. Euro Briefing, June and July; ECB Monetary Policy Statement, Opening Remarks by Mario Draghi, 6 September 2012 , full transcript at http://www.forextv.com/ (accessed 18 September 2012); Athens News. http://www.athensnews.gr/portal/1/53964# (accessed 3 April 2012); BBC News. http://www.bbc.co.uk (accessed 31 March 2012).

from Iran's threat to block oil shipments through the Strait of Hormuz remains a major threat. The growing consensus is, however, that the market can cope, given ample supply and weak demand.

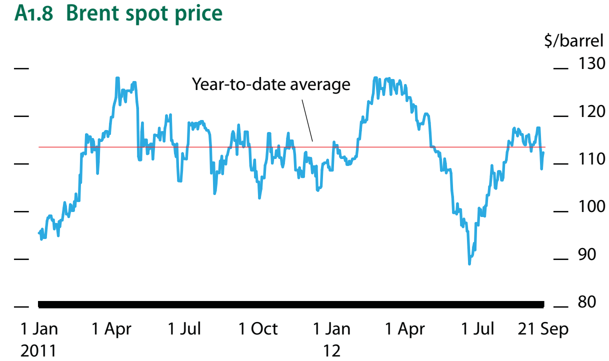
## Food riding high on weather

International food prices have been less volatile than oil prices, but weather continues to disrupt markets. Unlike in 2011, when agricultural prices generally slid, prices have been trending up in 2012, with indexes at or above their 2008 and 2011 peaks since July (Figure A1.9).

The upward trend in food inflation in the first half of this year was driven mainly by strengthening soybean prices caused by dry weather in the US and South America, decreased acreage in favor of more profitable maize, and record imports to the PRC drawing down stocks. Likewise, grain prices have been affected by weather, with maize prices in particular starting to increase in June as drought in the US intensified.

Prospects for cereal production are dim as drought affects maize in the US and wheat in Kazakhstan, the Russian Federation, and the Ukraine. Unfavorable weather has

**A1.8 Brent spot price**

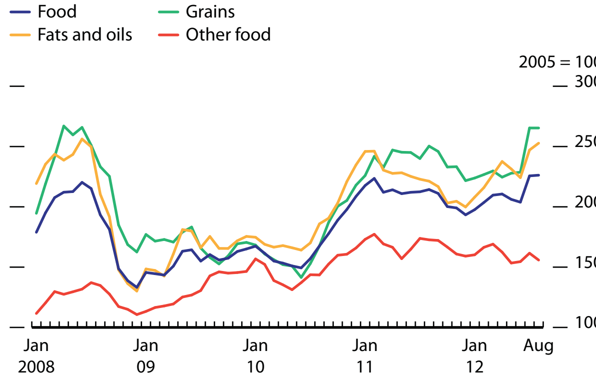



*Source:* Bloomberg (accessed 24 September 2012).

dragged down estimates for Asian rice production in 2012/13 to a minimal increase over the previous year. Lower crop production is expected in India, Cambodia, the Republic of Korea, and Nepal but offset by higher production expected in the PRC, Indonesia, and Thailand.

The paddy pledging scheme implemented by the Government of Thailand last 7 October 2011 has kept global rice prices artificially high. With the government offering support prices well above world market prices, almost all of the rice produced by farmers is going into government stockpiles. The decision of the government to release stocks will greatly influence the movement of international rice prices. Data from the Thai Rice Exporters Association show rice exports plummeting by 45% in the first 8 months of the year to 4.5 million tons. Thailand now ranks second among rice exporters behind Viet Nam, which exported 5.5 million tons over the same period.

**A1.9 Food commodity price indexes**




*Source:* World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 7 September 2012).

The price of benchmark Thai rice (100% B) averaged $518/ton in 2010. In 2011, before the implementation of the scheme, rice prices averaged $544/ton. It then rose to $620/ton in September and October 2011 and a year later is trading at around $600/ton. The quoted prices for Thai white and parboiled rice are more than $100/ton higher than for similar rice from India, Pakistan, or Viet Nam.

While growth in world cereal consumption is expected to outpace production, inventories are generally strong. As drought is already priced into maize prices, they are not expected to rise further this year. Wheat prices are expected to decline on strong inventories, as are rice prices. In 2013, demand for grains may further rise while production and stocks decline, putting upward pressure on prices.

Given declines at the beginning of the year, food prices will decline further by only 1% over the course of 2012. In 2013, prices will increase by 2%. Policy-induced shocks are risks to prospects, as prices will reflect measures such as trade restrictions or stock hoarding.

## External environment in sum

The international macroeconomic environment should not be expected to give strong positive impulse to emerging Asia over the forecast horizon. The situation in Europe is what weighs most heavily on the outlook. The only consolation stems from demand and prices for food and other commodities remaining subdued. Absent major supply shocks, commodity prices are not expected to pose a threat to overall price stability in the region.

## References


Aizenman, J. and Y. Jinjarak. 2011. The Fiscal Stimulus of the 2009–10: Trade Openness, Fiscal Space and Exchange Rate Adjustment. *NBER Working Paper No. 17427*. Cambridge, Massachusetts: National Bureau of Economic Research.

Carabenciov, I., I. Ermolaev, C. Freedman, M. Juillard, O. Kamenik, D. Korshunov, D. Laxton, and J. Laxton. 2008. A Small Quarterly Multi-country Projection Model with Financial-Real Linkages and Oil Prices. *IMF Working Paper.* Washington, DC: International Monetary Fund.

Congressional Budget Office. 2012. *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*. Washington, DC: Congressional Budget Office.

Corsetti, G., A. Meier, and G. Müller. 2012. What Determines Government Spending Multipliers? *Discussion Paper 9010*. London: Centre for Economic Policy Research.

Dees, S, F. Di Mauro, M.H. Pesaran, and V. Smith. 2007. Exploring the International Linkages of the Euro Area: a Global VAR Analysis. *Journal of Applied Econometrics*. 22(1). pp. 1–38.

Diebold, F.X. and K. Yilmaz. 2012. Better to Give than to Receive: Predictive Measurement of Volatility Spillovers. *International Journal of Forecasting*. 28(1). pp. 57–66.

Ferrarini, B., R. Jha, and A. Ramayandi. Forthcoming (17 October 2012). *Public Debt Sustainability in Developing Asia*. Oxford: Routledge.

Ilzetzki, E., E.G. Mendoza, and C.A. Végh. 2010. How Big (Small?) Are Fiscal Multipliers? *NBER Working Paper No. 16479.* Cambridge, Massachusetts: National Bureau of Economic Research.

Ilzetzki, E. 2011. Fiscal Policy and Debt Dynamics in Developing Countries. *Policy Research Working Paper 5666*. Washington, DC: World Bank.

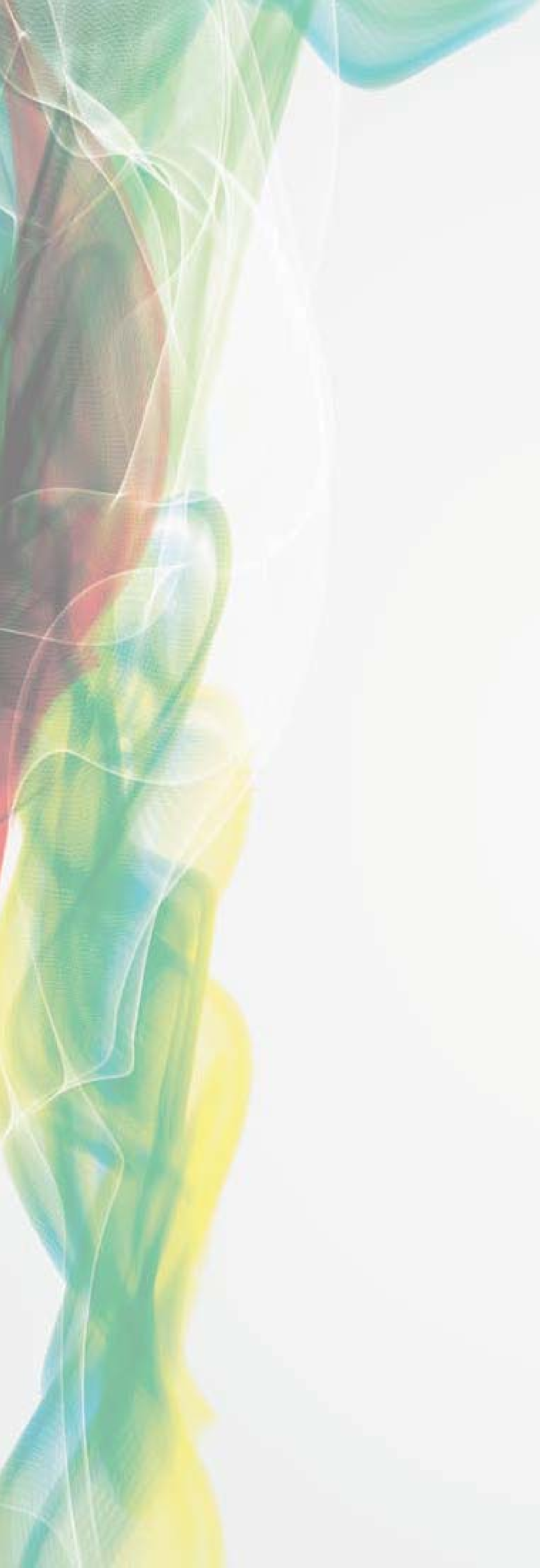
Ostry, J.D., A.R. Ghosh, J.I. Kim, M.S. Qureshi. 2010. Fiscal Space. *IMF Staff Position Note.* Washington, DC: International Monetary Fund.

Pesaran, M.H. and Y. Shin. 1998. Generalized Impulse Response Analysis in Linear Multivariate Models. *Economics Letters.* 58(1). pp. 17–29.

Reinhart, C.M. and K.S. Rogoff. 2009. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, New Jersey: Princeton University Press.

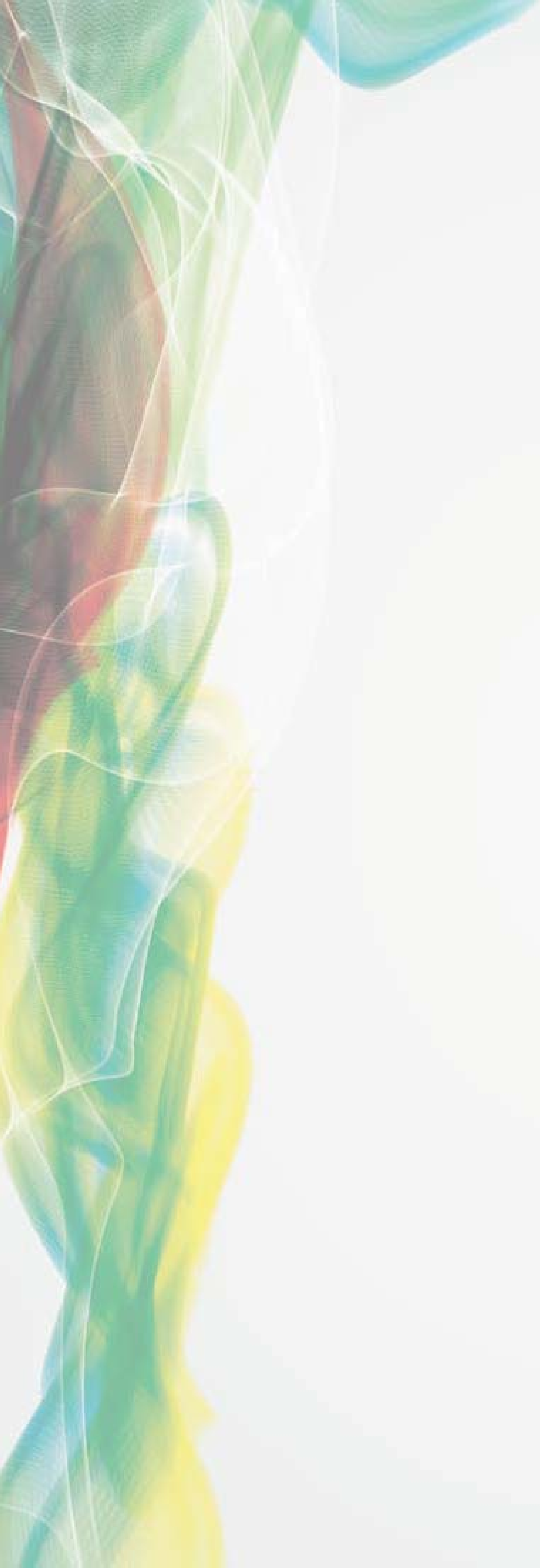
Smith, L.V. and A. Galesi. 2011. *GVAR Toolbox 1.1.* www.cfap.jbs.cam.ac.uk/research/gvartoolbox

Tang, H.C., P. Liu, and E.C. Cheung. 2010. Changing Impact of Fiscal Policy on Selected ASEAN Countries. *ADB Working Paper Series on Regional Economic Integration No. 70.* Manila: ADB.



# Services and Asia's future growth

# 2



# Services and Asia's future growth

Headwinds continue to slow economic growth and poverty reduction in developing Asia. Hard times emanate from advanced economies into developing Asia as fewer orders are placed with the factories upon which East and Southeast Asia have built their prosperity. Developing Asia has dodged the worst of the slowdown, but persistent hard times for exports illustrate the risk of depending too heavily on faraway markets. As advanced economies are unlikely to bounce back any time soon, developing Asia cannot afford to sit back and wait for its order books to fill up again.

Hard times are a good time to start rebalancing the economies of developing Asia toward more sustainable growth. One strategy is to sell more products at home and expand intraregional trade. Another is to strengthen the underdeveloped service sector.

Asia's transformation into the factory of the world led business leaders to believe that they put their best foot forward by forever churning out more goods for eager world markets. Now it is evident that the region's hidden backward leg—its service sector—needs exercise to restore symmetry and enable the regional economy to stand on both legs.

Despite neglect, the service sector is large and expanding in Asia and the Pacific. And the region is no stranger to service excellence, as ranking websites attest. All 3 of the world's top airports are in Asia, as are 5 of the 6 best airlines and 4 of the 5 best airport hotels. Asia remains the backpacker favorite, boasting 4 of the top 10 destinations and 2 of the 4 cities offering the best street food. Half of the world's 10 coolest movie theaters are in Asia, as is the world's best mass transit system.[1]

The problem is that developing Asia remains trapped, for the most part, in traditional services with limited potential for value addition: wholesale and retail trade, hotels and restaurants, real estate, and transport. These industries employ lots of workers but offer mostly low pay and dead-end prospects to those unable to find a better job.

Even firms that have built modern service industries—notably Indian and Philippine providers of outsourced business processes—have not come close to engineering the kind of transformation that manufacturing brought to Asia. Nor have they sold Asians on using technology services to improve other industries or enrich their leisure.

Challenges abound in studying diverse services across a vast and complex continent. Compounding them are meager statistics on intangibles and the confounding econometrics of new industries rising rapidly from zero. Yet rigorous analysis can support proposals on how to pilot developing Asia's emergence as a world player in modern services.

This chapter was written by Donghyun Park of the Economics and Research Department. It draws on the background papers listed at the end of the chapter. Artur Andrysiak provided background material on challenges of measuring Asia's service sector. Changyong Rhee, chief economist, provided guidance at various stages.

# Competitive services for sustained growth

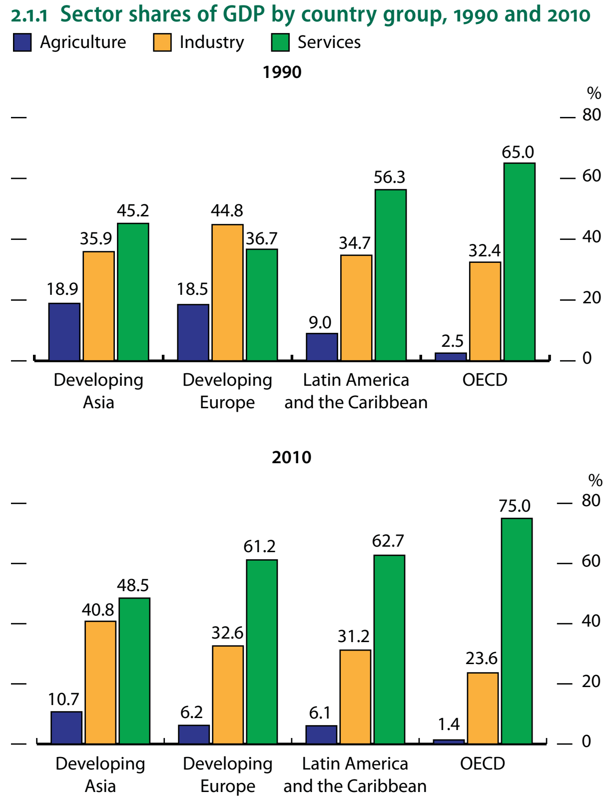
Services are set to play a bigger role in the economic future of developing Asia. How policy makers nurture the expanding sector will determine whether economies move toward dynamic high-end services—services with beneficial productivity spillovers into other sectors—or remain mired in traditional service industries with low productivity. The impact of the global economic slowdown on the region's export manufacturers highlights the need for diversified economies. Achieving this requires a more competitive environment for an increasingly tradable service sector.

## A large and growing sector

The service sector already looms large in the region's economic landscape, accounting for 48.5% of regional output in 2010, but it will be even more prominent in the coming years. Historically, economies followed similar patterns of structural transformation to high-income status. In the early phase of development, the dominance of agriculture as a share of production and employment gives way to industry, particularly manufacturing. As industrialization proceeds, labor productivity in manufacturing improves, reducing the sector's labor intensity while increasing incomes and demand for services. Service industries expand to meet rising demand, engaging the workers no longer required to support industrial growth. The service sector's share of employment thus rises as the economy moves into its postindustrial phase.

Developing Asia has broadly followed this pattern of structural change. The region's share of industry in gross domestic product (GDP) surpassed that of Organisation for Economic Co-operation and Development (OECD) output in 2010, but its share of services still lags by a wide margin (Figure 2.1.1). Services occupy a much smaller share of the economy in developing Asia than in Latin America or developing Europe, while agriculture still has a conspicuously larger share. This suggests that future structural transformation in Asia will mainly see a net shift from agriculture to services.

**2.1.1 Sector shares of GDP by country group, 1990 and 2010**




GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development.

*Sources:* ADB estimates using data from ADB (2007); *Asian Development Outlook* database; World Bank. World Development Indicators online database (databases accessed 16 April 2012).

## A relatively backward sector

What does the rising prominence of the service sector imply for the region's future growth? The process of structural transformation does not itself guarantee economic dynamism. Labor productivity across sectors in developing Asia lags that of the OECD. But as the share of services in output expands, the region's scope for economywide productivity gains will increasingly depend on raising service sector productivity. The task is daunting. In most Asian countries, labor productivity in services is less than one-fifth of the current OECD figure, and in extreme cases it may take up to 30 years to reach even that level. Constraints that hinder greater efficiency and productivity in the region's service industries are pervasive. Whether the shift to services comes from stagnant, low-productivity industries or vibrant, high-productivity industries will determine how effectively it catalyzes economic dynamism. This is the crux of the problem.

Low productivity in Asia's service sector partly reflects the dominant role of traditional service industries such as wholesale and retail trade, hotels and restaurants, real estate, transport, personal services, and public administration. Modern services such as information and communication technology (ICT), finance, and professional business services still occupy only a sliver of Asia's service economy. Advanced economies, in contrast, have shifted more aggressively toward modern services, which tend to enjoy higher productivity than traditional services and so offer better wages. Further, modern services are tradable internationally and thus offer countries the opportunity to widen their foreign trade and to create incentives for greater productivity domestically.

## Sector modernization for growth

It is critical that policy steer the development of the sector away from the backward elements toward a vibrant future. Doing so will enable services to contribute even more to growth. Four key factors highlight the urgent need to direct the development path of the service sector. First, service sector development has positive spillovers for industry and other productive sectors. Second, the sector helps make growth more inclusive. Third, uncertain prospects in key export markets call for a more diversified production structure to make Asian economies more balanced. Finally, new opportunities are emerging as technological innovation enables more international trade in services.

### Synergies between services and industry

Spillovers from services into other sectors provide part of the answer to the low labor productivity that plagues all industries in Asia. The region's labor productivity in industry and services lags far behind OECD levels partly because both sectors have settled on low-wage, labor-intensive industries. Because services and industry each use the output of the other as input to its own production, services can play an important role in raising the productivity of industry and the rest of the economy. This synergy makes improving service sector employment all the more urgent.

One group of services with especially large benefits for industry is business services. An efficient ICT subsector, for example, reduces the cost of information, which is a key production input in all sectors, not just services. Likewise, an education system that yields workers and skills toward meeting employers' needs benefits the entire economy. Conversely, spillover can flow from manufacturing to services. New and improved ICT hardware clearly improves the quality of ICT services, as faster computers make call centers, for example, more responsive to clients' needs. In short, productivity improvements matter because they lift productivity across the economy regardless of where they originate.

### Services and inclusive growth

Further, a dynamic service sector can contribute to Asia's quest for inclusive growth, helping to ensure that broader segments of the population participate in generating growth and that the fruits of growth are spread more widely and equitably. The fundamental reason is that services tend to be labor-intensive, and employment is central to inclusive growth. As rising wages make capital-intensive automation more attractive to manufacturers, industry becomes less labor intensive, reinforcing the need for services to provide employment.

Services have already made a huge contribution to employment and inclusive growth in Asia, underwriting the region's impressive record of lifting people out of poverty. Improving labor productivity in the sector will further expand the contribution of service employment to inclusive growth. This is because a vibrant, highly productive service sector will create high-quality, high-wage jobs, whereas a stagnant, low-productivity service sector would mean only marginal, low-wage jobs. As a big employer of women, an expanded service sector may also advance gender equality, a key dimension of inclusive growth.

Further, a well-developed service sector that produces a wide range of high-quality services expands consumers' options and allows individuals to achieve higher living standards. The development of leisure industries further enables individuals to enjoy a better work–life balance. Some services such as health care and education enable individuals to enhance their consumption and quality of life along with their productivity.

Service sector development can also promote environmental sustainability. Services tend to be less resource-intensive than other sectors and thus place less strain on the environment. Food and beverage manufacturing, for example, uses in addition to labor such resource inputs as agricultural products, land, water, fuel, and electricity. In contrast, an ICT firm depends heavily only on labor and electricity. Post production, ICT exports can be delivered over the internet and so incur much lower transport and energy costs than do manufactured exports.

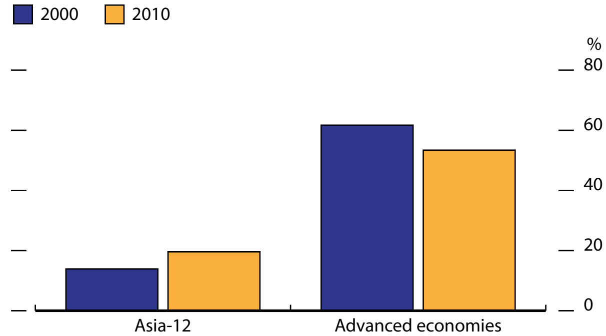
### Need for diversified production

Less favorable external conditions further strengthen the case for promoting a more vibrant Asian service sector. Since the 2008–2009 global financial crisis, advanced economies have languished in a slowdown. This has undercut developing Asia's growth prospects because advanced economies are still the main markets for the region's manufactured exports. Revving the services engine to offset stalling demand for merchandise exports can maintain Asia's growth momentum and make it more balanced, as services tend to be more geared toward domestic demand. Further, strong growth allows every year millions of the region's citizens to join the middle class, which typically has a healthy appetite for services, including the highly productive service industries that Asia needs to nurture.

### Opportunity in foreign trade of services

World trade is dominated by the movement of goods across national boundaries, with services conventionally viewed as untradable. A recent trend, however, is the growing tradability of many services resulting from technological progress. Cross-border trade in services as a share of world income has risen steadily in the past quarter century globally and, despite Asia's relatively high trade barriers, in this region as well. Asia already accounts for a substantial share of the global trade in services, and that share is growing (Figure 2.1.2). Lowering barriers and opening up to international trade will force Asian service providers to raise their game to cope with stiffer competition. As they become more competitive and efficient, they will sharpen their ability to capture a larger share of the global trade in services.

**2.1.2 Shares of global services trade held by Asia-12 and advanced economies, 2000 and 2010**




*Note:* In Asia-12 are the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. The advanced economies are the European Union-15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom), Japan, and the United States.

*Sources:* ADB estimates using data from CEIC Data Company; World Bank. World Development Indicators online database (accessed 2 September 2012).

## Reform key to realizing services' potential

Notwithstanding the large and growing role of the service sector in Asian economies, several challenging factors constrain its transformation into a more dynamic sector. For one, the region still suffers a scarcity of the highly skilled workers who are indispensable to modern, high-end services. For another, investment in infrastructure supporting services, such as ICT systems, needs to be ramped up. Above all, a wall of regulations and restrictions erected to protect incumbent firms stifles competition and innovation in services markets. In India, for instance, a staggering 13 bodies regulate higher education. Further, Asian economies have some of the world's highest barriers to trade in services. In short, anticompetitive regulations and restrictions, both domestic and external, constitute the biggest category of constraints on the development of Asia's service sector.

Low labor productivity in the service sector underlines the daunting magnitude of the constraints that must be tackled to fully unleash the potential of Asia's service sector as an engine of growth and employment. Service sector development is, to a much greater extent than industrial development, largely a matter of removing burdensome regulations that shackle entrepreneurship and private enterprise. However, easing such regulations requires a great deal of political will to counter well-entrenched vested interests. Promisingly, international experience shows that regulatory reform often catalyzes competition and delivers significant economic benefits. Lowering trade barriers can both promote productivity and contribute directly to exports and growth—as demonstrated by India's well-known success as an exporter of ICT and outsourced business processes. Therefore, the guiding principle by which Asian policy makers foster a more vibrant service sector must be to create a more competitive environment for their service industries.

Building up a vibrant service sector based on dynamic, high-end industries and activities will inevitably be a lengthy and challenging process. Because services are vital to Asia's future growth and economic dynamism, the time to act is now. It is encouraging that Asian policy makers have begun to show signs of understanding the urgency of creating a regulatory environment that promotes competition and innovation.

# The quiet rise of services

The service sector in developing Asia plays a major role as a producer and employer. Although overshadowed by manufacturing because of the latter's leading role in the region's transformation, the contribution of services is on the rise and looks poised to expand further. Will manufacturing need to share the limelight in Asia's future growth model?

## Measuring the service sector in Asia

A key structural characteristic of the service sector is its immense heterogeneity. Services encompass a bewildering array of activities and require a broad range of skills. As defined by the United Nations International Standard Industrial Classification, Revision 4 (Table 2.2.1), the sector includes wholesale and retail trade, transport and storage, information and communication, accommodation and food service, finance, real estate, professions, and government, as well as personal services such as education, health care, and recreation.

In the region, the heterogeneity of services is compounded by the enormous heterogeneity of countries across this vast continent.[2] Asian countries are at very different stages of developing their service sectors, as with their economies overall. While a growth strategy favoring export-oriented industries stunted the development of services in the People's Republic of China (PRC), services play a visibly bigger role in the economies of India and the Philippines, as epitomized by the success of their globally competitive ICT and business process outsourcing industries. In the Republic of Korea—a high-income economy already moving into its postindustrial phase—the service sector's share of output has grown at a much slower pace than its share of employment, indicating productivity problems. In Thailand, with its large tourism industry, the share of services in output has declined since the 1997–1998 Asian financial crisis. This heterogeneity makes analyzing the sector across the region a complex undertaking.

The analytical challenges created by the sector's heterogeneity are compounded by basic measurement problems. The output of many services is hard to measure, which complicates attempts to assess levels and changes in productivity. These conditions stand in stark contrast to those prevailing in agriculture, mining, and manufacturing, where output is more standardized, greatly facilitating understanding of their productivity drivers.

Metrics of service activity are further obscured at the firm level. Many of today's major multinational corporations trace their origins to manufacturing but now, like General Motors or General Electric, have large service divisions. Firms have changed the way they operate as service sector activity has intensified, with outsourcing and offshoring now increasingly common. Cross-sector linkages within firms make it difficult to disentangle the value added by services from that of manufacturing, further complicating attempts to gauge the

**2.2.1 United Nations International Standard Industrial Classification, Divisions 45–99**

| Section | Division |
|---|---|
| G - Wholesale and retail trade; repair of motor vehicles and motorcycles | 45 - Wholesale and retail trade and repair of motor vehicles and motorcycles<br>46 - Wholesale trade, except of motor vehicles and motorcycles<br>47 - Retail trade, except of motor vehicles and motorcycles |
| H - Transportation and storage | 49 - Land transport and transport via pipelines<br>50 - Water transport<br>51 - Air transport<br>52 - Warehousing and support activities for transportation<br>53 - Postal and courier activities |
| I - Accommodation and food service activities | 55 - Accommodation<br>56 - Food and beverage service activities |
| J - Information and communication | 58 - Publishing activities<br>59 - Motion picture, video and television programme production, sound recording and music publishing activities<br>60 - Programming and broadcasting activities<br>61 - Telecommunications<br>62 - Computer programming, consultancy and related activities<br>63 - Information service activities |
| K - Financial and insurance activities | 64 - Financial service activities, except insurance and pension funding<br>65 - Insurance, reinsurance and pension funding, except compulsory social security<br>66 - Activities auxiliary to financial service and insurance activities |
| L - Real estate activities | 68 - Real estate activities |
| M - Professional, scientific and technical activities | 69 - Legal and accounting activities<br>70 - Activities of head offices; management consultancy activities<br>71 - Architectural and engineering activities; technical testing and analysis<br>72 - Scientific research and development<br>73 - Advertising and market research<br>74 - Other professional, scientific and technical activities<br>75 - Veterinary activities |
| N - Administrative and support service activities | 77 - Rental and leasing activities<br>78 - Employment activities<br>79 - Travel agency, tour operator, reservation service and related activities<br>80 - Security and investigation activities<br>81 - Services to buildings and landscape activities<br>82 - Office administrative, office support and other business support activities |
| O - Public administration and defense; compulsory social security | 84 - Public administration and defense; compulsory social security |
| P - Education | 85 - Education |
| Q - Human health and social work activities | 86 - Human health activities<br>87 - Residential care activities<br>88 - Social work activities without accommodation |
| R - Arts, entertainment and recreation | 90 - Creative, arts and entertainment activities<br>91 - Libraries, archives, museums and other cultural activities<br>92 - Gambling and betting activities<br>93 - Sports activities and amusement and recreation activities |
| S - Other service activities | 94 - Activities of membership organizations<br>95 - Repair of computers and personal and household goods<br>96 - Other personal service activities |
| T - Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use | 97 - Activities of households as employers of domestic personnel<br>98 - Undifferentiated goods- and services-producing activities of private households for own use |
| U - Activities of extraterritorial organizations and bodies | 99 - Activities of extraterritorial organizations and bodies |

*Source:* United Nations Statistics Division. International Standard Industrial Classification of All Economic Activities, Revision 4. http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=27 (accessed 10 September 2012).

productivity of services (Yuskavage, Strassner, and Medieros 2008, Houseman et al. 2011).

The data collected and compiled on service activities are less varied and comprehensive than that on goods production. While aggregate service sector data are available, what is lacking are data showing the backward and forward linkages of services within an economy in the way that input–output tables show these linkages for goods. As such, the role of services in the overall development of the economy may be understated. On the one hand, a country may have a successful enclave tourism sector based on local natural, cultural, or historical endowments but with little spillover into the rest of its economy. On the other hand, a vibrant business service industry, such as architecture and engineering, may facilitate investment and development of new products. The cross-benefits work both ways as a dynamic industry sector creates demand for more business services. Any analysis of these trends requires industry-specific data that are disaggregated down to a narrowly defined range of services.

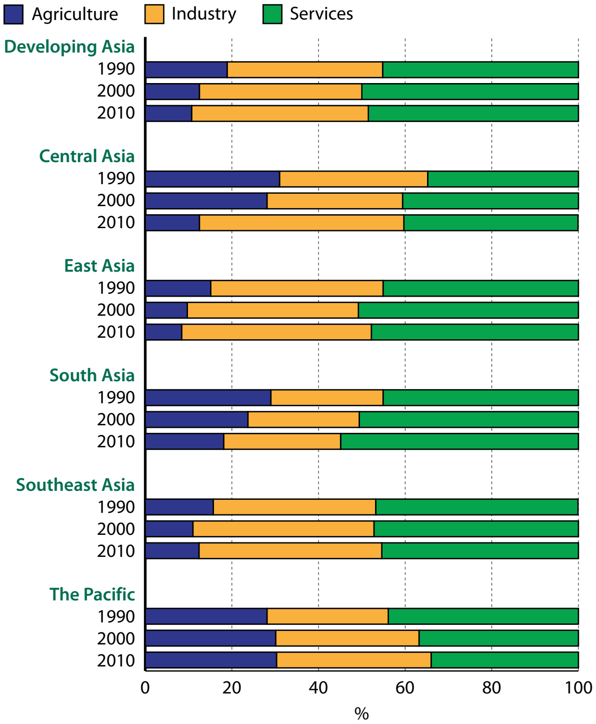
Noland, Park, and Estrada (forthcoming) surveyed national bureaus of statistics and labor and found a tendency for occupational employment and wage data to be available at finer levels of disaggregation than are data on sector output. This unevenness appears partly due to a lack of coordination among government ministries. For example, labor ministries take the lead on employment data, while the output data are often the domain of ministries of economy or industry. Greater coordination and consistency across reporting sources could improve the accuracy and usefulness of service data.

## Service sector trends

Data problems notwithstanding, the service sector has clearly been on the rise across the region, whether viewed in terms of output or employment. It occupied an average share of 45% of GDP in 1990 but now accounts for about half of GDP in developing Asia. These recent increases in services' contributions to GDP can be seen as evidence that Asian economies are beginning to catch up with more advanced economies, where services account for larger shares of output. There is, however, some variability in the share of services by subregion (Figure 2.2.1) and country (Figure 2.2.2). In most Asian countries, the services share of GDP remains well below that of advanced economies. In East Asia, the service sector comprises about 48% of GDP, this high share mainly reflecting the newly industrializing economies—Hong Kong, China; the Republic of Korea; and Taipei,China—but also the significant rise of services in the PRC by some 20 percentage points over the past 3 decades.

Services are less dominant in Southeast Asia than in other subregions, as only in the Philippines and Singapore do they occupy more than half of GDP. In contrast, a uniform pattern of rapidly growing service sectors can be seen across South Asia, most notably in India, Nepal, and Sri Lanka, where service sector shares have risen by 15–20 percentage points since 1980. Central Asia has also seen some expansion of services, as the subregion's transition from centrally planned to market economies since the 1990s saw the rise of new service activities and industries. Owing

**2.2.1 Sector shares of GDP by subregion**




*Note:* Countries covered are those with data around 1990, 2000, and 2010. Central Asia includes Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. East Asia covers the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. South Asia covers Bangladesh, Bhutan, India, Nepal, Pakistan, and Sri Lanka. Southeast Asia comprises Brunei Darussalam, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. The Pacific includes Fiji, Kiribati, Papua New Guinea, Solomon Islands, and Tonga.

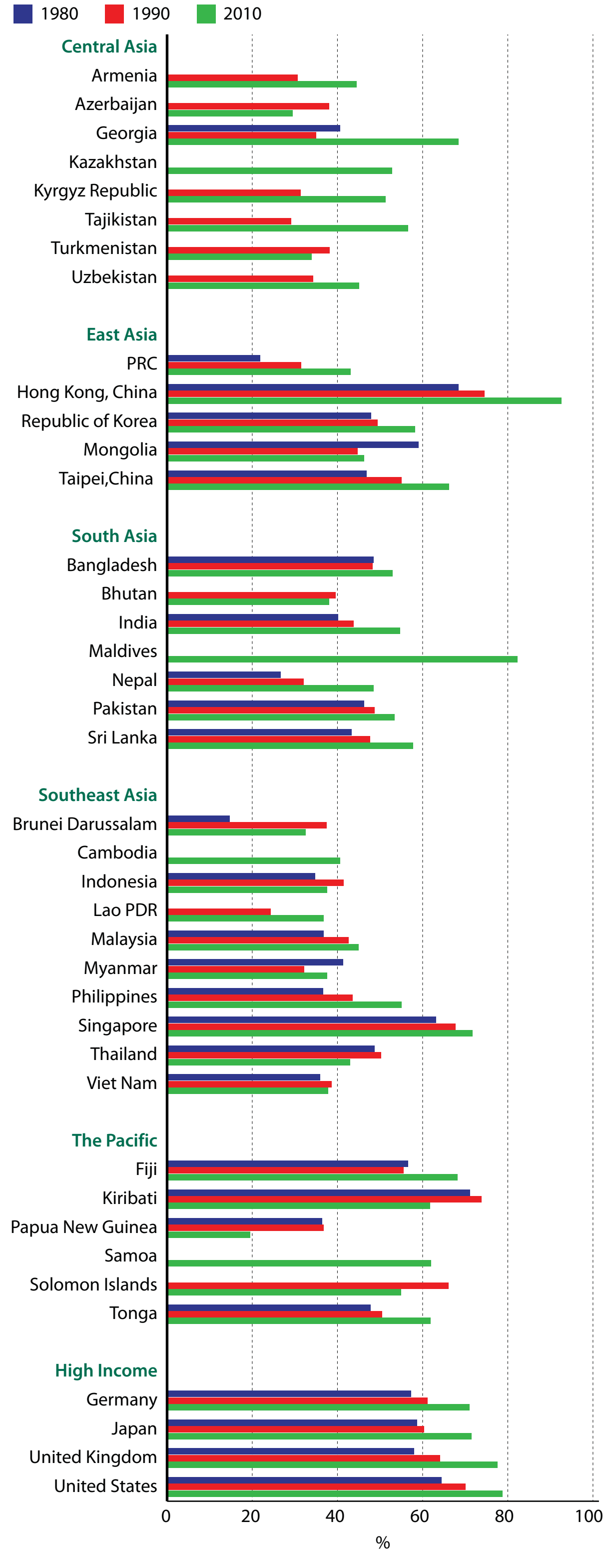
*Sources:* ADB estimates using data from ADB 2007; *Asian Development Outlook* database; CEIC Data Company; World Bank. World Development Indicators online database (databases accessed 16 April 2012).

to their geographic conditions and significant tourism, most Pacific countries have relatively large service sectors.

The service sector is a big employer in the region, and the share of the Asian labor force engaged in services has rapidly grown to about 34% of all workers, though it still lags that of the advanced economies. In 1990, services accounted for over half of employment in only two economies—Hong Kong, China and Singapore—but now this is the case for (in descending order) the Republic of Korea; the Maldives; Malaysia; Taipei,China; Kazakhstan; and the Philippines (Figure 2.2.3). Even countries where services make a smaller contribution to employment, such as Cambodia, the PRC, and Viet Nam, show a visible increase in contribution.

The services share of employment has risen by 10–20 percentage points in most countries during the past 2 decades. It remains generally low, despite some growth, in South Asia, where the share of agriculture remains high, suggesting that future structural change will see services absorb large numbers of agricultural workers. That the share of services in employment is large and growing across developing Asia

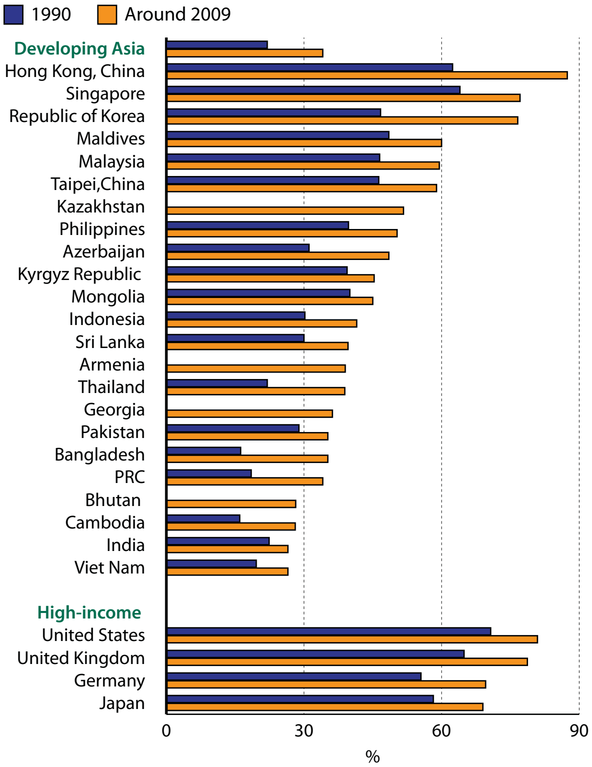
**2.2.2 Services sector share of GDP by country**




PDR = people's democratic republic, PRC = People's Republic of China.

*Sources:* ADB 2007; *Asian Development Outlook* database; CEIC Data Company; World Bank, World Development Indicators online database (accessed 16 April 2012); ADB estimates.

**2.2.3 Share of services in employment**

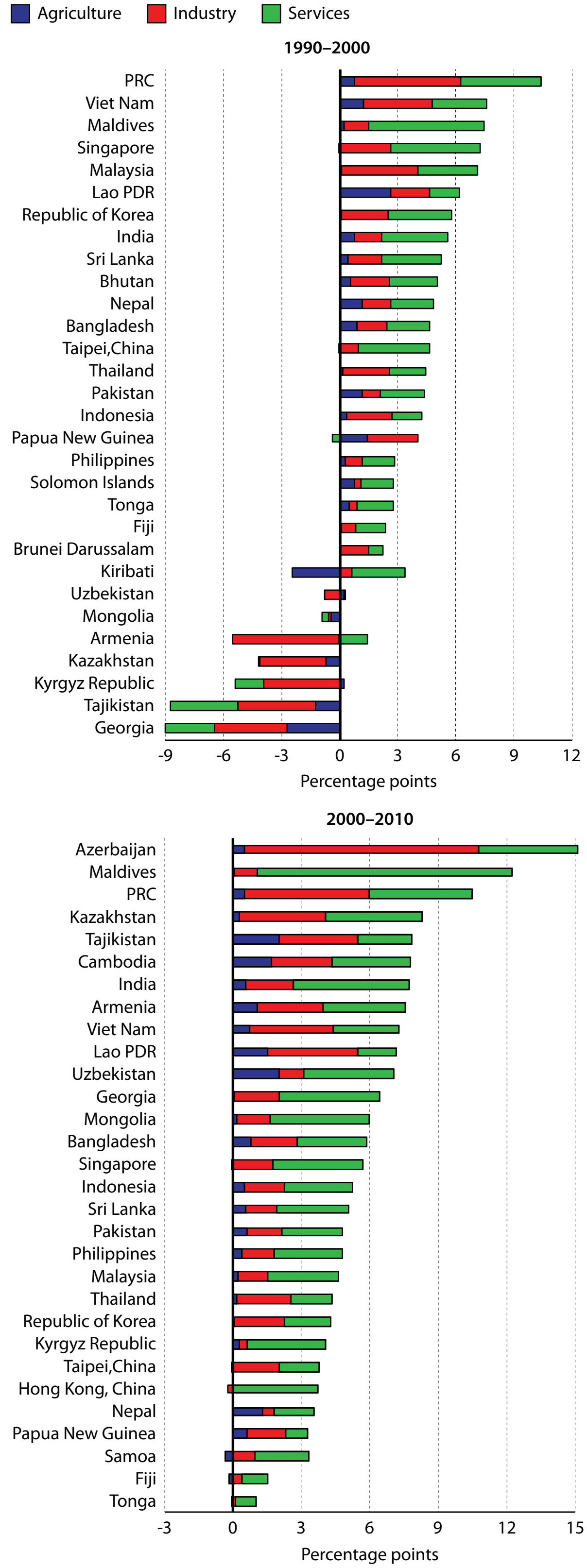



PRC = People's Republic of China.

*Note:* Latest data refer to 2006 for Cambodia and the Maldives; 2007 for Georgia; 2008 for Armenia, the Kyrgyz Republic, and Pakistan; and 2010 for Bangladesh and India. Initial data refer to 1991 for Bangladesh, Germany, and Singapore; 1993 for Cambodia and Mongolia; and 1994 for India.

*Sources:* CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database (both accessed 16 April 2012); ADB estimates.

**2.2.4 Sector contributions to annual GDP growth**




GDP = gross domestic product, PDR = people's democratic republic, PRC = People's Republic of China.

*Note:* The contribution of each sector in GDP growth is equal to the real growth of this sector during the period weighted by its share in GDP in the initial year.

*Sources:* ADB estimates using data from CEIC Data Company; World Bank. World Development Indicators online database (both accessed 16 April 2012).

suggests that the sector is making a major contribution to inclusive growth. The job-creating role of the service sector will become more important in Asia as automation makes manufacturing less labor-intensive.

The service sector is also a huge contributor to growth in recent times. During the 1990s, the sector was already a large contributor to growth, and this accelerated further with services accounting for more than half of GDP growth in most economies in the region in the 2000s (Figure 2.2.4).

Services' contribution to growth has been higher in South Asia than in other subregions; in India, the Maldives, Pakistan, and Sri Lanka, some 60% of the growth or more in 2000–2010 came from services. In Southeast Asia, particularly in Indonesia, Malaysia, the Philippines, and Singapore, services contributed over half of the growth in 2000–2010. But in East Asia—particularly in the PRC; the Republic of Korea; and Taipei,China—industry drives growth more than does the service sector. As noted in ADB (2007), the service sector has played an important role in countries where the pace of industrialization has been slow, notably South Asian countries and the Philippines. In South Asia, the modern service sector has played an especially prominent role in overall growth (Bosworth and Maertens 2010, Ghani 2010).

## Structural transformation and the rise of services

The data show the service sector is already playing an important role in developing Asia's growth story, but will these trends continue in the years ahead? A well-known pattern of economic development and growth has the share of services in output and employment rising as a country grows richer. This rise of services is actually the latter phase of evolution from agriculture to industry and on to postindustrial pursuits, which has been repeated so often and widely as to appear inevitable.

Typically, as industrialization takes hold, agriculture's employment share decreases while those of industry and services increase. Low labor productivity in agriculture in the earliest phase means that workers can shift from agriculture to manufacturing without substantially affecting agricultural output. These laborers migrate from rural areas to cities and find work in factories and shops, giving a boost to industrial employment and output as a share of total economic activity.

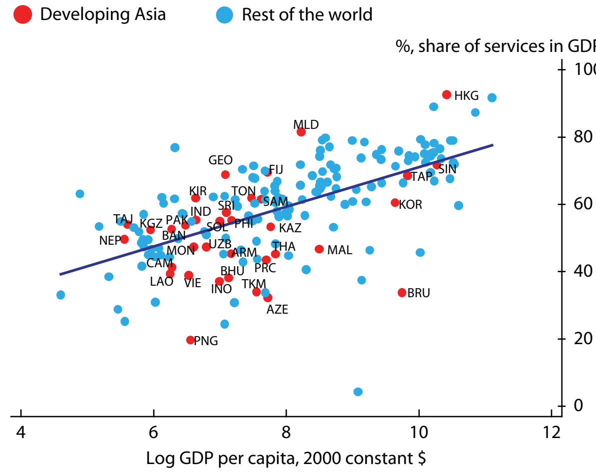
In the second phase, agriculture continues its decline as a share of employment and output, but industrial expansion also slows. Employment in services continues to rise, however, as the economy moves into its postindustrial phase. This continuing rise in the share of services is enabled by higher incomes across the economy and consequently higher demand for services.

Cross-country global data show that service sector share in GDP (Figure 2.2.5) and share of employment (Figure 2.2.6) both positively correlate with per capita income. That is, service sector output and employment tend to be more important to the economies of richer countries.

But the rise in services may not be linear. Eichengreen and Gupta (2009) argue that there are two distinct waves of service sector growth. The first wave sees service sector output rise at a decelerating rate until it levels out at about $1,800 per capita (2000 purchasing power parity dollars). Sector output then accelerates again in the second wave to reach about $4,000 per capita before leveling off again. The first wave is the rise of the traditional services such as lodging, meal preparation, housecleaning, beauty shops, and barbershops. The second wave is dominated by modern services like banking, insurance, computing, communication, and business services. This "two wave" pattern is robust using more recent data (Box 2.2.1).

These global trends apply broadly to developing Asia (Noland, Park, and Estrada, forthcoming). Richer Asian countries tend to have larger service sectors, as do better-educated countries in the region. In all Asian countries, the service sector expands as per capita income grows. Results from

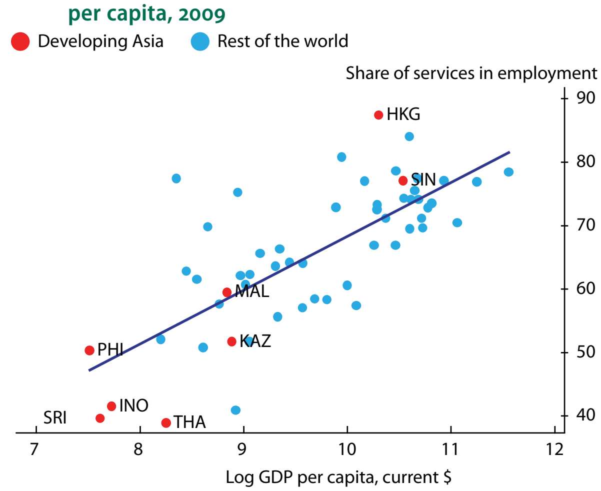
**2.2.5 Share of services in GDP against log GDP per capita, 2009**




ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, BRU = Brunei Darussalam, CAM = Cambodia, PRC = People's Republic of China, FIJ = Fiji, GEO = Georgia, HKG = Hong Kong, China, IND = India, INO = Indonesia, KAZ = Kazakhstan, KIR = Kiribati, KOR = Republic of Korea, KGZ = Kyrgyz Republic, LAO = Lao People's Democratic Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, NEP = Nepal, PAK = Pakistan, PNG = Papua New Guinea, PHI = Philippines, SAM = Samoa, SIN = Singapore, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, TAP = Taipei,China, THA = Thailand, TKM = Turkmenistan, TON = Tonga, UZB = Uzbekistan, VAN = Vanuatu, VIE = Viet Nam.

*Sources:* CEIC Data Company; World Bank. World Development Indicators online database (accessed 24 February 2012).

**2.2.6 Share of employment in services against log GDP per capita, 2009**




HKG = Hong Kong, China, INO = Indonesia, KAZ = Kazakhstan, MAL = Malaysia, PHI = Philippines, SIN = Singapore, SRI = Sri Lanka, THA = Thailand.

*Source:* World Bank. World Development Indicators online database (accessed 24 February 2012).

### 2.2.1 Two waves of growth in services

According to Eichengreen and Gupta (2009), the two waves of the service sector growth can be characterized mathematically by a quartic relationship between income and the output share of services, defined as

$$\frac{S_{it}}{GDP_{it}} = \text{constant} + \sum_{T=1}^{2} \theta_T D_T + \alpha_1 Y_{it} + \alpha_2 Y_{it}^2 + \alpha_3 Y_{it}^3 + \alpha_4 Y_{it}^4 + \epsilon_{it}$$

where $S_{it}$, $GDP_{it}$, and $Y_{it}$ are the service sector value added, GDP, and log per capita GDP, respectively, for country *i* at time *t*. $D_T$ is a period dummy, which is included to allow different intercepts for different time periods.

But how robust is this relationship? Replicating the Eichengreen and Gupta (2009) estimations using a larger sample size (157 countries compared with 80 countries) and more recent data (1960–2010 compared with 1950–2005), the basic "two wave" pattern emerges again (Box table). All GDP per capita terms from the first to fourth order are highly significant for both GDP and share of employment, confirming the quartic relationship between income and service sector development.

**Quartic relationship between log GDP per capita and service sector GDP and employment shares**

| Variable | Services Share of GDP | Services Share of Employment |
|---|---|---|
| Log income per capita | 414.668*** | 1,013.291*** |
| | [5.472] | [4.173] |
| Log income per capita, squared | -72.132*** | -177.987*** |
| | [-5.050] | [-4.210] |
| Log income per capita, cubed | 5.453*** | 13.694*** |
| | [4.623] | [4.220] |
| Log income per capita, quartic | -0.149*** | -0.386*** |
| | [-4.132] | [-4.169] |
| Dummy for 1970–1989 | 1.069*** | |
| | [2.927] | |
| Dummy for 1990–2010 | 4.929*** | 4.345*** |
| | [12.604] | [13.117] |
| Observations | 5,402 | 2,222 |
| Number of countries | 157 | 139 |
| R-squared | 0.249 | 0.439 |

*Note:* The t-statistics are in square brackets. *** indicates that the coefficient is significant at 1%. The estimation allows the intercepts to differ in the periods 1970–1989 and 1990–2010 for column 1, and in 1990–2010 for column 2. Country fixed effects are included in both estimates.

*Source:* Park and Shin, forthcoming-a.

cross-country analysis hold when looking at individual developing Asian economies over time. In 12 major Asian economies, the evolution of the share of agriculture, industry, and services in GDP and employment largely mirrors international historical experience (Park and Shin, forthcoming-a). Based on these historical trends, the already-large service sector will likely expand significantly as Asian economies continue to grow.

Within the region-wide trend of service sector expansion exists a great deal of heterogeneity among Asian countries regarding the relative importance of services, as emphasized by Ghani (2010). To some extent, such heterogeneity reflects the wide range of income and development levels in Asia (as explained above, the share of services in GDP and employment tends to rise with per capita income). However, income and development levels can explain only part of this heterogeneity. For example, the share of services in India's GDP was 54.7% in 2010, while the corresponding figure for the PRC was only 43.1% despite the PRC's having substantially higher per capita income. Further, there is also a great deal of heterogeneity with respect to how quickly services' shares of GDP and employment grow. For example, in 1980 the share of services in employment was similar in Indonesia and the Philippines, but by 2010 it was notably higher in the Philippines. Such differences notwithstanding, the service sector is expanding in both absolute and relative terms throughout the region.

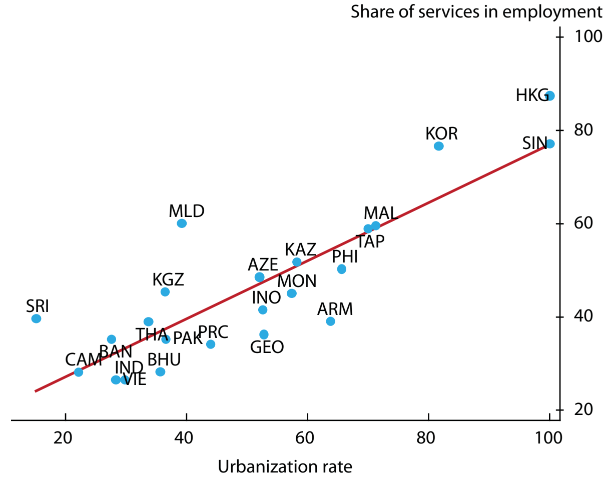
Urbanization is a powerful driver of structural change behind the inevitable expansion of services in Asia. Asia added more than 1 billion people to its cities from 1980 to 2010 and will add another 1 billion by

2040 (ADB 2012b). Rising urbanization and the resulting higher population density spur demand for an array of services. With its diverse offerings, the service industry thrives on the large range of business activities in urban areas. The location advantage of urban areas offers proximity to firms and suppliers alike. For services such as retailing, education, health care, and other community and personal services, face-to-face interaction with clients is important, giving urban locations a further advantage (Kolko 2010).

Large concentrations of people and firms in urban centers are ideal incubators for services. The evidence in Asia shows that service sectors in more urbanized economies make up a greater share of employment (Figure 2.2.7). The rapid urbanization of Asia is therefore another reason to expect that the service sector will become more important as a source of future growth and jobs.

Overall, Asia's service sector has been large and growing, and trends point to services becoming an even bigger force in Asia's future growth. An important indicator is that the region is following the well-established international historical pattern of structural transformation in which the share of services in output and employment tends to rise with income level. The rapid urbanization and expansion of the middle class and its purchasing power should also boost the share of services in the economy. In addition, some countries in East and Southeast Asia are approaching the postindustrial phase of growth and development where the share of manufacturing in output and employment peaks and eventually declines, with a corresponding increase in the share of services.

**2.2.7 Urbanization rate and share of services in employment, developing Asia, 2009 (%)**




ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, CAM = Cambodia, PRC = People's Republic of China, GEO = Georgia, HKG = Hong Kong, China, IND = India, INO = Indonesia, KAZ = Kazakhstan, KOR = Republic of Korea, KGZ = Kyrgyz Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, PAK = Pakistan, PHI = Philippines, SIN = Singapore, SRI = Sri Lanka, TAP = Taipei,China, THA = Thailand, VIE = Viet Nam.

*Sources:* CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database; World Bank. World Development Indicators online database (all accessed 16 April 2012).

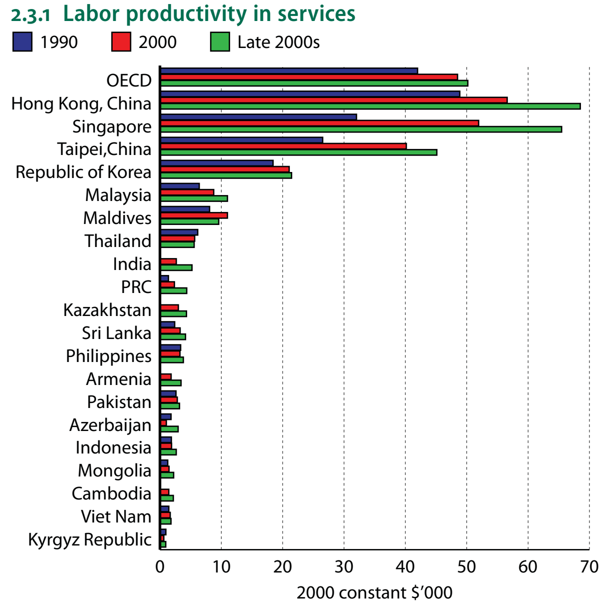
# Trapped in traditional services

Developing Asia's service sector must confront the related challenges of lifting its low productivity and moving to activities with higher value added. Although the sector has rapidly become more important across economies in the region, its low productivity keeps it from contributing even more to regional growth and development.

## Low labor productivity in services

Developing Asia's labor productivity in services, defined as service output per worker, lags that of OECD countries by a wide margin. For many economies in the region, this important measure of service sector performance is less than 10% of the OECD average (Figure 2.3.1). While Singapore and Hong Kong, China have caught up with and surpassed the OECD average, and Taipei,China is approaching it, the rest of the region languishes well below. Perhaps most strikingly, the Republic of Korea, a highly successful industrializer, has failed to achieve services labor productivity even half that of the OECD (Box 2.3.1). Other countries lag even further behind. Among the larger economies, only Malaysia exceeds 20%, and the others hover at 10% or less. While there is considerable diversity, labor productivity in developing Asia as a group clearly has a lot of catching up to do with the advanced economies.

**2.3.1 Labor productivity in services**




OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

*Sources:* ADB estimates using data from CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database; World Bank. World Development Indicators online database (all accessed 16 April 2012).

The literature, as summarized in Eichengreen, Perkins, and Shin (2012), contains a number of arguments why it is difficult to achieve labor productivity growth in the service sector: First, services are labor intensive, not capital intensive, making it difficult to benefit from the innovation embodied in physical capital. Second, service sector firms are typically too small to devote significant resources to research and development or to risk new production techniques. Third, international competition is generally weak because most services are not tradable. Finally, a large portion of employment in services masks the underemployment of those unable to find better jobs. It has long been argued for these reasons that, as economies become more service oriented, growth slows. As manufacturing automates and resources are reallocated to services, achieving labor productivity growth becomes more challenging.

In Asia, an important reason for low productivity in the service sector is the dominant role of traditional services. Modern services—such as information and communication, finance, and professional business services—generally account for a smaller share of the sector in Asia than they do in advanced economies (Table 2.3.1). In 2010, they comprised only 8%–12% of the economy in the PRC; India; Indonesia; Taipei,China; and Thailand, while in advanced economies such as France, Japan, and the United States (US) they were twice as large, accounting for 17%–25%. Only

### 2.3.1 Stark lessons from the Republic of Korea on improving labor productivity in services

The Republic of Korea is one of the few developing countries to successfully dodge the middle-income trap and join the high-income club. Its remarkable economic success has been largely built on export-oriented industrialization, which gave rise to a world-class manufacturing sector that exports a wide range of high-tech goods to global markets. Many large Korean manufacturers such as Samsung, LG, and Hyundai have become leaders in their fields, marketing globally recognized brands.

But services lag far behind the economy's dynamic manufacturing sector. In 2010, industry's labor productivity was 118% of the OECD figure, but labor productivity in services languished at 43%. Of particular concern is the weak performance of modern areas such as business services. This poses a big problem for future growth, as the country is in the midst of a structural transition into a more service-oriented postindustrial phase.

The service sector share of employment has surged much more sharply than its share of output. From 1980 and 2008, the sector's share of employment soared 31 percentage points, from 37% to 68%, but its share of GDP rose only 14 percentage points, from 47% to 61%. As a result of the Republic of Korea's exceptionally rapid pace of deindustrialization, the service sector has become a provider of many marginal, low-wage jobs for workers who cannot find good jobs in manufacturing. This drags down the labor productivity of the entire service sector.

Some policy options to address sector weaknesses are uncontroversial—for example, setting up well-designed training programs to help workers that have lost manufacturing jobs gain the skills needed for modern services. Also, ramping up investment in research and development and in ICT infrastructure would foster the development of modern services.

Yet some factors holding the sector back—such as government regulations and restrictions, barriers to foreign trade in services, and impediments to foreign direct investment—can be more sensitive. In particular, serious political considerations complicate regulatory reform since service sector regulations protect small- and medium-sized enterprises and their large workforce. Further, regulatory barriers tend to be high for business and professional services such as finance, law, education, and health care. This holds down service sector labor productivity even as the share of modern services in GDP approaches OECD levels.

The Republic of Korea thus faces big obstacles to developing its modern service sector. It also has some valuable assets, notably its highly skilled, well-educated workforce, but the transition will still require a lot of hard work. The Korean experience shows that success in manufacturing does not necessarily translate into success in services. The stark lesson for developing Asia is that even a highly successful economy can find it challenging to build up a dynamic, highly productive service sector. The challenges should not be underestimated.

*Source:* Park and Shin, forthcoming-b.

three economies in developing Asia—Singapore, the Republic of Korea and Hong Kong, China—have modern service industries comparable in size with those of the OECD.

Advanced economies have shifted toward a larger modern service subsector, which tends to enjoy higher productivity and offer better wages than traditional services. Eichengreen and Gupta (2009) find a positive correlation between the share of services in output and income per capita, but this relationship does not hold for traditional services. It holds only for services that combine both traditional and modern features that are consumed mainly by households such as education and health care and for modern services provided to households and businesses alike, such as finance and ICT. Furthermore, modern services enjoy the highest productivity growth among service industries, and their share of output tends to rise rapidly as high income is achieved. These findings further support the notion that the key to improving Asia's service sector productivity overall lies in shifting from traditional service industries, which typically add little value, to modern service industries with high value addition.

**2.3.1 Share of services in value added, 1990 and 2010 (%)**

| Economy | Total services | | Trade | | Hotels and restaurants | | Transport and storage | | Real estate and dwellings | | Public administration, community, personal, and other services | | Communication, finance, and business services | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 2010 | 1990 | 2010 | 1990 | 2010 | 1990 | 2010 | 1990 | 2010 | 1990 | 2010 | 1990 | 2010 |
| **Developing Asia** | | | | | | | | | | | | | | |
| PRC | 31.5 | 43.4 | 6.8 | 8.5 | 1.6 | 2.1 | 3.8 | 4.9 | 2.1 | 7.3 | 7.9 | 11.2 | 9.4 | 9.4 |
| Hong Kong, China | 87.2 | 92.9 | 21.8 | 24.0 | 3.0 | 3.3 | 7.7 | 8.1 | 5.1 | 5.2 | 30.3 | 27.9 | 19.4 | 24.4 |
| India | 46.1 | 54.7 | 11.8 | 15.1 | 1.0 | 1.4 | 6.4 | 6.4 | 5.0 | 6.1 | 13.3 | 14.5 | 8.8 | 11.2 |
| Indonesia | 42.4 | 37.7 | 13.5 | 10.9 | 3.2 | 2.8 | 6.1 | 3.4 | 2.9 | 2.6 | 10.1 | 10.2 | 6.5 | 7.8 |
| Republic of Korea | 51.5 | 58.5 | 11.8 | 8.6 | 2.4 | 2.3 | 4.7 | 4.2 | 6.5 | 7.2 | 14.8 | 20.1 | 11.2 | 16.1 |
| Malaysia | 44.9 | 46.0 | 10.9 | 11.9 | 2.2 | 2.3 | 3.8 | 3.3 | 5.4 | 4.1 | 8.3 | 9.7 | 14.4 | 14.6 |
| Philippines | 50.8 | 55.1 | 14.7 | 17.4 | … | … | 3.2 | 3.9 | 5.8 | 6.5 | 15.7 | 13.4 | 11.5 | 13.9 |
| Singapore | 67.8 | 71.7 | 13.1 | 16.5 | 3.5 | 2.2 | 11.4 | 8.6 | 3.6 | 4.1 | 9.6 | 10.7 | 26.6 | 29.6 |
| Taipei,China | 55.0 | 66.2 | 13.4 | 18.8 | 1.7 | 2.0 | 4.6 | 3.3 | 6.4 | 8.9 | 17.5 | 20.8 | 11.4 | 12.4 |
| Thailand | 50.9 | 43.0 | 17.8 | 13.1 | 5.4 | 4.7 | 4.5 | 4.1 | 2.2 | 1.4 | 9.7 | 12.0 | 11.3 | 7.7 |
| **OECD** | | | | | | | | | | | | | | |
| France | 69.2 | 79.7 | 11.8 | 10.6 | 2.3 | 2.6 | 4.6 | 5.0 | 9.8 | 13.4 | 21.7 | 26.1 | 18.9 | 22.0 |
| Japan | 59.8 | 72.6 | 12.8 | 12.3 | … | … | 4.9 | 4.5 | 9.4 | 13.0 | 19.1 | 25.7 | 13.6 | 17.2 |
| United States | 73.4 | 80.2 | 12.9 | 11.6 | 3.4 | 3.8 | 3.0 | 2.8 | 12.1 | 12.2 | 23.0 | 24.8 | 18.9 | 25.1 |
| **Latin America** | | | | | | | | | | | | | | |
| Chile | 49.8 | 53.9 | 14.7 | 9.4 | … | … | 5.0 | 5.9 | 4.9 | 4.4 | 12.7 | 16.2 | 12.5 | 17.9 |
| Mexico | 61.1 | 64.2 | 15.7 | 11.5 | 2.2 | 3.3 | 6.9 | 5.7 | 8.8 | 10.0 | 14.9 | 20.4 | 12.4 | 13.1 |

… = data not available or combined with other services, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

*Note:* Initial data for Malaysia and Hong Kong, China are from 2000; for Indonesia and Mexico from 1993; and for the Philippines from 1998. Latest data for the PRC and Japan are from 2009.

*Sources:* ADB estimates using data from CEIC Data Company (accessed 25 April 2012).

The key question then is why developing Asia's modern service sector is relatively underdeveloped. One factor is the education prerequisites for employment in business-related services such as ICT, finance, professional services, and management support. Stiff education and skills requirements are hurdles to entry into such services, but the industry compensates with high average earnings. Table 2.3.2 shows the high share of workers in business-related services in the US with college and advanced degrees—44%, compared with 23% in manufacturing—and earnings premiums of 20% over manufacturing and more than 65% over traditional service industries.

Figure 2.3.2 shows the share of total employment provided by business services in selected economies in developing Asia. (It excludes large parts of the PRC because data are available only for urban areas, which account for 15% of the workforce,

**2.3.2 Education and earnings in selected sectors in the United States, 2007**

| Sector | Workers with a college degree (%) | Workers with an advanced degree (%) | Average earnings ($) |
|---|---|---|---|
| Manufacturing | 23 | 7 | 49,081 |
| Business services | 44 | 14 | 59,096 |
| Personal services | 36 | 16 | 35,261 |
| Wholesale & retail | 19 | 3 | 35,819 |

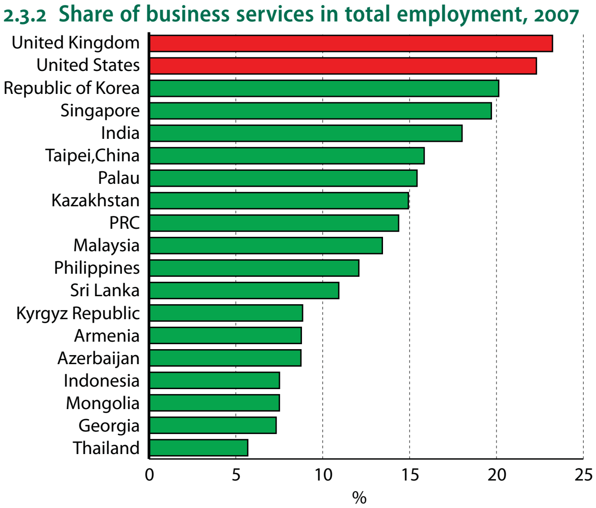
*Source:* Jensen, forthcoming.

and of India, as detailed industry data are available only for the formal sector.) The business service industries of most countries in developing Asia—excepting Singapore and the Republic of Korea—are small and undeveloped compared with those of the US or the United Kingdom. It is notable that the PRC has a relatively small business service industry even in urban areas. India's formal sector has a respectably large business service industry, but it is likely unrepresentative of the country.

One reason business service industries in developing Asia tend to be smaller than in the US or the United Kingdom is their relatively high skills requirement. The prospects for business services growth in developing Asia depend, therefore, on raising the region's skills endowment through higher education. Figure 2.3.3 shows the average educational attainment of two age cohorts in select countries in 2010. The countries are plotted by average number of years of schooling and per capita GDP, with the size of the bubble indicating the relative size of the workforce. Ample stocks of human capital, including well-educated older workers, have contributed to the development of business services in advanced economies, while lower educational attainment, especially among older workers, has held it back in developing Asia.

The figure reveals a dramatic improvement in educational attainment in developing Asia in little more than a generation. As Asian attainment converges with that of advanced countries, the size and productivity of the business service industry will likely converge as well. However, as average educational attainment cannot rise much in the short term, this constraint on business services will continue to hinder developing Asia's growth prospects for years to come.

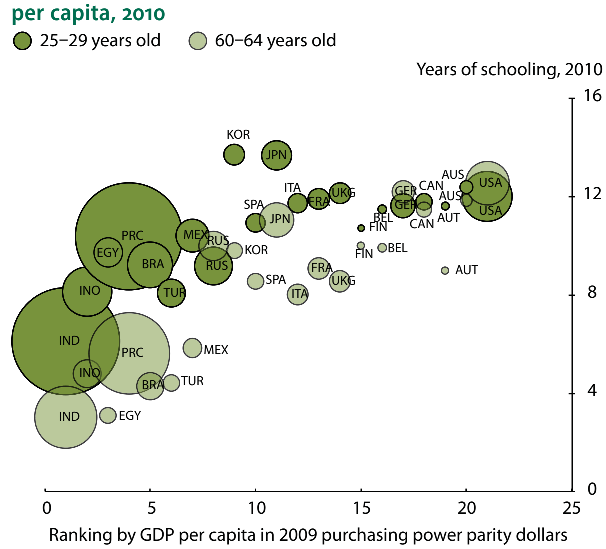
**2.3.2 Share of business services in total employment, 2007**




PRC = People's Republic of China.

*Source:* Jensen, forthcoming

**2.3.3 Two cohorts' average years of schooling against GDP per capita, 2010**

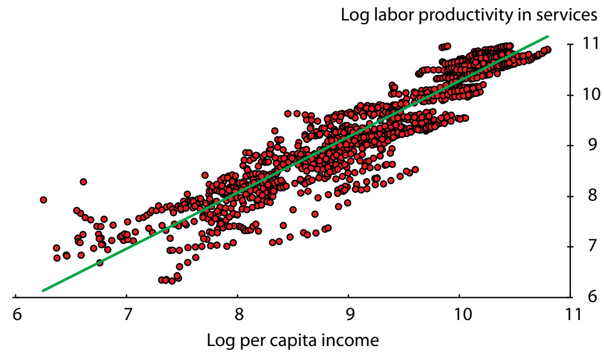



AUS = Australia (20), AUT = Austria (19), BEL = Belgium (16), CAN = Canada (18), EGY = Egypt (3), BRA = Brazil (5), FIN = Finland (15), FRA = France (13), GER = Germany (17), IND = India (1), INO = Indonesia (2), ITA = Italy (12), JPN = Japan (11), KOR = Republic of Korea (9), MEX = Mexico (7), PRC = People's Republic of China (4), RUS = Russian Federation (8), SPA = Spain (10), TUR = Turkey (6), UKG = United Kingdom (14), USA = United States of America (21), GDP = gross domestic product.

*Note:* Bubble size indicates the size of the workforce.

*Source:* Jensen, forthcoming.

2.3.4 Labor productivity in services against per capita income




*Note:* Both labor productivity in services and per capita income refer to logarithm values of 2000 constant dollars.

*Source:* Park and Shin, forthcoming-a.

Another reason that labor productivity in the service sectors of most Asian countries remains far below the OECD figure is developing Asia's relatively low income per capita. Figure 2.3.4 shows the relationship between the log labor productivity of services and the log per capita income. The trend line shows a clear positive relationship between the two variables, as services labor productivity rises with per capita income.

Labor productivity is determined by an array of factors that go beyond this simple correlation with per capita income. Drawing on the literature studying empirical economic growth, cross-country regressions of labor productivity yield insights into the drivers of labor productivity (Box 2.3.2).

The cross-country empirical results suggest a number of policy implications for tackling both internal and external distortions to foster productivity growth. For example, as services labor productivity grows more readily in poorer countries, policy reform to unshackle the service sector is especially important in those countries. This makes reform all the more urgent for developing Asian countries since they generally still have lower incomes. Similarly, that services trade boosts productivity suggests that lowering barriers to trade in services can contribute to upgrading the region's service sector.

An important issue going forward is how to improve labor productivity in developing Asia's service sector. While it is widely argued that productivity growth is inherently difficult to achieve in services, some countries have in fact been able to achieve substantial gains. Table 2.3.3 shows labor productivity growth rates in agriculture, industry, and services, along with the aggregate growth rate, in 12 major Asian economies for two time periods. During 2000–2010, labor productivity growth in the PRC's service sector improved more quickly than during 1980–2000 and even surpassed productivity improvement in industry. In India, services similarly outperformed industry by more than double during 2000–2010. But other Asian countries have not performed as well. Services labor productivity growth fell markedly in the Republic of Korea and Taipei,China, which partly reflects their maturing as high-income economies. For the regional group as a whole, services labor productivity growth has improved. Although labor productivity continued to improve more quickly in industry than in services during 2000–2010, services narrowed the gap in improvement rates.

In sum, while labor productivity in Asia's service sector remains much lower than in the OECD, significant gains are possible, especially for low- and middle-income countries. This gives cause for optimism that, with the right institutional and policy environment, Asian countries can start catching up more quickly.

### 2.3.2 Determinants of labor productivity growth in services

The overarching problem confronting developing Asia's service sector is the large gap in labor productivity with the advanced economies. Going forward, how fast the region can close this gap will depend on the growth rate of labor productivity in its service sector. Therefore, it is worthwhile to empirically examine the determinants of labor productivity growth in services using econometric regressions.

A number of empirical studies investigate the determinants of growth, notably Barro and Sala-i-Martin (2003) and other studies cited therein. This approach also lends itself to understanding the determinants of labor productivity in services. Following Eichengreen and Gupta (2009), Park and Shin (forthcoming-a) estimate a parsimonious model of the growth rate of labor productivity in services, controlling for a set of initial levels of country characteristics that may affect the productivity of the economy: per capita income, total international trade, trade in services, degree of urbanization, institutionalized democracy, proximity to the US or the United Kingdom, land outside the tropics, old-age dependency, and latitude of the center of the country. The dependent variable is the growth rate of 5-year average labor productivity in the service sector for the seven 5-year increments between 1975 and 2010.

The box table reports the estimation results. The coefficient of the initial per capita GDP is negative and highly significant. This means that the lower the initial per capita GDP, the higher the subsequent growth rate of labor productivity in the service sector. This result is consistent with other studies in the empirical growth literature, in which the explanatory variable is typically the growth rate of output instead of labor productivity. Further, it bodes well for services labor productivity growth in developing Asian countries, where incomes are still relatively low.

The coefficient of service trade as a percentage of GDP is positive and significant at 1%, suggesting that trade in services contributes to improved labor productivity in the sector. This is plausible as the export of services exposes domestic service providers to stiff competition from enterprising foreigners and forces them to become more efficient (Francois 1990). Likewise, exporting services requires firms to learn to compete in foreign services markets. The negative coefficient of total trade as a percentage of GDP is somewhat puzzling.

**Determinants of labor productivity in the service sector (dependent variable: average 5-year growth rate of labor productivity)**

| Item | Coefficient |
|---|---|
| Log per capita income | -0.024*** |
| | [-5.174] |
| Log trade (% of GDP) | -0.015* |
| | [-1.861] |
| Log trade in services (% of GDP) | 0.019*** |
| | [2.898] |
| Urban population (% of total) | 0.000** |
| | [2.161] |
| Institutionalized democracy score | -0.001 |
| | [-0.831] |
| Log minimum distance from the United Kingdom or United States | 0.005 |
| | [1.160] |
| Land outside the tropics (% of total) | 0.01 |
| | [1.307] |
| Age dependency ratio (% of working-age population) | -0.001*** |
| | [-4.230] |
| Latitude of country centroid | 0.000 |
| | [1.537] |
| Observations | 266 |
| Number of countries | 73 |
| R-squared | 0.083 |

*Notes:* The t-statistics are in parentheses. The symbol *** indicates significance at 1%, ** at 5%, and * at 10%. The results are based on panel estimation with random effects. The institutionalized democracy score is collected from the Polity IV data series; distance from Centre d'Etudes Prospectives et d'Informations Internationales; area outside the tropics and latitude from Gallup, Sachs, and Mellinger (1999); and governance indicators from the World Bank. Aggregate governance indicators and all other data are from World Development Indicators. According to Eichengreen and Gupta (2009), proximity to New York or London is beneficial for the finance industry and hence its labor productivity.

*Source:* Park and Shin, forthcoming-a.

**2.3.3 Sector labor productivity growth rates in Asia-12, 1980–2010 (%)**

| | Period 1 (1980–2000) | | | | Period 2 (2000–2010) | | | |
|---|---|---|---|---|---|---|---|---|
| Country | Agriculture | Industry | Services | Aggregate | Agriculture | Industry | Services | Aggregate |
| PRC | 4.52 | 7.88 | 5.30 | 7.46 | 6.10 | 7.93 | 8.07 | 9.54 |
| Hong Kong, China | ... | ... | ... | ... | -0.24 | 1.67 | 1.88 | 2.34 |
| India | ... | ... | ... | 4.46 | 3.34 | 3.11 | 6.96 | 6.36 |
| Indonesia | -1.66 | 0.98 | -4.98 | -1.43 | 3.25 | 1.40 | 3.83 | 3.34 |
| Republic of Korea | 6.14 | 6.38 | 2.03 | 4.78 | 5.59 | 5.74 | 1.57 | 3.32 |
| Malaysia | 0.50 | 1.79 | 0.91 | 1.68 | 4.26 | 2.05 | 2.10 | 2.08 |
| Pakistan | 1.52 | 5.43 | 1.64 | 2.82 | -1.81 | 3.54 | 4.39 | 2.24 |
| Philippines | 0.71 | -1.35 | -1.21 | -0.29 | 1.13 | 1.89 | 1.84 | 1.75 |
| Singapore | -7.36 | 4.17 | 4.54 | 4.40 | -8.58 | 5.29 | 0.78 | 1.88 |
| Taipei,China | 3.27 | 3.70 | 4.33 | 4.78 | 3.00 | 5.16 | 1.17 | 2.75 |
| Thailand | 2.01 | 3.29 | 1.05 | 3.88 | 2.94 | 2.71 | 0.08 | 2.44 |
| Viet Nam[a] | ... | ... | ... | 4.46 | 3.00 | 0.73 | 3.10 | 4.38 |
| Average | 1.07 | 3.59 | 1.51 | 3.36 | 1.83 | 3.44 | 2.98 | 3.54 |

... = data not available, PRC = People's Republic of China.

[a] Period 2 uses 2005–2010.

*Sources:* Park and Shin, forthcoming-a; ADB estimates.

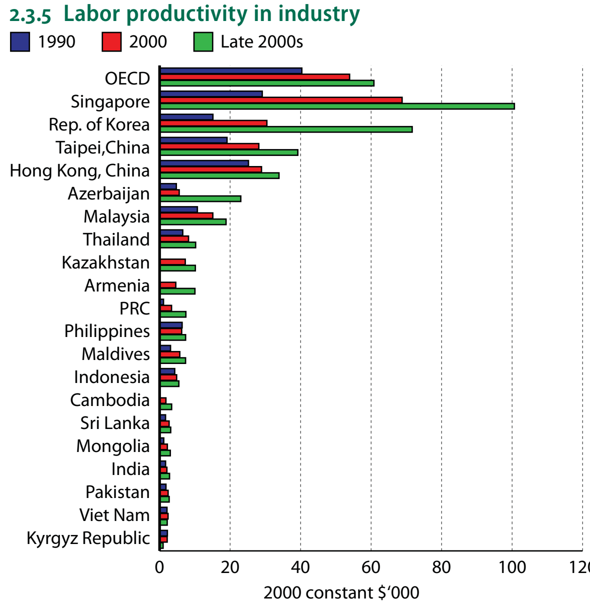
## Low productivity in industry too

It should be noted that low labor productivity also plagues the industry sector in developing Asia. As is the case for services, labor productivity in Asia lags far behind the OECD level (Figure 2.3.5). In some countries, the productivity gap with OECD is wider for services than for industry, but in others the reverse is true, revealing no clear pattern (Figure 2.3.6). Most Asian economies face the daunting challenge of closing the productivity gap in both industry and services. Addressing this challenge will require tackling a wide range of structural and policy impediments that hamper productivity economywide. In addition, synergies between industry and services have implications for policies that can address productivity concerns simultaneously in both sectors.

## Strategy for more productive services

The wide gap in labor productivity between the service sectors of the OECD and developing Asia suggests that much remains to be done to upgrade the region's service sector. From a positive perspective, there appears to be plenty of room for productivity growth in services and thus for services to contribute more to Asia's future economic growth. The large and growing share of services in Asian economies adds urgency to the task of improving their productivity.

**2.3.5 Labor productivity in industry**

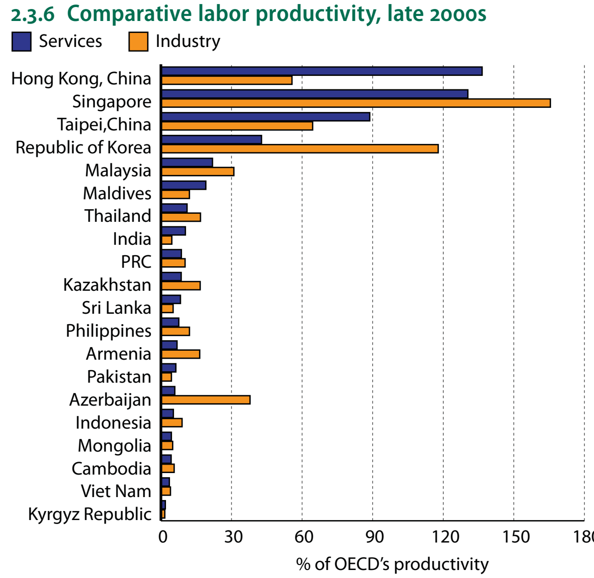



OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

*Sources:* ADB estimates using data from CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database; World Bank. World Development Indicators online database (all accessed 16 April 2012).

According to Eichengreen and Gupta (2009), the service sector develops in two waves, the first wave occurring while incomes are still low and featuring traditional services, and the second wave coming after incomes have risen and shifting the focus to modern services. One obvious strategy for improving productivity in services is to catch the second wave of service sector development, carrying modern services with high value added. This strategy makes sense in light of the findings of Eichengren and Gupta (2009) that modern services experience the highest productivity growth. Modern service industries require better-educated, highly skilled workers and create high-quality, high-wage jobs. However, while a major shift toward a larger service sector is taking place in most economies in developing Asia, not much has changed in terms of the composition of services. Gauging from the pace at which the mix of service activities has evolved, the road to a more sophisticated and modern service sector is likely to be long. Asian policy makers can either let the process get moving in its own good time, or they can take bold steps to hasten it. The time to act is now.

**2.3.6 Comparative labor productivity, late 2000s**




OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

*Sources:* ADB estimates using data from CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database; World Bank. World Development Indicators online database (all accessed 16 April 2012).

# Services fueling Asia's future growth

Service sector development is important for Asia's future growth because a vibrant service sector lifts productivity across the economy through cross-sector synergies, contributes to inclusive growth and poverty reduction primarily by boosting employment, and redirects the economy toward more balanced growth.

## Synergy between sectors

The service sector plays an important role in raising the productivity of manufacturing and of the economy as a whole. Better transportation services, for example, improve the ability of factories and farms to deliver their products to national and international markets. Productivity spillovers flow from business services in particular, which provide to industrial firms key intermediate inputs such as financing, legal services, human resource recruitment, marketing, and ICT. Rather than handling such tasks internally, manufacturing firms may find it more cost-effective to outsource them to specialized service providers, freeing themselves up to concentrate on their core business.

In addition, beneficial spillovers can occur across different service industries. Service innovations have given rise to whole new industries and activities. ICT services created e-commerce as an entirely new arena for retailing, for example, and they stimulate tourism by making it easier to buy air tickets and find information about distant destinations.

Spillover effects flow both ways, as developments in manufacturing can benefit the service sector. ICT hardware improvements, for example, expand the range of ICT applications for services such as health care by allowing remote access to doctors, and for education by facilitating online courses and programs. Such improvements also open up e-commerce opportunities for wholesalers and retailers without the need for significant mortar-and-brick investments. As these examples show, better ICT hardware can upgrade both traditional and modern services, increasing the value added.

Correlation between labor productivity in industry and services is a rough measure of their synergy. Figure 2.4.1 reveals a high 0.85 correlation in productivity between the two sectors. This likely reflects primarily factors that affect labor productivity in both industry and services, such as human capital and physical infrastructure, but such strong correlation suggests that synergy also plays a role.

Studies that have examined the links between the service sector and other sectors and their beneficial effects broadly underscore the critical role the service sector plays in lifting productivity across the economy. A survey of such studies

**2.4.1 Correlation of productivity in services and industry, late 2000s (2000 constant $'000)**


*Note:* Data from 2005 to 2010.

*Sources:* ADB estimates using data from CEIC Data Company; International Labour Organization. Key Indicators of the Labor Market online database; World Bank. World Development Indicators online database (all accessed 16 April 2012).

by Francois and Hoekman (2010) found services raising aggregate productivity and explaining national differences in aggregate productivity and growth rates. A study by Pilat and Wölfl (2005) shows how services contribute to production by generating not only finished outputs for end users but also intermediate inputs to the production of other sectors. The growing interdependence of services and manufacturing is evident in the service sector's rising value addition to manufactured goods. Box 2.4.1 discusses evidence of the impact of mobile telephony on economic growth.

These synergies between industry and services mean a country's development strategy must encompass both sectors, though their relative importance may evolve over time. In most countries in Asia and elsewhere, the industry and service sectors each accounts for a large share of output and employment, so maximizing development likely depends on the two sectors moving forward in tandem. The real challenge for Asian countries is thus to address the impediments that stand in the way of efficiency in both manufacturing and services. In India, for example, improving physical infrastructure in ICT and transportation would boost productivity in both sectors.

## Services and inclusive growth in Asia

A powerful motivation for strengthening Asia's service sector is its impact on inclusive growth. Asia's rapid, sustained growth during the past few decades has lifted hundreds of millions of Asians out of poverty. However, Asia's stellar growth performance has been marred by growing income and non-income inequality. As a result, Asia has recently witnessed growing popular demand for more inclusive growth that distributes the fruits of growth more widely.

Services are already a major employer in developing Asia, and even more workers will be occupied in services as the sector's role expands. A key ingredient of inclusive growth is productive employment, which labor-intensive services play a vital role in generating. Manufacturing requires more physical capital in the form of buildings and machines than do services. But while much of the population may own little or no physical capital, everyone, including the very poor, is endowed with labor. A shift in economic structure toward services can thus help reduce poverty and inequality through increased employment.[3] Empirical evidence supports the idea of the link between service sector expansion and poverty reduction (Box 2.4.2). Crucially, these jobs are not solely in modern services but also in traditional services. Improving service sector productivity will, however, create more high-quality, high-wage jobs and thus contribute even more to inclusive growth.

Service sector development can arguably promote gender equity in employment because service jobs tend to be less physically demanding than manufacturing jobs. World Bank (2012a) shows that service industries do indeed employ more women than men. Similarly, Ghani (2010) finds that countries in which services account for a higher share of employment have higher rates of female participation in the workforce. In India and Pakistan over the past 3 decades, women's employment grew more quickly in the service sector than in any other sector. Further,

### 2.4.1 How cellular phones impart upward economic mobility

Macroeconomic evidence of how mobile telephony spurs growth in developing countries is well established. Research has found greater mobile phone penetration significantly affecting the average rate of economic growth in developing countries from 1980 to 2005. Roeller and Waverman (2001) established a causal relationship between the spread of telecommunications and rising productivity in the developed countries of the OECD from 1970 to 1990, during which the spread of modern, fixed-line telephony alone was responsible for one-third of growth in OECD output. The authors note, however, that marginal returns diminish rapidly as telecommunication services reach near-universal penetration.

Waverman, Meschi, and Fuss (2005) examined data from 92 high- and low-income countries from 1980 to 2003 to test whether the introduction and rollout of mobile phone networks added to economic growth. Study results showed that mobile telephony significantly boosted economic growth with an effect twice as large in developing countries as in developed ones. Differences in how mobile telephony has matured in various developing countries explain differentials in their growth rates, so it is reasonable to expect gaps in mobile penetration and diffusion to cause continuing differences in future growth rates.

While Waverman, Meschi, and Fuss (2005) support the conclusion that ICT network development speeds economic growth, it does not identify the particular factors that stimulate growth in countries performing above average, the barriers constraining countries performing below average, or how to overcome these barriers. It does not recognize countries' vastly different economic circumstances or inform international development agencies' ICT investment priorities or sector policies for particular countries.

Sridhar and Sridhar (2009) find, in a sample of 63 developing countries analyzed from 1990 to 2001, that a 10% increase in cell phone penetration boosts national output by 0.1%. Estimates in Qiang (2009) of the average growth effect of fixed line, mobile, internet, and broadband services for a sample of 120 developed and developing countries during 1980–2006 align with earlier results on mobile telephony from Waverman, Meschi, and Fuss (2005), finding that a 10% increase in mobile phone penetration can increase economic growth in low- and middle-income countries by 0.81 percentage points. Results for internet and broadband are more tentative because the adoption of these technologies is more recent and their impact less studied.

Policy makers and economists should be aware of caveats surrounding findings that ICT contributes to economic growth in developing countries (in addition to issues of endogeneity). Roeller and Waverman (2001) mention three factors to bear in mind. First, growth is not solely a function of ICT, so low growth can reflect poor governance, the lack of physical or human capital, and other factors. Second, the more recent the technological advance, such as broadband, the less likely it is that apparent connections between penetration rates and other trends are real. Finally, mobile penetration is both rapid and rising from zero, which can confound econometrics.

Microeconomic analysis has shown information spread by voice telephony to have considerable impact on the productivity of labor and firms and to enhance market efficiency (Jensen 2007, Aker 2008 and 2010). Evidence of the pro-poor effects of ICT, as in Klonner and Nolen (2008), may be sparse, but Best and Kenny (2009) point out that there is no reason to believe that investments in ICT are less effective in developing countries than in developed ones.

Research has identified the necessary conditions and priority areas for maximizing the potential of ICT investments to enhance growth and job creation. To be effective, ICT investment requires parallel investment in human resources and institutional capacity consistent with current and future demand, as well as a favorable regulatory and institutional environment for business and entrepreneurship.

In addition to their impact on economic growth, which indirectly promotes inclusive growth via employment, cell phones can contribute more directly to inclusive growth. For example, the poor in Africa, who do not otherwise have access to financial services, rely on mobile phone banking for basic financial services. Farmers can use their mobile phones to check the weather, crop prices, and other changing information. Such effects on inclusive growth further raise the returns from investment in mobile telephony and, more generally, ICT infrastructure.

*Source:* World Bank 2011.

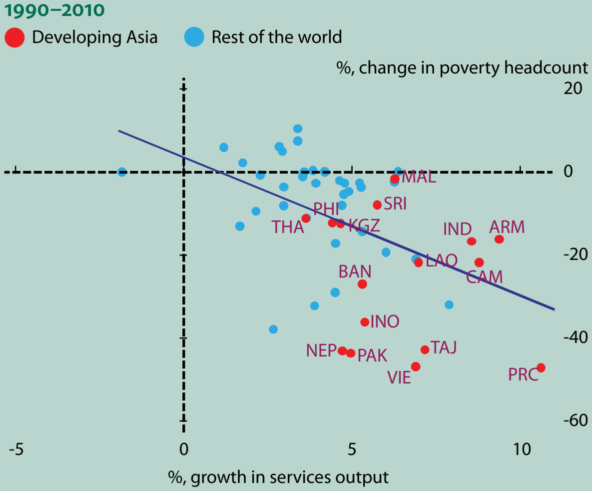
## 2.4.2 Poverty reduction through inclusive service-led growth

Is an expanding service sector good for poverty reduction? A simple plot of service sector growth shows a correlation with the decline in the poverty rate (Box figure), but this may simply reflect the influence of factors common to both, such as rising per capita income. Does a significant relationship between services growth and poverty reduction remain after accounting for other variables?

Using data for 56 countries (17 of them in developing Asia) from 1990 to 2010, a convergence growth model based on Ghani and Kharas (2010) is estimated to identify the factors affecting poverty reduction after accounting for initial poverty rates. A number of economic and institutional variables besides initial poverty rates can affect poverty alleviation. These include structural factors such as differential growth in agriculture, industry, and services, as well as previous status as a centrally planned economy. Industry-led growth may be more capital-intensive and thus worsen inequality, while service sector growth can reduce poverty and inequality through employment.

The results of this examination, as shown in the box table, are consistent with those of Ghani and Kharas (2010), supporting their earlier finding of service sector development reducing poverty over a shorter sample period.[1] As expected, initial poverty rates are associated with poverty reduction because countries with high poverty rates have more latitude to reduce poverty quickly, as do economies transitioning from central planning. Most significantly, poverty headcount also falls with growth in services output, supporting the conjecture that services growth is inclusive and reduces poverty through employment.[2]

**Change in poverty and growth in services output, 1990–2010**




ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, CAM = Cambodia, PRC = People's Republic of China, IND = India, INO = Indonesia, KGZ = Kyrgyz Republic, LAO = Lao People's Democratic Republic, MAL = Malaysia, NEP = Nepal, PAK = Pakistan, PHI = Philippines, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, VIE = Viet Nam.

*Source:* Noland, Park, and Estrada, forthcoming.

**Cross-country regressions on change in poverty headcount, 1990–2010**

| Variable | Coefficient |
|---|---|
| Initial poverty rate | -0.421*** |
| | (-5.847) |
| Former centrally planned economy | -7.681*** |
| | (-3.117) |
| Services output growth | -1.179*** |
| | (-2.690) |
| Agricultural output growth | -0.358 |
| | (-0.437) |
| Manufacturing output growth | 0.051 |
| | (0.157) |
| Constant | 21.706*** |
| | (3.676) |
| Observations | 56 |
| R-squared | 0.685 |

*Notes:* Robust t-statistics are reported in parentheses. The symbol *** indicates significance at 1%, ** at 5%, and * at 10%. All regressions control for time period. The poverty line is $1.25/day.

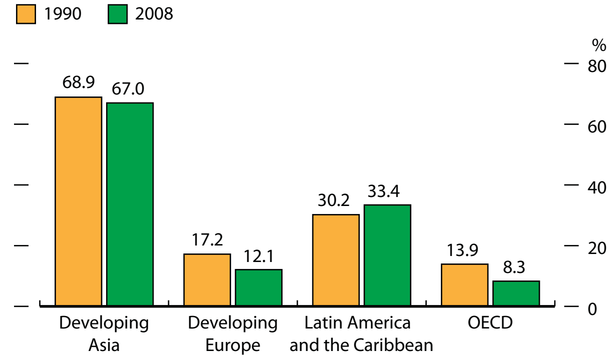
*Source:* Noland, Park, and Estrada, forthcoming.

1 Noland, Park, and Estrada (forthcoming) offer a fuller discussion of empirical methodology and results, as well as consider other models. A major limitation of the analysis is the high correlation among structural factors associated with poverty reduction, which may frustrate precisely identifying causal relations.

2 The insignificant coefficient on manufacturing growth may be due to the sample period beginning in 1990, by which time industrialization had already slowed in many Asian countries.

India's thriving modern service sector has opened up huge employment opportunities. Women fill 30% of ICT jobs in India, which is higher than the female share of employment in all service industries.[4]

2.4.2 Informal workers in total employment, 1990 and 2008




OECD = Organisation for Economic Co-operation and Development.
*Source:* ADB 2011.

### Services and informal employment

The service sector helps alleviate poverty by providing the urban poor with informal employment, which is a large part of the economy in many Asian countries and will remain so in the foreseeable future. The share of informal employment in total employment in the region is not only several times higher than in OECD countries but also twice as high as in Latin America (Figure 2.4.2).

Services are often the main arena of informal employment, which is one of the reasons the service sector constitutes a large and growing part of regional output and employment, especially in low-income countries. Rapid urbanization fuels demand for urban services. Informal employment may not always be attractive, but many urban migrants settle for it because their low skills and limited education impede their finding formal jobs. Poor urban migrants can easily find simple service jobs such as street vendor, peddler, and shop assistant. This starkly contrasts with manufacturing, which requires machine operators and production line workers to possess certain skills.

As incomes rise, the informal sector recedes (ADB 2005), even as the service sector continues to expand. But job creation and inclusive growth in low-income economies depends heavily on informal employment in urban services, especially in a country's early stages of development.

### Public services and inclusive growth

Services provided by the government matter greatly to the poor. The state has traditionally played a major role in education and health care, the public provision of which translates into important policy tools for promoting equity and inclusive growth. Broadened access to education and health care improves the productivity of the poor and disadvantaged and is, in fact, among the most important avenues toward equity (ADB 2012a). However, public spending must be efficient to be fiscally sustainable, so promoting private sector participation (and therefore competition) is an important way to foster greater efficiency in public services.

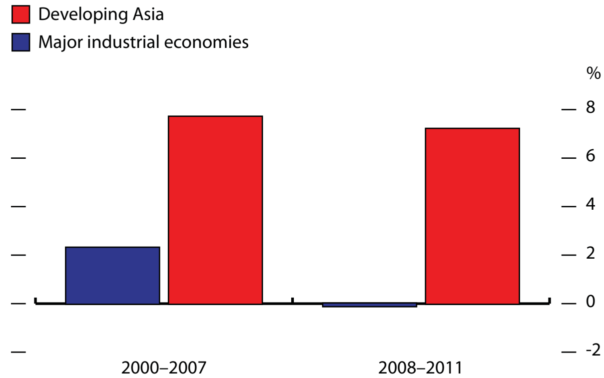
## Toward more balanced economic growth

The global financial and economic crisis of 2008–2009 had a pronounced impact on exports and growth in developing Asia, highlighting the risk of disproportionate dependence on exports. The region as a whole saw growth fall from 10.1% in 2007 to 6.7% in 2008 and further to 6.0% in 2009. Some of Asia's successful export-oriented economies, including Malaysia, Singapore, and Taipei,China, experienced outright contractions. Exports to advanced economies in particular are likely to be less of an engine of growth for the region than they have been in the past because the crisis originated in advanced economies and hit them much harder than developing Asia (Figure 2.4.3). As advanced economies grapple with deep-seated structural problems—most evident in the ongoing euro area sovereign debt crisis—uncertainty will continue to cloud their growth prospects.

In light of the less-favorable external environment, economies in developing Asia need to rebalance their growth toward domestic demand. However much exports have contributed to the region's growth in the past and will continue to contribute in the future, better balance is now needed between domestic and foreign demand. Expanding domestic demand requires expanding the supply of goods and services for the domestic market. A dynamic service sector that offers a wide range of high-quality services can help by stimulating consumption. Services play a particularly important role because they remain less tradable than goods—notwithstanding trends, explored in the next section, that enable services trade.

Strengthening domestic demand does not mean Asia turning its back on exports. By the same token, a dynamic service sector does not reduce the need for dynamism in manufacturing and other sectors. While service-led growth—leapfrogging over the industrial stage—is arguably a potential path to achieving high-income status, it is an unproven strategy. The success that India and the Philippines have enjoyed leveraging ICT and other technologies to boost their service sectors despite underdeveloped manufacturing subsectors is seen as evidence supporting the leapfrogging hypothesis, yet these economies have not risen above middle-income status. As such, a good balance between services and manufacturing remains the most viable growth strategy for Asia. The synergies between industry and services discussed earlier further reinforce the soundness of a strategy that fosters both sectors.

**2.4.3 Average GDP growth before and since the 2008–2009 economic crisis**




*Note:* Major industrial economies refer to the euro area, Japan, and United States.

*Source: Asian Development Outlook* database.

# Global market for services

Two developments are enhancing the service sector's potential to contribute to sustained economic growth and poverty reduction in developing Asia. One is the emerging tradability of services. The other is the expansion of foreign direct investment (FDI) in services. Opening up international trade and foreign investment in services can immediately benefit the region by satisfying unmet demand for modern services. There are also dynamic benefits from greater openness such as bolstering competition and acquainting local service providers with new methods. These dynamic forces can help narrow productivity gaps vis-à-vis advanced economies.

## The two-way benefits of tradable services

International trade was once seen as the domain of goods, not services. The words "goods" and "tradables" were used almost interchangeably, as were "services" and "nontradables." While services are still less tradable than goods, the old ironclad distinction no longer holds. Technological progress, especially in ICT, is rendering services more tradable than ever before, and the share of services output that is traded is rising in Asia and elsewhere (Table 2.5.1). Many Asian countries are increasing their share of the global trade in services (Figure 2.5.1).[5]

Business-related services—ICT; finance and insurance; professional, scientific, and technical services; and management and administrative support—have become particularly tradable. They are also especially important to economic growth because they can greatly improve the productivity of the whole economy by providing intermediate inputs to a range of sectors (including manufacturing) to improve quality, efficiency, and competitiveness. Technological progress has enormous impact on business services—conspicuously, the impact of ICT on finance—and is making these services eminently tradable. Through trade, business services establish linkage with the global economy and are thus drivers of export growth, including exports of manufactured goods.

In the section above on the region's concentration in traditional services, it was seen that developing Asia has a relatively backward industry offering business services, which are highly skills-intensive. Low educational attainment, especially among older workers, has held back the sector. But is there a way for developing Asia to benefit more from business services without waiting 2–3 decades for the young, well-educated Asian cohort to rise through the ranks? Can developing Asia import business services from advanced economies to augment the capacity of its small and inefficient business service industry? After all, when countries lack natural resources such as oil, minerals, and lumber, they buy them from abroad.

The prospects are promising. Because many business services are tradable, developed economies have built large and competitive business

**2.5.1 Share of service sector output that is exported (%)**

| Economy | 1990 | 2009 |
|---|---|---|
| **Developing Asia** | | |
| People's Republic of China | 5.2 | 6.0 |
| Hong Kong, China | … | 46.7 |
| India | 3.7 | 13.0 |
| Indonesia | 5.2 | 7.3 |
| Republic of Korea | 8.6 | 16.1 |
| Malaysia | 20.6 | 32.2 |
| Pakistan | 8.2 | 4.8 |
| Philippines | 16.8 | 11.9 |
| Singapore | 51.0 | 75.6 |
| Thailand | 15.0 | 25.2 |
| Viet Nam | … | 15.3 |
| **Latin America** | | |
| Argentina | 3.1 | 6.4 |
| Brazil | 1.8 | 2.9 |
| Chile | 12.9 | 10.6 |
| Mexico | 5.3 | 3.0 |
| **Eastern Europe** | | |
| Czech Republic | … | 19.8 |
| Hungary | 21.9 | 23.2 |
| **Developed Countries** | | |
| France | 10.0 | 7.8 |
| Germany | 6.6 | 10.8 |
| United Kingdom | 9.6 | 15.7 |
| United States | 3.9 | 5.2 |

… = data not available.

*Note:* Hungary and the United States show data from 2008.

*Source:* World Bank, World Development Indicators online database (accessed 14 March 2012).

service industries eager to export their services. Significant opportunities exist for buyers and sellers alike to gain from trade in business services. Examining relative prices reveals evidence of comparative advantage, and hence mutual benefits, from trade in business services. Table 2.5.2 shows the relative price of tradable business services using as a proxy the wage differential with manufacturing. The price determined this way is higher in India than in advanced economies. According to Jensen (forthcoming) the same is true in the PRC, where wages for urban workers in business services are 77% higher than for urban workers in manufacturing. In contrast, US business services wages are only 22% higher than manufacturing wages. Finally, as many Asian countries currently maintain high barriers against trade in services, global business services would become much more accessible with barriers lowered (Figure 2.5.2).

**2.5.2 Average wages by sector in selected countries, 2007 (manufacturing = 100)**

| Sector | India | Chile[a] | France | United Kingdom | United States[b] |
|---|---|---|---|---|---|
| Primary | 96 | 88 | 71 | 100 | 113 |
| Tradable business services | 167 | 185 | 113 | 120 | 154 |
| Nontradable business services | 132 | 143 | 100 | 100 | 82 |
| Personal services | 108 | | 84 | 68 | 62 |
| Retail and wholesale trade | 85 | | 84 | 79 | 71 |
| Other[c] | 134 | 111 | 92 | 109 | 98 |

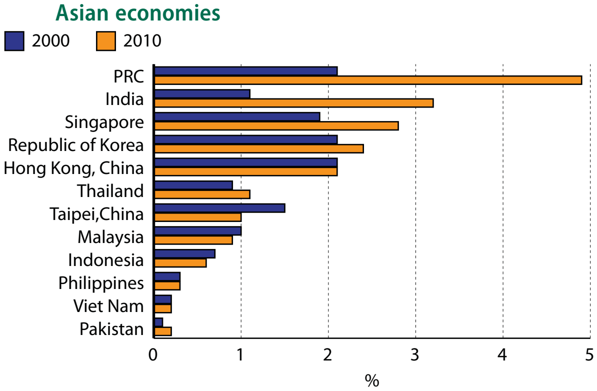
[a] Data from 2006.

[b] Not including the public sector or parts of agriculture.

[c] Data for Chile include personal services and retail and wholesale trade.

*Source:* Gonzales et al. 2012.

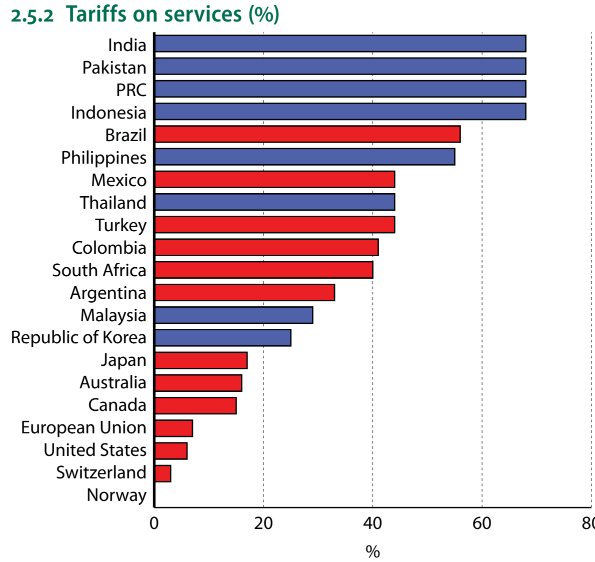
**2.5.1 Share of global services trade, selected developing Asian economies**




PRC = People's Republic of China.

*Sources:* ADB estimates based on data from CEIC Data Company; World Bank. World Development Indicators online database (both accessed 16 April 2012).

**2.5.2 Tariffs on services (%)**



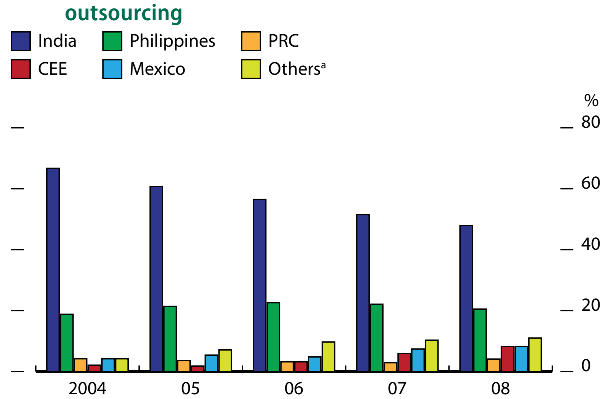

PRC = People's Republic of China.

*Note:* "Tariff" is used here to mean the combined effect of the various regulations and restrictions on services trade, which, in the PRC, India, Indonesia, and Pakistan, are equivalent to a tariff of over 60%.

*Source:* Hufbauer, Schott, and Wong 2010.

The preceding discussion highlighted how developing Asia could benefit from imports of services, but the growing tradability of services is also opening up avenues by which developing Asia can export services. Technological progress, especially in ICT, is making a wide range of previously nontradable services tradable. Among developing countries, India was a pioneer in ICT and business process outsourcing (ICT–BPO), and is still a dominant player (Box 2.5.1). Other countries have followed India's lead, with the Philippines and others outside of Asia expanding their shares at India's expense (Figure 2.5.3).

**2.5.3 Developing economies' shares of business process outsourcing**




CEE = Central and Eastern Europe, PRC = People's Republic of China.

[a] Argentina, Brazil, Malaysia, Singapore, and countries in Central America and the Caribbean.

*Source:* Mitra, forthcoming-a.

## Foreign direct investment in services

FDI can contribute significantly to growth and job creation in services, just as it does in manufacturing. It exposes firms to foreign competition and thus forces them to raise their game. Competition-driven productivity gains are especially relevant to the service sector in developing Asia because the region lags in terms of service sector labor productivity. In recent years developing Asia has become a major source of outward FDI, which is another channel through which economies can tap advanced foreign technology, knowhow, and other valuable assets.

Analyzing flows of FDI can yield a number of observations with policy implications, but traditional FDI data are plagued with serious shortcomings. Analysis of new, improved data sets derived from transactional FDI yields a number of interesting findings.[6] Table 2.5.3 breaks down cumulative transactional FDI from ADB regional members—including developed members Australia, Japan, and New Zealand—from 1988 to 2011 by sector: manufacturing, services, raw materials, and vertically integrated composites that straddle sectors. The table shows all FDI flows into and out of the region, revealing services to be the region's biggest sector for both—and apparently an object of keen investor interest. Considering the traditional importance of manufacturing in Asian economies, it is striking that manufacturing ranks only third. The table shows, moreover, that ADB regional members were net recipients of transactional FDI recorded over the period in all four meta sectors, especially in services.

Table 2.5.4 breaks down inward services transactional FDI from 1988 to 2011 by service industry and category of recipient country defined by income level.[7] Financial services, construction and real estate,[8] and transportation services absorbed roughly $1 trillion in cumulative inflows, or about half of all FDI. In dollar terms, total service sector inflows are well distributed across the top three country tiers, leaving little for the region's least-developed economies. However, viewing FDI in terms of its share of GDP reveals FDI intensity to be similar across all country income groups, contradicting the widespread belief that poorer countries do not receive substantial FDI inflows. Figure 2.5.4 presents income groups' shares of FDI inflows by service industry from 1988 to 2011.

**2.5.3 ADB regional members' FDI by meta sector, 1988–2011 ($ million)**

| Meta Sector | Inward | Outward | Net |
|---|---|---|---|
| Raw materials | 1,101,109 | 981,043 | 120,066 |
| Manufacturing | 1,011,598 | 818,809 | 192,789 |
| Composites | 647,394 | 406,612 | 240,782 |
| Services | 1,377,058 | 1,061,619 | 315,439 |
| Total | 4,137,158 | 3,268,084 | 869,075 |

ADB = Asian Development Bank, FDI = foreign direct investment.

*Note:* ADB regional members include Australia, Japan, and New Zealand, as well as developing Asia.

*Source:* Kirkegaard, forthcoming.

## 2.5.1 India's success in exporting services

The Indian ICT–BPO industry illustrates how exportable services promise to sustain regional growth. Little systematic assessment of the sector's economywide impacts exists toward fully understanding this promise, but anecdotal evidence suggests that the industry's broader impact on the economy is substantial.

Growth in the industry has been phenomenal (Box figure). India's ICT–BPO revenues were less than $1 billion in 1990 but amounted to $51.5 billion in 2008, or 4.2% of GDP. By 2011, these revenues had grown by half to $76.4 billion, and the industry employed 2.5 million workers. The Credit Rating Information Service of India found in 2007 that every job created in India's ICT–BPO industry generated four additional jobs in other industries.

Initially, most of the growth occurred in ICT services at the lower end of the value chain, but it subsequently climbed into higher-end ICT services, including software products and engineering services. India's initial success in developing its ICT–BPO export industry stems from its large pool of English-speaking technicians, managers, and entrepreneurs. Coupled with strong demand from advanced economies increasingly attracted to offshoring since the 1980s, these human resources gave India a first-mover advantage to establish the industry. Since the late 1990s, India has developed an increasingly diverse BPO industry enabled by information technology, as well as a major telecommunications industry.

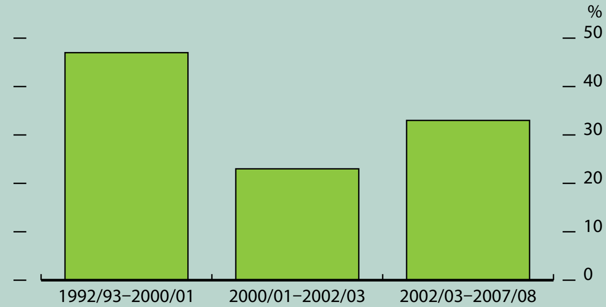
India's ICT–BPO industry continues to be overwhelmingly oriented toward exports, which provided almost 80% of revenues in 2008. Exports are led by ICT services, followed by BPO (Box table). The shares of software products and engineering services are still small but growing, unlike India's stillborn ICT hardware industry for export.

Many hypotheses have been advanced on what drives the growth and dominance of India's ICT–BPO industry. One factor in particular stands out: human resources. The size and quality of India's ICT–BPO workforce, its competence in various technologies, its international mobility, and its low cost compared with high-income countries are the main reasons for the industry's competitiveness. India's many university graduates, in particular in science and engineering, provide a deep pool of technical, managerial, and entrepreneurial talent to meet industry requirements. The Indian diaspora has further catalyzed the development of knowledge-based industry in India. English language proficiency and cultural familiarity continue to give India, and now the Philippines, decisive advantages over comparable countries.

Despite its export success, India lags behind advanced and East Asian countries in terms of applying ICT to its domestic economic development. Linkages and positive spillover into the rest of the economy are lacking, especially toward applying ICT to achieve productivity and efficiency gains. Low average income nationwide, deficiencies in computer availability and basic infrastructure such as internet connectivity, limited education and ICT literacy, and other impediments have constrained the scope for domestic ICT–BPO industry growth.

India's weakness in ICT manufacturing hobbles backward and forward linkages or synergy between ICT–BPO and the rest of the economy. This reinforces the argument that the most viable strategy for sustaining growth in developing Asia is to maintain a good balance between services and manufacturing.

**2.5.1 Growth rates of India's ICT–BPO industry**




BPO = business processes outsourcing, ICT = information and communication technology.

*Note:* Compounded annual growth rate, excluding hardware.

*Sources:* Mitra, forthcoming-a; Nasscom, various issues.

**India's ICT–BPO exports ($ billion)**

| | FY2003 | FY2008 |
|---|---|---|
| Export Market | | |
| ICT services | 7.3 | 26.5 |
| Software products | 0.8 | 2.3 |
| Engineering services | 1.7 | 4.8 |
| BPO | 3.1 | 12.7 |
| ICT–BPO total excluding hardware | 12.8 | 46.3 |
| Hardware | 0.4 | 0.3 |
| ICT–BPO total including hardware | 13.2 | 46.6 |

BPO = business processes outsourcing, ICT = information and communication technology.

*Notes:* Data for FY2008 are provisional. Numbers may not sum precisely because of rounding.

*Source:* Mitra, forthcoming-a.

*Source:* Mitra, forthcoming-a.

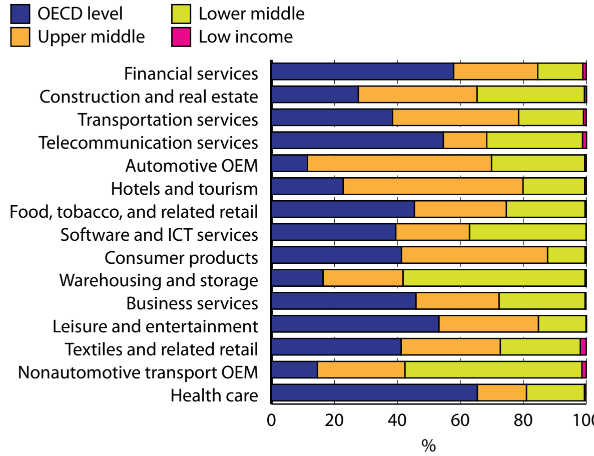
Some three-quarters of inward service sector transactional FDI comes from wealthy countries, provided in equal portions by regional countries with OECD income levels, the US, and the European Union (Kirkegaard, forthcoming). Investment flows among ADB regional members supply 37% of total regional inflows, including sizable upward-flowing investments from poorer countries into richer ones.

Greenfield transactions are by far the more important mode of investment into the region's service sectors, accounting for fully 75% of all inward investments from 2003 to 2011 and especially important in poorer countries. This distinction matters as greenfield investments typically create more jobs than do mergers and acquisitions, which often eliminate jobs when acquiring firms restructure target firms to boost efficiency (details in Jensen, forthcoming).

Analysis of transactional FDI data yields a number of observations with policy implications. First, the service sector's large share of FDI inflow reveals strong investor interest and potentially large gains from liberalization. Second, Asian countries at all income levels receive substantial FDI, undercutting claims that poor countries are ill-equipped to receive FDI. Third, upward FDI flows from poorer to richer countries suggests that poor countries need not unduly fear competition in their domestic services markets from firms based in advanced economies. Finally, that FDI inflows into services finance mainly greenfield ventures is good news for job creation.

Developing Asia is unprepared, however, to make the most of potential trade and investment in services. Shortcomings in the region's regulatory regimes and in its infrastructure and human resource endowments need to be clearly identified and then rectified. What are the policy priorities for a vibrant service sector?

**2.5.4 Inward FDI by sector and recipient country income group, 1988–2011**




FDI = foreign direct investment, ICT = information and communication technology, OECD = Organisation for Economic Co-operation and Development, OEM = original equipment manufacture.

*Source:* Kirkegaard, forthcoming.

**2.5.4 Inward FDI by sector and recipient country income group, 1988–2011 ($ million)**

| Industry | Total | Country Income Groups: OECD income level | Upper-middle income | Lower-middle income | Low income |
|---|---|---|---|---|---|
| Financial services | 340,169 | 197,074 | 90,706 | 48,766 | 3,623 |
| Construction and real estate | 324,641 | 89,489 | 122,291 | 110,662 | 2,198 |
| Transportation services | 302,103 | 116,173 | 120,953 | 62,179 | 2,798 |
| Telecommunication services, etc. | 197,273 | 107,713 | 27,162 | 59,891 | 2,507 |
| Automotive OEM, etc. | 164,407 | 18,902 | 95,978 | 48,709 | 818 |
| Hotels and tourism | 143,083 | 32,638 | 81,748 | 28,048 | 650 |
| Food, tobacco, and related retail | 133,134 | 60,417 | 38,911 | 33,253 | 554 |
| Software and ICT services | 90,740 | 35,842 | 21,242 | 33,542 | 113 |
| Consumer products, etc. | 85,952 | 35,504 | 39,908 | 10,200 | 340 |
| Warehousing and storage | 57,694 | 9,485 | 14,659 | 33,323 | 227 |
| Business services | 51,559 | 23,680 | 13,620 | 14,080 | 179 |
| Leisure and entertainment | 50,809 | 27,006 | 16,074 | 7,650 | 80 |
| Textiles and related retail | 46,295 | 19,083 | 14,600 | 11,752 | 860 |
| Nonautomotive transport OEM, etc. | 20,333 | 2,966 | 5,662 | 11,424 | 281 |
| Health care | 16,260 | 10,641 | 2,535 | 2,997 | 87 |
| Total | 2,024,452 | 786,614 | 706,048 | 516,475 | 15,315 |
| Total as a share of income group aggregate GDP in 2011 | 9% | 8% | 9% | 10% | 7% |

FDI = foreign direct investment, ICT = information and communication technology, GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development, OEM = original equipment manufacture.

*Sources:* International Monetary Fund 2012; Kirkegaard, forthcoming.

# Bridging the gaps that constrain services

The service sector has greatly contributed to output, employment, and growth in developing Asia. As the share of services in output and employment tends to rise with income, and regional income is rising quickly, services will inevitably become even more important. Yet service sector labor productivity in most Asian countries is only a fraction of the OECD figure. The challenge across the region is to remove barriers to improved labor productivity in services and to develop modern service industries with high labor productivity.

Diversity in the service sector and across Asia means that barriers and policy options will largely be specific to individual countries and industries. Some common themes regarding the enabling environment for service sector development nevertheless emerge, notably gaps in regulations, infrastructure, and human capital. Meanwhile, the scarcity of high-quality data constrains the research and analysis that policy makers depend on to formulate effective policies to fill these gaps.

## Regulatory gaps and policy responses

A well-functioning regulatory environment protects consumers and maintains competitive markets. In contrast, poorly designed and inconsistently executed regulations can stifle competition and innovation with requirements that are excessive and burdensome, inadequate, or otherwise inappropriate. Anecdotes abound about regulatory overload and multiple regulatory bodies creating thickets of regulation requiring multiple clearances. India has, for example, some 13 bodies to regulate higher education, each functioning in isolation. In the PRC, private service providers bear the brunt of heavy regulation because the state's impartiality as the industry regulator is undermined by its simultaneous participation as a major competitor.

Wölfl et al. (2010) developed what they call product market regulation indicators to identify and quantify burdensome and potentially anticompetitive regulations and allow comparison across countries. These indicators, shown in Table 2.6.1, cover three domains that jointly influence regulation—state control, barriers to entrepreneurship, and barriers to trade and investment—each divided further into categories. A higher score denotes a heavier regulatory burden. Although country coverage is limited, the table shows that firms in developing Asia generally face heavier regulatory burdens than do their counterparts in the OECD. Firms in the PRC face higher regulatory barriers than their Indian or Indonesian counterparts, largely due to the continued prominence of state-owned enterprises (SOEs) and administrative burdens in the PRC. More importantly, all three countries suffer a regulatory burden at least twice as heavy as in OECD countries.

**2.6.1 Comparative product market regulation, 2010 (Index scale of 0–6 from least to most restrictive)**

| Indicator | PRC | India | Indonesia | Republic of Korea | OECD average |
|---|---|---|---|---|---|
| **Product market regulation** | **3.30** | **2.84** | **2.73** | **1.48** | **1.36** |
| **State control** | **4.63** | **3.58** | **4.36** | **1.99** | **2.04** |
| **1. Public ownership** | **5.33** | **4.00** | **5.10** | **2.76** | **2.93** |
| Scope of public enterprise | 6.00 | 4.91 | 5.73 | 1.75 | 3.08 |
| Government involvement in infrastructure | 5.48 | 4.65 | 4.83 | 2.65 | 3.30 |
| Direct control over business enterprise | 4.50 | 2.45 | 4.74 | 3.88 | 3.20 |
| **2. Involvement in business operation** | **3.94** | **3.15** | **3.63** | **1.22** | **2.42** |
| Price controls | 4.38 | 1.13 | 3.00 | 1.78 | 2.64 |
| Use of command and control regulations | 3.50 | 5.18 | 4.25 | 0.67 | 2.53 |
| **Barriers to entrepreneurship** | **2.89** | **2.73** | **1.86** | **1.14** | **1.42** |
| **1. Regulatory and administrative opacity** | **0.25** | **2.01** | **0.16** | **0.00** | **1.55** |
| License and permits system | 0.00 | 2.00 | 0.00 | 0.00 | 1.87 |
| Communication and simplification of rules and procedures | 0.50 | 2.02 | 0.32 | 0.00 | 0.91 |
| **2. Administrative burdens on startups** | **5.58** | **4.44** | **1.64** | **1.57** | **1.68** |
| Administrative burdens for incorporation | 5.25 | 4.50 | 1.00 | 2.75 | 1.36 |
| Administrative burdens for sole proprietorships | 5.50 | 5.50 | 2.25 | 0.75 | 1.53 |
| Sector-specific administrative burdens | 6.00 | 3.33 | 1.67 | 1.21 | 1.55 |
| **3. Barriers to competition** | **2.83** | **1.74** | **3.79** | **1.85** | **1.77** |
| Legal barriers | 1.43 | 0.86 | 4.57 | 1.14 | 1.52 |
| Antitrust exemptions | 0.00 | 1.23 | 2.86 | 0.44 | 1.37 |
| Barriers to entry into network sectors | 5.39 | 3.56 | 3.92 | 3.52 | 1.57 |
| Barriers to entry into services | 4.50 | 1.33 | 0.00 | 2.31 | 1.76 |
| **Barriers to trade and investment** | **2.40** | **2.22** | **1.97** | **1.30** | **0.63** |
| **1. Explicit barriers to trade and investment** | **2.52** | **2.84** | **2.33** | **1.00** | **1.08** |
| Barriers to foreign direct investment | 3.36 | 2.52 | 2.88 | 1.01 | 1.34 |
| Tariffs | 2.00 | 4.00 | 1.00 | 2.00 | 1.31 |
| Discriminatory procedures | 2.21 | 2.00 | 3.13 | 0.00 | 1.08 |
| **2. Other barriers** | **2.27** | **1.60** | **1.60** | **1.60** | **0.79** |
| Regulatory barriers | 2.27 | 1.60 | 1.60 | 1.60 | 0.87 |

OECD = Organisation for Economic Co-ordination and Development, PRC = People's Republic of China.

*Source:* Park and Shin (forthcoming-b) using data for the beginning of 2008 from OECD. 2011. Product Market Regulation database (accessed 14 March 2012).

The heavy presence of SOEs in many Asian service industries militates against service sector development, as regulations often protect SOEs from domestic competition mounted by private firms and new entrants. In the PRC, SOEs still play a large role in rail transportation, education, health care, news and publishing, and television broadcasting. In India, railways and postal services remain government monopolies. More generally, vested interests that stand to lose from competition—regardless of whether competitors are public or private—exert political pressure on governments to protect their market positions. A notorious pattern is vested interests in professional services abusing industry standards and codes of practices to limit market entry and competition. One reason this abuse is hard to eliminate is that standards and codes of practice are needed to ensure service providers' satisfactory performance.

Regarding competition from abroad, developing Asia maintains some of the world's most restrictive policies on services trade. Borchert, Gootiiz, and Mattoo (2011) have indexed the restrictiveness of policies on services trade in 79 developing and transitional economies and in 24 developed countries. The authors find fairly strong correlation between lower per capita income and restrictive barriers, identifying the PRC, India, Indonesia, Malaysia, the Philippines, and Thailand as having notably high barriers (Figure 2.6.1).

More broadly, the governments of many countries in developing Asian, most notably in East and Southeast Asia, have favored manufacturing over services. This policy bias against services has reinforced and magnified the adverse impact of government regulations.

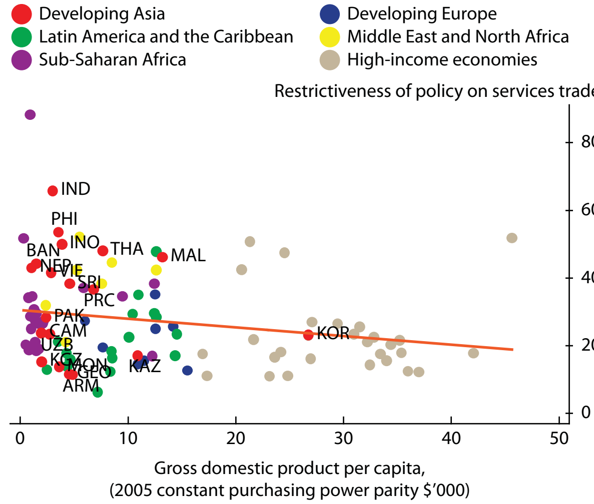
Perhaps nowhere is policy discrimination against services more evident than in taxes. In the PRC, service providers are plainly burdened with heavier tax burdens than are manufacturers. In 2008, the industries that faced the heaviest tax burdens were wholesale and retail (with a tax-to-revenue ratio of 29.6%), finance (38.8%), real estate (26.6%), leasing and business services (25.1%), and individual services (28.5%). The corresponding figure for manufacturing was only 21.0%.

The guiding principle for regulatory reform should be to tackle entrenched vested interests toward creating more competitive service markets, however politically difficult disarming them can be. Where public monopolies exist, restrictions on the entry of private firms should be eased to promote greater competition. SOEs themselves must be reformed to run along more commercial lines. Where private vested interests hold sway, the government should prevent the capture of regulatory authority by the firms it is supposed to regulate. Vested interests, whether public or private, limit competition and hence efficiency and productivity.

Sometimes vested interests perniciously impede service delivery and development. A classic example is fixed-line telephony in India. Even after liberalization, the private sector faced difficulty entering and operating in the market for lack of third party access, opaque procedures for sharing scarce resources, and other obstacles that protected incumbent SOEs in the industry. The result is fixed-line telephone density in India languishing at 2.9%, a seventh of the 21.9% recorded in the PRC and a twentieth of the 59.2% recorded in the Republic of Korea (Table 2.6.2). In striking contrast, India's mobile penetration, which did not have public monopoly service providers, stands at a much higher 61.4%. In the case of the PRC, government domination of some services markets continues to hold back the entry of the private sector.

Political will is needed to tackle the entrenched vested interests that hinder competition in the service sectors of many Asian countries. The large benefits that public and private vested

**2.6.1 Trade restrictiveness and per capita income**




ARM = Armenia, BAN = Bangladesh, CAM = Cambodia, PRC = People's Republic of China, GEO = Georgia, IND = India, INO = Indonesia, KAZ = Kazakhstan, KOR = Republic of Korea, KGZ = Kyrgyz Republic, MAL = Malaysia, MON = Mongolia, NEP = Nepal, PAK = Pakistan, PHI = Philippines, SRI = Sri Lanka, THA = Thailand, UZB = Uzbekistan, VIE = Viet Nam.

*Note:* Data on restrictiveness of policy on services trade are from 2008 to 2011, and on gross domestic product in 2010.

*Sources:* Borchert, Gootiiz, and Mattoo 2012; World Bank. World Development Indicators online database (accessed 16 April 2012).

**2.6.2 Telecommunications indicators, 2010**

| Indicators | PRC | India | Republic of Korea |
|---|---|---|---|
| Telephone subscribers (million) | 1,153.4 | 787.3 | 79.3 |
| Telephone teledensity[a] | 86.1 | 65.1 | 163.5 |
| Fixed telephone lines (million) | 294.4 | 35.1 | 28.5 |
| Fixed line teledensity[a] | 21.9 | 2.9 | 59.2 |
| Cellular subscribers (million) | 859.0 | 752.2 | 50.8 |
| Cellular teledensity[a] | 64.0 | 61.4 | 105.4 |

PRC = People's Republic of China.

[a] Teledensity is the number of telephone lines or subscribers per 100 people.

*Source:* Derived from International Telecommunications Union. ICT Statistics database (accessed 10 April 2012).

interests draw from regulatory advantages serve their narrow interests but can seriously harm the broader public interest. Meaningful service sector reform requires strong political commitment. One high priority of reform should be to enact laws to ensure competition and vigorously implement them. Promoting competition among public organizations through, for example, budgetary allocation is an option in service industries such as education that are naturally dominated by the public sector.

Often what is needed is better regulation rather than less regulation. India's airport liberalization in the early 1990s went ahead long before the regulator was established. Private airport developers took advantage of their local monopoly positions to randomly increase tariffs and facility charges to the detriment of airport users. In the PRC and other countries, strengthening the regulatory framework requires replacing outmoded regulatory tools and measures with modern ones that are transparent and market friendly. A sound, transparent, and responsive regulatory framework that creates certainty is key to creating a sound business environment that attracts investment.

Developing Asia should promote trade and FDI in services. Despite the prospects of large gains from opening up—gains associated with both exports and imports—the region still maintains high trade barriers. The advancing tradability of services and the region's recent history of benefiting hugely from liberalized merchandise trade strengthen the argument for more trade. Countries in developing Asia need to prioritize services when negotiating regional agreements and to expand those pacts' coverage of services. Liberalizing FDI regimes would boost already-large FDI inflows into the region. Because trade and FDI barriers protect vested interests and restrict competition as much as domestic regulations do, dismantling them requires strong political will.

Policies and tax inequities that promote manufacturing at the expense of services should be phased out, and market forces should be allowed to play a greater role in the allocation of resources to sectors. The preference of policy makers for manufacturing was understandable when Asian economies were more backward, as the first stage of structural transformation is the shift from agriculture to manufacturing. However, the region has advanced beyond that stage, and East and Southeast Asia have collectively become the workshop of the world. It is high time for Asian policy makers to phase out their pro-manufacturing, anti-services policies and tax distortions to create a more level playing field in which market forces have greater influence in allocating resources to sectors.

An important caveat is that regulatory reform may dislocate previously protected firms in the short run. In the Republic of Korea, regulations and restrictions on the service sector are designed to protect small and medium-sized enterprises, as they provide over 90% of service employment. Yet these companies also suffer from declining labor productivity—from 49% of the productivity of large service firms in 2001 to 41% in 2009 (Park and Shin forthcoming-b). Service sector regulations designed to protect a particular group of firms from competition inevitably relieve competitive pressure and so abet the sector's poor productivity. However, to minimize short-term dislocation caused by deregulation, a process of gradual, well-sequenced deregulation—coupled with adequate safety nets to catch those affected—is the best approach.

## Infrastructure gaps and policy responses

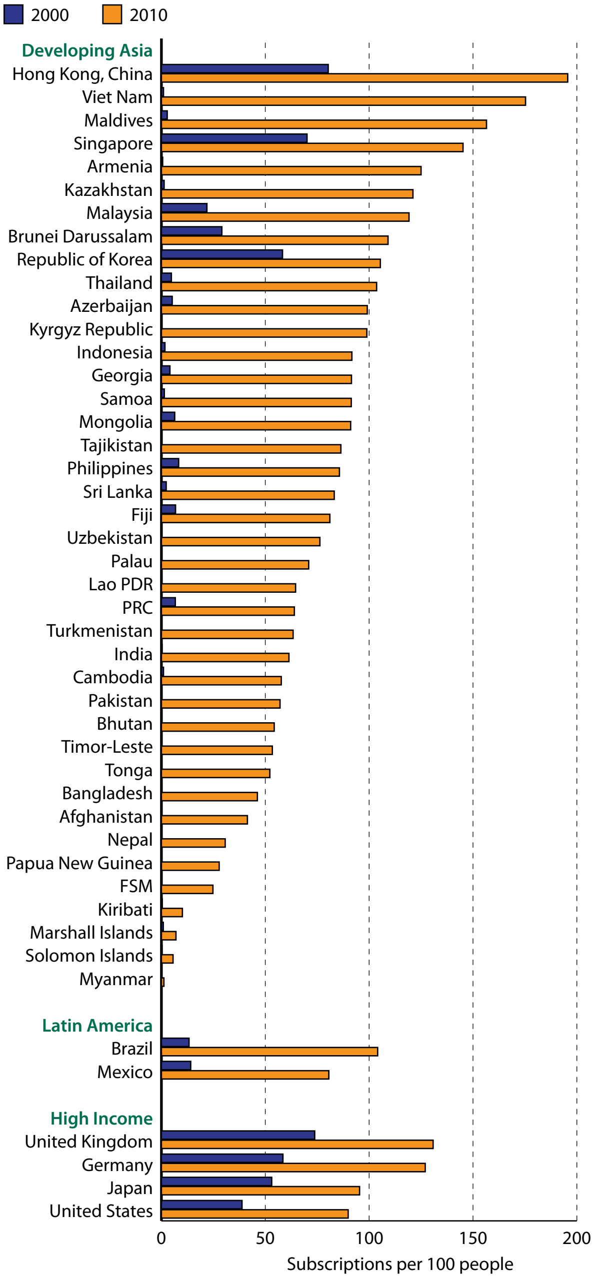
Basic infrastructure for electricity, transportation, and communication affects the productivity of the entire economy, including the service sector. While countries in East and Southeast Asia have invested heavily to build relatively good infrastructure, other countries in the region have poor infrastructure that hinders both manufacturing and services. Poor infrastructure constrains even successful service industries. Erratic power supply forces most Indian ICT–BPO companies to invest in captive power units, which increases their costs. Poor transportation infrastructure limits tourism to the Philippines, which attracts substantially fewer tourists than Malaysia or Thailand despite boasting comparable tourism potential. Even countries with good infrastructure overall suffer inadequate investment in certain areas. For example, the Republic of Korea's service sector still invests less in ICT than do advanced economies.

It is especially important to address infrastructure gaps in sectors such as ICT that have potential to catalyze large gains across the economy. As discussed in the section above on services fueling Asia's growth, ICT's contributions to economic and productivity growth in a number of countries have been widely documented as flowing through three channels (De Vries et al. 2010). First, ICT is an important capital input to production. Second, it reduces inefficiency, creates spillover effects, and stimulates technological change. Finally, productivity improvements in industries that manufacture ICT goods magnify the impact of growth. Further, ICT can promote inclusive growth by expanding access to basic services for the poor through, for example, mobile phone banking and remote education. By reducing the cost of information and enabling new economic activities, ICT offers the promise of leapfrogging onto higher growth paths.

While many countries have reaped the gains from expanded ICT use in the past decade, others continue to be held back by gaps in ICT infrastructure. Figures 2.6.2 and 2.6.3 demonstrate the uneven rates of ICT diffusion across countries in the region. While some countries enjoy access to ICT comparable with that of advanced countries, lower-income economies in the region still suffer limited access. Greater investment is needed to address ICT infrastructure gaps in areas such as mobile broadband technology. For developing countries, access to mobile technology and related innovations can foster growth by expanding opportunities for entrepreneurship, enhancing access to financing, facilitating agricultural transactions and the dissemination of market information, improving the delivery of health care, and making the public sector more transparent and accountable (World Bank 2012-b).

Across the region, there is a huge need to improve infrastructure in the years to come. Developing Asia needs to invest some $8 trillion in physical infrastructure during 2010–2020 just to maintain growth rates like those enjoyed in recent years (ADB and ADBI 2009). It needs to build more schools to deliver more and better education and more facilities for health care and other basic services. The need for large infrastructure investments is not confined to countries with infrastructure deficits such as India but extends to the PRC and other countries perceived to have relatively good infrastructure.

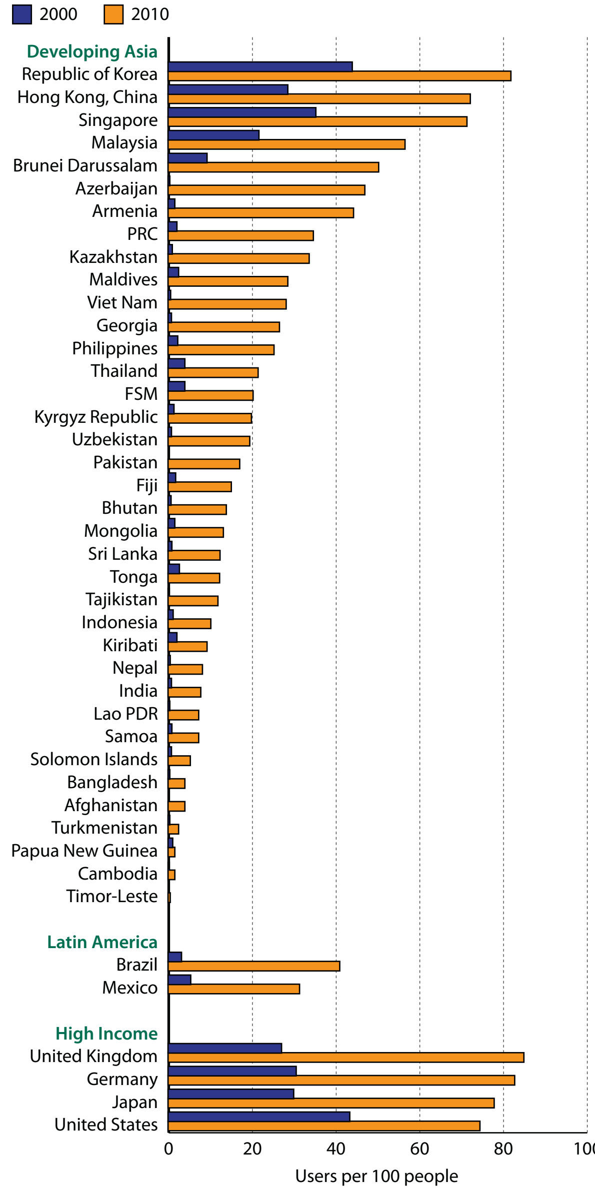
**2.6.2 Cellular subscriptions by country, 2000 and 2010 (per 100 people)**




PDR = people's democratic republic, PRC = People's Republic of China, FSM = Federated States of Micronesia.

*Source:* World Bank, World Development Indicators online database (accessed 31 August 2012).

**2.6.3 Internet users by country, 2000 and 2010 (per 100 people)**




PDR = people's democratic republic, PRC = People's Republic of China, FSM = Federated States of Micronesia.

*Source:* World Bank, World Development Indicators online database (accessed 31 August 2012).

Policy makers in the region will need to look beyond direct public investment in infrastructure to meet these huge investment demands while maintaining fiscal soundness. Fiscal constraints point to the need to prioritize public infrastructure investment into areas with large spillover effects, in particular ICT including broadband. In addition to making business services, tourism, and other industries more productive, ICT can promote inclusive growth. Asian governments may offer tax breaks and other financial incentives for private investment in ICT infrastructure. To complement public infrastructure spending, policy makers must also attract private investment. Governments must actively explore public–private partnership and create an investment climate conducive to private sector participation in infrastructure.

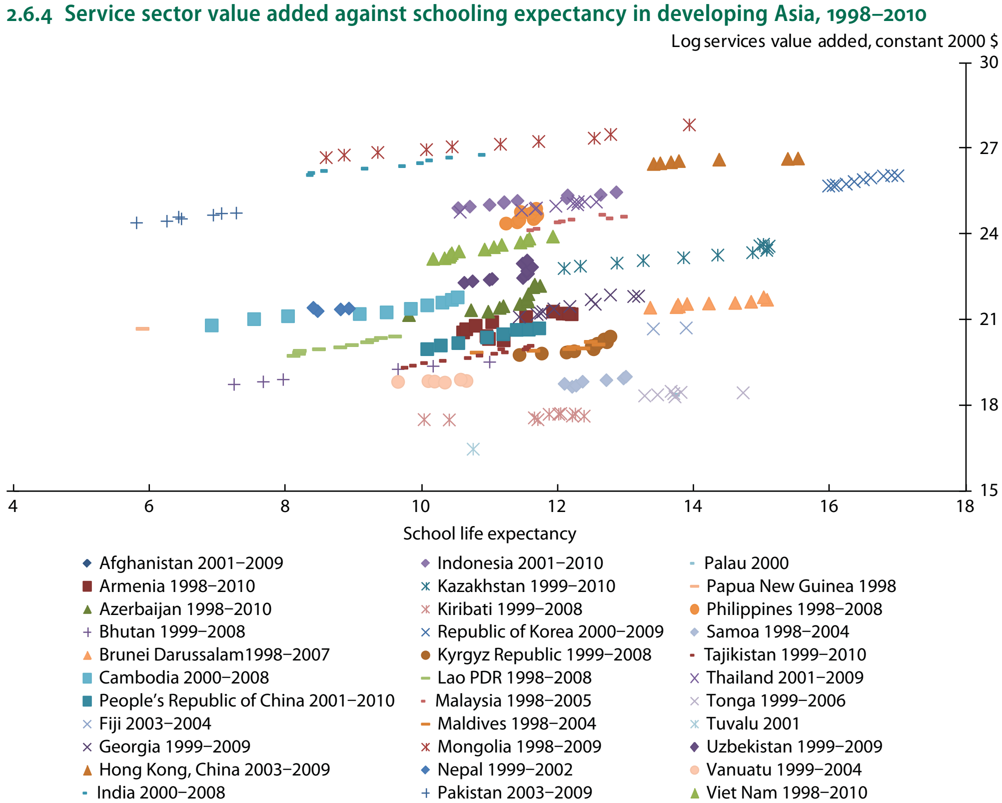
## Human capital gaps and policy responses

Relatively low educational attainment and skills shortages are major barriers to building more vibrant services, especially modern services, in Asia. The positive relationship worldwide between education and services development is also evident in Asia (Figure 2.6.4). Better-educated Asian countries tend to have larger service sectors, and a country's service sector tends to expand as it becomes more educated. In the section above on the region's concentration in traditional services, it was seen that human capital is critical to developing business services. Abundance of skilled workers helps to explain the comparative advantage of the US and other advanced economies in business services. By the same token, developing Asia's lower education attainment helps explain the region's comparative disadvantage.

Although educational attainment in developing Asia still lags that of advanced economies by a substantial margin, it has been catching up rapidly. While this bodes well for the future of Asian services, Asia currently suffers sometimes acute shortages of a wide range of skills (ADB 2008). Especially evident are shortages of highly skilled professionals—accountants, business managers, engineers, lawyers, medical doctors, scientists, and software specialists—who are indispensable to modern service industries. Notwithstanding the general improvement of education in Asia, the lack of higher skills slows Asia's transition from traditional to modern services.

Skills shortages are not limited to a few hot spots but prevalent enough to pose a genuine risk to regional growth over the long run (ADB 2008). The shortfall stems largely from Asia's rapid economic growth and fast-rising incomes, which have fueled demand

**2.6.4 Service sector value added against schooling expectancy in developing Asia, 1998–2010**




PDR = people's democratic republic.

*Sources:* Central Intelligence Agency. The World Factbook; World Bank. World Development Indicators online database (accessed 24 February 2012).

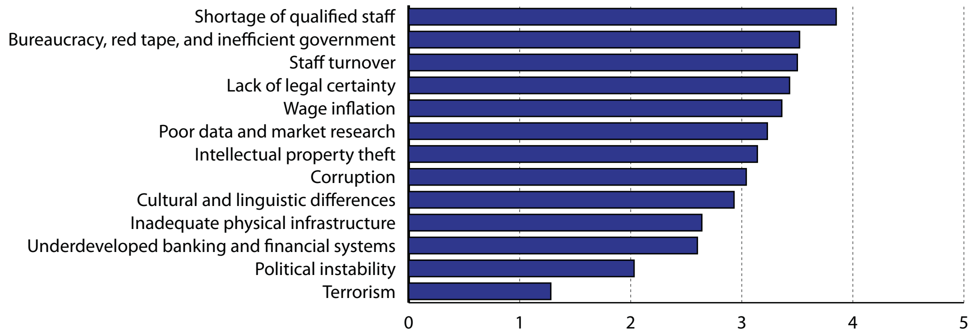
for skills-intensive goods and services. Asia's skills crisis may force multinational companies operating in the region to pay salaries to their scientists and engineers commensurate with Western salaries. The surveyed perceptions of employers, who bear the brunt of the skills crisis, confirm its severity and breadth. Figures 2.6.5 and 2.6.6 show that the shortage of qualified staff ranked first among employers' concerns in the PRC and Southeast Asia. The same pattern is evident in other parts of Asia, with higher skills most acutely in short supply.

Education reform should aim to match the skills of graduates with industry requirements to narrow the human capital gap. Investment in primary and secondary education, in which the state typically plays a larger role, remains important. However, Asia's skills crisis primarily reflects the failure of Asian universities to produce enough graduates with the strong skills and qualifications required by modern service industries. The fundamental solution to the crisis thus lies in building stronger education systems capable of delivering better-qualified graduates with more skills. The guiding principle of education reform must be to foster more competitive education markets.

Building world-class tertiary education systems, by whatever path, is key to filling human capital gaps in modern service industries. One way is to allow greater private sector participation. As skills training is profitable, there should be plenty of interest in the private sector. Microsoft's partnership with top universities in the PRC is a good example of the benefits of private sector participation. To mitigate its own skills shortage, Microsoft formed partnerships with four universities to set up software labs where interns learn practical software development.

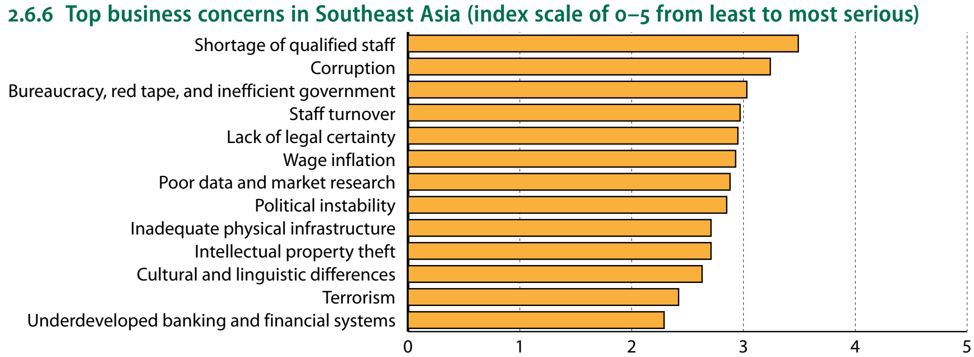
Fostering competition among public educational institutions is also important. The Republic of Korea recently slashed public funding for underperforming universities to improve performance. Public–private partnership is yet another mechanism for encouraging entry into education and hence competition. As education reform is inevitably a costly, long-term process, the time to act is now, given the urgent need to transform the service sector. Policy options over the shorter term include adopting Singapore's exceptional openness to skilled workers from

**2.6.5 Top business concerns in the People's Republic of China (index scale of 0–5 from least to most serious)**




*Source:* ADB estimates using data from Economist Intelligence Unit Corporate Network 2007.

**2.6.6 Top business concerns in Southeast Asia (index scale of 0–5 from least to most serious)**




*Source:* ADB estimates using data from Economist Intelligence Unit Corporate Network 2007.

overseas, which has contributed greatly to its success as a global financial services center.

While closing regulatory, infrastructure, and human capital gaps is necessary to upgrade developing Asia's service sector, a number of other policy options can speed growth in the region's service sector. Governments can promote greater investment in services research and development by providing fiscal incentives such as tax credits and grants. Parsimonious research and development can be a significant barrier to innovation and movement up the value ladder to services with higher value added. Lower-income countries that lack capacity for research and development can import advanced services technology through trade and FDI. Another approach is to speed the development of inclusive finance to provide more and cheaper loans to the entrepreneurs and small and medium-sized enterprises that drive service industries.

## Data gaps and policy responses

The lack of high-quality data relevant to Asia's service sector limits understanding of it and thus constrains the ability of Asian policy makers to formulate and implement appropriate policies. By far the most important constraint on timely, conceptually sound, and comprehensive analysis of services is the lack of high-quality, publicly available data. The sheer diversity of services, their intangible nature, and their multiple modes of delivery make services difficult and costly to measure consistently, comprehensively, and validly.

This is not unique to developing Asia—or to emerging economies in general. Even the US, which collects a wide range of service sector data, suffers data deficiencies (Feenstra et al. 2010). Predictably, the quantity and quality of data on the service sector is even more limited in developing Asia. Box 2.6.1 outlines the challenges Asian authorities face in collecting and compiling accurate service sector data.

To facilitate more accurate understanding of services and their constraints, governments in the region should strive to collect better data on the sector and publish it more promptly. Service sectors' size and growing importance justify Asian governments' investing more resources in this activity. Otherwise, governments will remain hard pressed to put in place policies that foster service sector development. Better data would directly inform policy makers and provide indispensable inputs to empirical research that would ultimately deepen knowledge of the sector.

The huge diversity of services argues for prioritizing the collection of industry-level data. If several different bodies produce services data, effective coordination to ensure consistency is essential. Technical assistance from development partners with expertise in collecting services data—international financial institutions, United Nations agencies, and national statistical agencies—can move the process along.

Several priority actions stand out. National statistics systems should advocate for the collection and dissemination of services statistics, thereby raising awareness and securing the means to improve human resources and statistical infrastructure toward better data collection. They should reassure respondents of their commitment to preserving confidentiality. Systems should improve the coordination of

### 2.6.1 Challenges in measuring Asia's service sectors

Despite the importance of services to GDP and employment, comprehensive, accurate, and up-to-date statistics on services are available in only a handful of countries (Box table).

There are many reasons why national statistics systems cannot readily produce services statistics. The wide range of economic activities that services encompass poses a challenge, along with low priority, insufficient data sources and information about producing units, lack of expertise and knowledge, and lack of statistical infrastructure.

Responsibility for collecting services data is often spread across agencies that include national statistics offices, central banks, and ministries of commerce and education. Bringing the statistics together depends on collaboration that is often hindered by insufficient laws on statistics, poor institutional relationships, and insufficient ICT infrastructure.

Services constitute an important part of the balance of payments current account. The intangible nature of services means that information about trade in services cannot be captured by customs, as can trade in goods. A number of countries in the region conduct surveys specifically on trade in services but generally focused only on the main services and their key providers. Recent trends in globalization, outsourcing, and services becoming ever more sophisticated will make accurately capturing trade in services even more challenging.

**Economic statistics published by ADB's 48 regional members**

| | Available out of 48 | Published at least annually | Published at least quarterly | Published at least monthly |
|---|---|---|---|---|
| GDP | 48 | 48 | 27 | 3 |
| GDP production approach, current prices | 47 | 46 | 24 | 2 |
| GDP production approach, by economic activity | 42 | 42 | 23 | 2 |
| GDP production approach, constant prices[a] | 44 | | | |
| Balance of payments | 46 | 44 | 32 | 6 |
| Balance of payments and current account for services[a] | 40 | | | |
| Retail trade turnover | 24 | 21 | 13 | 10 |
| Index of services production or similar measures | 14 | 13 | 11 | 6 |

ADB = Asian Development Bank, GDP = gross domestic product.

*Note:* ADB's 48 regional members include Australia, Japan, and New Zealand, in addition to developing Asia.

[a] No information available about frequency.

*Source:* ADB 2012b; Economic and Social Commission for Asia and the Pacific 2009.

administrative sources of data and access to them, which may require legal changes. Finally, they should develop road maps toward sustainably improving statistics on services.

The international community, meanwhile, should provide training and technical assistance to build capacity in handling statistics and support research into more cost-effective methods of handling data. It should actively facilitate collaboration, experience sharing, and staff exchanges with national statistics systems, encouraging South–South cooperation. Development partners should support the implementation of new frameworks, manuals, and guidelines—in particular more specific guidelines on compiling services statistics that especially target statistics systems in developing countries.

## Final thoughts

The service sector will lead structural change in Asia's economy in the coming years. Asia is largely following the international historical pattern of structural change and can expect services to provide a rising share of output and employment. Further, the region's rapid growth is giving rise to a large and growing middle class, which typically has a healthy appetite for services in health care, education, finance, leisure, and other areas.

The quantitative expansion of services is, in and of itself, neither good news nor bad for Asia. On the negative side, the sector is often the last resort of workers unable to find jobs in manufacturing, providing only marginal, low-wage jobs. Tellingly, labor productivity in Asia's service sector currently falls far short of standards in advanced economies. Therefore, the region faces the fundamental challenge to foster the expansion of vibrant, highly productive services.

The guiding principle for Asian policy makers must be to create a more competitive environment for their service industries. Many across the region are dominated by SOEs protected by regulatory barriers from competition mounted by domestic upstarts. Trade and FDI barriers similarly protect them from foreign competitors. Removing these and other anticompetitive impediments is key to promoting competition. More competition will raise service sector productivity, which can lift productivity in other sectors.

The future of the sector depends on whether the expansion of services in Asia is driven by dynamic, open competition or by the sclerotic protection of vested interests. If competition prevails, Asia can establish a robust, highly productive sector generating spillovers that benefit other industries and providing services that power inclusive growth. Competition, in particular foreign competition, worked miracles for manufacturing in Asia as the region transformed itself into the factory of the world. It can work new miracles for the region's services and the broader economy.

## Endnotes

1 Skytrax. http://www.airlinequality.com/AirportRanking/5-Star.htm, http://www.airlinequality.com/StarRanking/5star.htm, http://www.worldairportawards.com/awards_2012/top20airporthotels.htm; Lonely Planet. http://www.lonelyplanet.com/europe/travel-tips-and-articles/76856; U.S. News and World Report. http://travel.usnews.com/features/Worlds_Best_Street_Food/; CNN International. http://www.cnngo.com/explorations/escape/worlds-10-coolest-movie-theaters-355218?page=0,0; Environmental Graffiti. http://www.environmentalgraffiti.com/green-living/free-ride-the-five-best-mass-transit-systems-worldwide/1095?image=5 (all accessed 29 September 2012)

2 Country examples throughout the chapter draw on the following background papers: Wang (forthcoming) for the People's Republic of China; Mukherjee (forthcoming) for India; Park and Shin (forthcoming-b) for the Republic of Korea; Mitra (forthcoming-b) for the Philippines; Koonnathamdee (forthcoming) for Thailand; and Acharya et al. (forthcoming) for Bangladesh, Cambodia, Nepal, Papua New Guinea, Uzbekistan, and Viet Nam.

3 A word of caution is in order here to avoid overgeneralization, as labor-intensity differs greatly across industries regardless of sector. Note that countries in East and Southeast Asia were able to leverage their ample supply of labor by investing in labor-intensive manufacturing.

4 While ICT advances can open new job possibilities for women, they can also disadvantage women with insecure jobs or wage disparity where gender gaps exist in education and skills. Addressing such gaps will be crucial to enhancing the potential of the service sector to narrow gender disparities in the labor market.

5 This section is based on Jensen, forthcoming.

6 Please refer to Kirkegaard (forthcoming) for an explanation of the new data sets.

7 OECD income level is $12,276 or more per capita: Australia; Brunei Darussalam; Hong Kong, China; Japan; New Zealand; Singapore; Republic of Korea; and Taipei,China. Upper-middle-income economies earn $3,976–$12,275 per capita: Azerbaijan, the PRC, the Cook Islands, Kazakhstan, Malaysia, the Maldives, and Thailand. Lower-middle-income economies earn $1,006–$3,975 per capita: Armenia, Bhutan, Fiji, Georgia, India, Indonesia, Laos, the Marshall Islands, Micronesia, Mongolia, Pakistan, the Philippines, PNG, Samoa, Solomon Islands, Sri Lanka, Turkmenistan, Uzbekistan, Vanuatu, and Viet Nam. Low-income economies earn $1,005 or less per capita: Afghanistan, Bangladesh, Cambodia, the Kyrgyz Republic, Myanmar, Nepal, and Tajikistan.

8 Limitations on FDI data do not allow construction, an industry sector, to be disaggregated from real estate, a service sector.

## References

Aker, J.C. 2008. Does Digital Divide or Provide? *Working Paper 154.* Berkeley, CA: Bureau for Research and Economic Analysis of Development.

_____. 2010. Information from Markets Near and Far: Mobile Phone on Agricultural Markets in Niger. *American Economic Journal: Applied Economics.* 2(3). pp. 46–59.

Asian Development Bank (ADB). 2005. *Key Indicators for Asia and the Pacific 2005*. Manila.

_____. 2007. *Asian Development Outlook 2007: Growth Amid Change.* Manila.

_____. 2008. *Asian Development Outlook 2008: Workers in Asia*. Manila.

_____. 2011. *Key Indicators for Asia and the Pacific 2011*. Manila.

______. 2012a. *Asian Development Outlook 2012: Confronting Rising Inequality in Asia*. Manila.

______. 2012b. *Key Indicators for Asia and the Pacific 2012*. Manila.

ADB and ADB Institute. 2009. *Infrastructure for a Seamless Asia*. Manila: ADB and Tokyo: ADB Institute.

Barro, R.J. and X. Sala-i-Martin. 2003. *Economic Growth*. 2nd edition. Cambridge, Massachusetts: MIT Press.

Best, M. and C. Kenny. 2009. ICTs, Enterprise and Development. In T. Unwin, ed. *Information Technology for Development*. Cambridge, U.K.: Cambridge University Press.

Borchert, I., B. Gootiiz, and A. Mattoo. 2011. Services in Doha: What's on the Table? In W. Martin and A. Mattoo, eds. *Unfinished Business?* Washington, DC: World Bank. pp. 115–144.

______. 2012. Guide to the Services Trade Restrictions Database. *Policy Research Working Paper*. No. 6108. Washington, DC: World Bank.

Bosworth, B. and A. Maertens. 2010. Economic Growth and Job Generation: The Role of the Service Sector. In E. Ghani, ed. *The Service Revolution in South Asia*. New York: Oxford University Press.

De Vries, G., N. Mulder, M. dal Borgo, and A.A. Hofman. 2010. ICT Investment in Latin America: Does It Matter for Economic Growth? In M. Cimoli, A.A. Hofman, and N. Mulder. *Innovation and Economic Development: The Impact of Information and Communication Technologies in Latin America*. Cheltenham and Northampson: Edward Elgar Publishing. pp. 96–117.

Eichengreen, B. and P. Gupta. 2009. Two Waves of Services Growth. *NBER Working Paper*. No. 14968. Cambridge, Massachusetts: National Bureau of Economic Research.

Eichengreen, B., D. Perkins, and K. Shin. 2012. From Miracle to Maturity: The Growth of the Korean Economy. Cambridge, Massachusetts: Harvard University Asia Center.

Economic and Social Commission for Asia and the Pacific. 2009. Report on the ESCAP Region-wide Assessment of the Capacity of National Statistical Systems in Asia and the Pacific to Produce Basic Economic Statistics. E/ESCAP/CST(2)/INF/9. Bangkok: ESCAP, United Nations.

Economist Intelligence Unit Corporate Network. 2007. *Asian Business Outlook Surveys*. Singapore.

Feenstra, R.C., R.E. Lipsey, L.G. Branstetter, C.F. Foley, J. Harrigan, J.B. Jensen, L. Kletzer, C. Mann, P.K. Schott, and G.C. Wright. 2010. Report on the State of Available Data for the Study of International Trade and Foreign Direct Investment. *NBER Working Paper*. No. 16254. Cambridge, Massachusetts: National Bureau of Economic Research.

Francois, J. 1990. Trade in Producer Services and Returns Due to Specialization under Monopolistic Competition. *Canadian Journal of Economics.* 23(1). pp. 109–124.

Francois, J. and B. Hoekman. 2010. Services Trade and Policy. *Journal of Economic Literature.* 48(3). pp. 642–692.

Gallup, J.L., J.D. Sachs, and A. Mellinger. 1999. Geography and Economic Development. *CID Working Paper*. No. 1. Cambridge, Massachusetts: Center for International Development, Harvard University.

Ghani, E., ed. 2010. *The Service Revolution in South Asia*. New Delhi: Oxford University Press.

Ghani, E. and H. Kharas. 2010. The Service Revolution in South Asia: An Overview. In E. Ghani, ed. *The Service Revolution in South Asia*. New Delhi: Oxford University Press.

Gonzales, F., J.B. Jensen, Y. Kim, and H.K. Nordas. 2012. Globalisation of Services and Jobs. In D. Lippoldt, ed. *Policy Priorities for International Trade and Jobs*. Paris: Organisation for Economic Co-operation and Development. www.oecd.org/trade/icite

Houseman, S., C. Kurz, P. Lengermann, and B. Mandel. 2011. Offshoring Bias in U.S. Manufacturing. *Journal of Economic Perspectives*. 25(2). pp. 111–32.

Hufbauer, G.C., J.J. Schott, and W.F. Wong. 2010. Figuring Out the Doha Round. *Policy Analyses in International Economics*. 91. Washington, DC: Peterson Institute for International Economics.

International Monetary Fund. 2012. *World Economic Outlook 2012*. Washington, DC.

Jensen, R. 2007. The Digital Provide: Information (Technology), Market Performance, and Welfare in the South Indian Fisheries Sector. *The Quarterly Journal of Economics.* 122(3). pp. 879–924.

Klonner, S. and P. Nolen. 2008. Does ICT Benefit the Poor? Evidence from South Africa. http://ifap-is-observatory.ittk.hu/node/583

Kolko, J. 2010. Urbanization, Agglomeration, and Coagglomeration of Service Industries. In E. Glaeser, ed. *Agglomeration Economics*. Chicago: National Bureau of Economic Research and The Chicago University Press. pp. 151–180.

Nasscom. Various issues. Strategic Review. New Delhi.

Pilat, D. and A. Wölfl. 2005. Measuring the Interaction between Manufacturing and Services. *STI Working Paper*. No. 2005/5. Statistical Analysis of Science, Technology and Industry. Paris: Organisation for Economic Co-operation and Development.

Qiang, Z.-W.C. 2009. Telecommunications and Economic Growth. Washington, DC: ICT Sector Unit, World Bank. http://siteresources.worldbank.org/EXTINFORMATIONANDCOMMUNICATIONANDTECHNOLOGIES/Resources/282822-1208273252769/ Broadband_Investment_in_Stimulus_Packages.pdf

Roeller, L.H. and L. Waverman. 2001. Telecommunications Infrastructure and Economic Development: A Simultaneous Approach. *American Economic Review*. 91(4). pp. 909–923.

Sridhar, K.S. and V. Sridhar. 2009. Telecommunications Infrastructure and Economic Growth: Evidence from Developing Countries. *Applied Economics and International Development*. 7(2). pp. 37–56.

Waverman, L., M. Meschi, and M. Fuss. 2005. The Impact of Telecoms on Economic Growth in Developing Countries. In Africa: The Impact of Mobile Phones, *Vodafone Policy Paper No. 2*. Newbury, Berkshire, U.K.: Vodafone.

Wölfl, A., I. Wanner, O. Röhn, and G. Nicoletti. 2010. Product Market Regulation: Extending the Analysis Beyond OECD Countries. *OECD Economics Department Working Papers*. No. 799. Paris: OECD Publishing.

World Bank. 2011. *An Evaluation of World Bank Group Activities in Information and Communication Technologies: Capturing Technology for Development*. Washington, DC.

______. 2012a. *World Development Report: Gender Equality and Development*. Washington, DC.

______. 2012b. *Information and Communications for Development: Maximizing Mobile*. Washington, DC.

Yuskavage, R.E., E.H. Strassner, and G.W. Medeiros. 2008. Outsourcing and Imported Services in BEA's Industry Accounts. In M. Reinsdorf and M. Slaughter, eds. *International Flows of Invisibles: Trade in Services and Intangibles in an Era of Globalization*. Chicago: University of Chicago Press.

## Background papers


Acharya, Y., A. Batten, P. Brimble, P. Doung, G. Estrada, M.I. Gulamov, M.Z. Hossain, D. Mellor, D. Park, and S. Rahman. Forthcoming. The Service Sector in Asia's Lower-income Economies. *ADB Economics Working Paper Series.* Manila: Asian Development Bank (ADB).

Jensen, J.B. Forthcoming. Overlooked Opportunity: Tradable Business Services, Developing Asia, and Growth. *ADB Economics Working Paper Series.* Manila: ADB.

Kirkegaard, J.F. Forthcoming. Transactions: A New Look at Service Sector FDI in Asia. *ADB Economics Working Paper Series.* Manila: ADB.

Koonnathamdee, P. Forthcoming. Thailand Service Sector: Toward a Possible Turning Point. *ADB Economics Working Paper Series.* Manila: ADB.

Mitra, R. Forthcoming-a, The IT and BPO sector in Developing Asia. *ADB Economics Working Paper Series.* Manila: ADB.

Mitra, R. Forthcoming-b. Developing the Service Sector as an Engine for Inclusive Growth: The Case of the Philippines. *ADB Economics Working Paper Series.* Manila: ADB.

Mukherjee, A. Forthcoming. Developing the Service Sector as an Engine for Inclusive Growth: The Case of India. *ADB Economics Working Paper Series.* Manila: ADB.

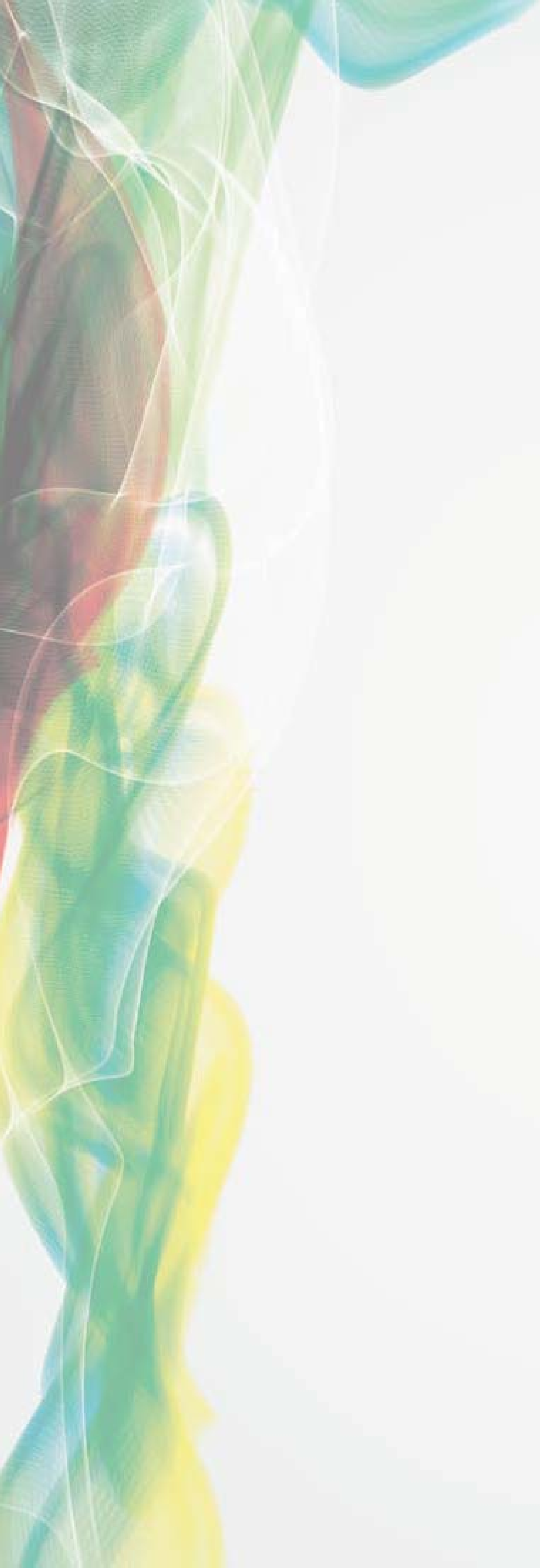
Noland, M., D. Park, and G.B. Estrada. Forthcoming. Developing the Service Sector as an Engine of Growth for Asia: An Overview. *ADB Economics Working Paper Series.* Manila: ADB

Park, D. and K. Shin. Forthcoming-a. The Service Sector in Asia: Is It an Engine of Growth? *ADB Economics Working Paper Series.* Manila: ADB.

Park, D. and K. Shin. Forthcoming-b. Performance of the Service Sector in the Republic of Korea: An Empirical Investigation. *ADB Economics Working Paper Series.* Manila: ADB.

Schott, J., M. Lee, and J. Muir. Forthcoming. Prospects for Services Trade Negotiations. *ADB Economics Working Paper Series.* Manila: ADB.

Wang, W. Forthcoming. The Development of the People's Republic of China's Service Sector: Features, Restrictions, and Policies Recommendations. *ADB Economics Working Paper Series.* Manila: ADB.



# Economic trends and prospects in developing Asia

# 3

# Subregional summaries

## Central Asia
## East Asia
## South Asia
## Southeast Asia
## The Pacific

## Bangladesh
## People's Republic of China
## India
## Indonesia
## Malaysia
## Pakistan
## Philippines
## Thailand
## Viet Nam

# Economic trends and prospects in developing Asia

## Subregional summaries

### Central Asia

#### Subregional assessment and prospects

Revising the *Asian Development Outlook 2012* (*ADO 2012*) projections released in April, this *Update* forecasts lower gross domestic product (GDP) growth for half of the countries in Central Asia in 2012 and 2013 and, despite upwardly revised forecasts for two countries, for the subregion as a whole. Projections for inflation in the *Update* are also lower than in April. With the revision, Central Asia's projected current account surplus is slightly wider in 2012 and substantially wider in 2013.

The four Central Asian countries with GDP growth revised downward are Azerbaijan, Kazakhstan, the Kyrgyz Republic, and Turkmenistan. Revision largely reflects weaker growth in two of the subregion's main trading partners—the euro area and the People's Republic of China (PRC)—causing energy-exporting Azerbaijan and Kazakhstan to export less oil in the first half of 2012. The Kyrgyz Republic faces other problems. Growth in Turkmenistan remains rapid despite a small downward revision reflecting global conditions.

In Azerbaijan, growth in the non-oil sector remains strong, but because oil production is now expected to be lower, the *Update* revises projected GDP growth in 2012 downward to 3.0% from the 4.1% forecast in April. Kazakhstan's economic growth in the first half of 2012 was lower than in the same period of 2011 due to the lower volume of hydrocarbon exports, the global economic slowdown, and poor agriculture performance. Public spending and the development of a new oil field are expected to mitigate these effects, but growth projections nevertheless edge down in 2012 from 6.0% in the *ADO 2012* to 5.8% and from 6.5% to 6.3% in 2013. The slowdown in Turkmenistan is mitigated by expanding gas exports to the PRC and public investment. Even with a percentage

---

This chapter was written by Tatsuji Hayakawa for Central Asia; Robert Boumphrey, Shiela Camingue, Donghyun Park, Arief Ramayandi, Aleli Rosario, and Akiko Terada-Hagiwara for East Asia; Yoko Niimi and Ruzette Mariano for South Asia; Rhodora Concepcion, Minsoo Lee, and Anthony Patrick for Southeast Asia; and Aaron Batten, Caroline Currie, Christopher Edmonds, Malie Lototele, Milovan Lucich, Rommel Rabanal, Craig Sugden, Cara Tinio, Laisiasa Tora, and Emma Veve for the Pacific—with contributions from various ADB resident mission staff.

point taken off GDP growth projections, the country is still expected to grow strongly by 9% in 2012 and 8% in 2013. The Kyrgyz Republic has been affected by a sharp drop in gold production and a poor grain harvest. The forecast for GDP growth in the Kyrgyz Republic is therefore slashed from 5.0% in the *ADO 2012* to nil in 2012 but maintained at 5.5% in 2013, in expectation of a recovery in gold production.

GDP growth projections for Georgia and Uzbekistan remain unchanged, despite the global slowdown. Georgia's growth is projected at 6.0% in 2012 and 6.3% in 2013, driven by government stimulus spending, with the construction, manufacturing, and financial intermediation sectors all expected to show strong growth. Uzbekistan's economy is forecast to grow at 8.0% in 2012 and 7.9% in 2013 thanks to continued public investment and rising wages and remittances, which will strengthen growth in services and retailing.

The *Update* offers higher GDP growth projections for Armenia and Tajikistan, notwithstanding the global slowdown. In both countries, this reflects the buoyant performance of the major sectors—industry, services, and agriculture—and significant increases in remittances.

Central Asia maintains extensive relations with the Russian Federation (now a member of the World Trade Organization) through trade, investment, and workers' remittances. These relations are particularly important to Armenia, Georgia, the Kyrgyz Republic, Tajikistan, and Uzbekistan. The key factors influencing remittances to these countries are the Russian Federation's resilient economic performance, underpinned by its energy sector, and higher wages in its tight labor market.

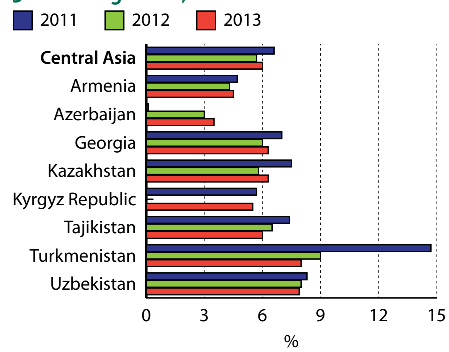
Weaknesses in international economic conditions and a severe drought have affected prospects for Central Asia, in particular for Azerbaijan, Kazakhstan, and Turkmenistan. Projected growth in 2012 for the subregion as a whole has therefore been revised down from 6.1% in the *ADO 2012* to 5.7% (Figure 3.1.1). The projection for 2013 growth edges down from 6.2% to 6.0%, reflecting revisions for Kazakhstan and Turkmenistan.

Inflation in the subregion fell in the first half of 2012, mainly tracking decreases in global food and fuel prices. Projections for inflation in the subregion as a whole in 2012 have been lowered from 7.2% in the *ADO 2012* to 6.4%, and in 2013 from 7.3% to 6.7% (Figure 3.1.2). Inflation in most countries is expected to be higher in 2013 than in 2012 because of rising domestic demand, a poor grain harvest in some countries, and expansionary monetary policies.

The *Update* lowers 2012 inflation forecasts for five of the eight countries: Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, and Tajikistan. Easing inflationary pressure in Kazakhstan reflects the weaker local and global economic outlook. The *Update* lowers the inflation projection for the Kyrgyz Republic in 2012 from 5.0% to 4.1% on account of lower food prices, but raises the 2013 inflation projection by almost half, from 5.5% to 8.1%, because of a poor grain harvest caused by a severe drought.

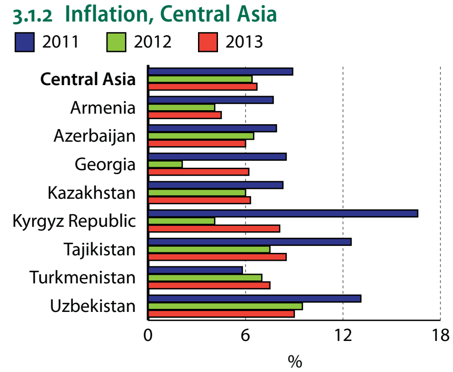
*ADO 2012* inflation forecasts for Armenia and Uzbekistan are unchanged. In Uzbekistan, inflationary pressures from higher wages and

**3.1.1 GDP growth, Central Asia**




*Source: Asian Development Outlook* database.

**3.1.2 Inflation, Central Asia**




*Source: Asian Development Outlook* database.

remittances have been offset by slower accumulation of net foreign assets and lower import costs.

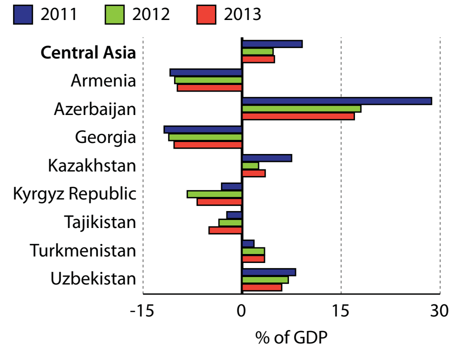
The *Update* raises inflation projections for Turkmenistan from 6.5% to 7.0% in 2012 and from 7.0% to 7.5% in 2013, reflecting ongoing and anticipated relaxation of price controls.

As energy exporters, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan generally maintain strong current account surpluses. The *Update* lowers Azerbaijan's projected surplus in both years because of slower oil production and a widening services deficit as foreign direct investment in the hydrocarbons sector spurs imports of services. Kazakhstan's projected surplus is revised upward in both years in light of strong oil export revenue and the current development of a new oil field. Uzbekistan's projected surplus in 2012 is now revised slightly lower, reflecting lower prices for export commodities.

The four energy-importing countries in the subregion suffer current account deficits, especially as less favorable prices for their export commodities discourage export growth. However, the current account deficits are narrower in the *Update* relative to the *ADO 2012* estimates for three energy-importing countries in both 2012 and 2013—for Armenia and Tajikistan largely because of anticipated lower import prices for fuel and increasing remittance inflows, and for Georgia in anticipation of ongoing real exchange rate adjustments and further strengthening in tradable sectors. On the other hand, the *Update* widens the 2012 current account deficit projection for the Kyrgyz Republic because of lower gold exports.

Central Asia's current account surplus is now projected to be 4.7% of GDP in 2012, up from the earlier forecast of 4.6%, and 4.9% in 2013, up from 3.9%, owing mainly to upgraded export forecasts for Kazakhstan (Figure 3.1.3).

**3.1.3 Current account balance, Central Asia**




*Source: Asian Development Outlook* database.

## Country highlights

### *Armenia*

GDP grew by 4.7% on an annual basis in the first quarter of 2012 on the back of solid growth in industry, services, and agriculture—and despite stagnant construction. On the demand side, private consumption and net exports were the main contributors to growth, while investment and public consumption shrank year on year in the first quarter of 2012. First quarter growth was higher than forecast in the *ADO 2012*, prompting upward revision of the growth forecast for the whole of 2012 to 4.3%. Trends in agriculture, industry, exports, and consumption remain broadly favorable, lifting the growth forecast for 2013 to 4.5%. This assumes that growth is not inhibited by weak economic prospects in Europe, which purchases 60% of Armenia's exports, and possible contagion from Europe enervating the Russian Federation, the origin of 80% of remittances.

Year-on-year inflation at 0.7% in June was well below the central bank's target band of 4% +/-1.5 percentage points. Average inflation fell to 2.2% in the first half of 2012, contained by agricultural recovery, moderating global food and commodity prices, and appropriate monetary policy responses. Forecasts for inflation nevertheless remain at 4.1% in

**3.1.1 Selected economic indicators, Armenia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.8 | 4.3 | 4.2 | 4.5 |
| Inflation | 4.1 | 4.1 | 4.5 | 4.5 |
| Current acct. bal. (share of GDP) | -11.2 | -10.2 | -10.0 | -9.8 |

*Source:* ADB estimates.

2012 and 4.5% in 2013 because inflationary pressures could revive with the recent dram depreciation against the dollar and the likely impact of the drought on the world wheat market.

The budget deficit fell to 2.8% of GDP in 2011 from 5.0% in 2010, improving on the official target of 3.9%. The current account deficit narrowed to 10.9% of GDP in 2011 from 14.8% a year earlier because export growth outpaced that of imports. With anticipated further export growth, higher remittances, and improvements to the business environment, the current account deficit is expected to continue to decline. The forecasts for the current account deficit have therefore been narrowed to 10.2% of GDP in 2012 and to 9.8% in 2013.

### *Azerbaijan*

In the first half of 2012, GDP grew by 1.5% on an annual basis, up from 0.9% in the same period of 2011 but still anemic, primarily reflecting inefficient oil well operation. The continued contraction of oil production has dampened expectations for growth, despite government commitment to continue its ambitious social and infrastructure programs. Industry is likely to contract with reduced oil output. Growth in services (led by retailing, communications, and tourism), construction, and agriculture drove the non-oil economy up by 11.3% in the first half of 2012. Intensive construction in the first half of 2012 helped that subsector soar by 29.5% over the same period of 2011. Inefficient oil production nevertheless prompts the *Update* to revise the April forecast for growth in 2012 downward to 3.0%, while maintaining the 2013 forecast at 3.5%.

**3.1.2 Selected economic indicators, Azerbaijan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.1 | 3.0 | 3.5 | 3.5 |
| Inflation | 9.0 | 6.5 | 8.5 | 6.0 |
| Current acct. bal. (share of GDP) | 22.0 | 18.0 | 19.0 | 17.0 |

*Source:* ADB estimates.

Oil revenues in the form of transfers from the State Oil Fund of Azerbaijan continue to be the prime funders of the budget. The government increased budget revenues and expenditures at the midyear review, mainly to fund the reconstruction and rehabilitation of infrastructure damaged by the earthquake and flooding early in 2012.

Year-on-year inflation remained moderate in the first half of 2012 at 2.2%. Domestic prices are expected to increase during the year as rising incomes boost domestic demand. Planned salary increases will have inflationary effects for the rest of the year but should be offset by the central bank having maintained the refinancing rate. In addition, the continuing depreciation of the euro against the local currency will blunt inflationary pressure from imports, as the euro area accounts for 65% of trade turnover. The *Update* revises the *ADO 2012* inflation forecast down to 6.5% in 2012 and 6.0% in 2013.

The current account will remain in surplus throughout the forecast period. However, funding to develop oil and gas fields and construct oil refineries will come mainly from foreign direct investment. This will narrow the current account surplus, especially during the second phase of the Shahdeniz gas project. The *Update* therefore revises the *ADO 2012* forecast for the current account surplus in 2012 down to 18.0% of GDP, and in 2013 to 17.0%.

### *Georgia*

Georgia's high economic growth, estimated at 7.0% in 2011, continued in the first quarter of 2012, with GDP climbing by an estimated 6.8%. Growth was driven by government spending on infrastructure and public consumption in the run-up to parliamentary elections in the autumn of 2012 and by foreign direct investment. The fastest-growing sectors were construction at 26.3%, manufacturing at 20.4%, and financial intermediation at 16.7%. Growth in government consumption at 9.4% far exceeded growth in private consumption at 2%. The *Update* maintains growth forecasts at 6.0% in 2012 and at 6.3% in 2013, as the economic outlook remains favorable.

Inflation is expected to fall in 2012 to a rate below the government's target of 6%. The *Update* revises April's inflation forecast downward to 2.1% in 2012 but maintains the 2013 forecast at 6.2%.

The central bank gradually reduced the policy rate from 6.75% at the end of 2011 to 5.75% in June 2012, where it has since been maintained. Government stimulus spending poured excess liquidity into the banking system, driving up bank assets as long-term loans denominated in the local currency increased. Annual growth in the M3 money supply is expected to reach 22% in 2012. Nonperforming loans amounted to 7.9% of total loans as of the end of June 2012, down from 8.6% at the end of 2011.

The current International Monetary Fund (IMF) program requires the government to reduce the fiscal deficit from 3.6% of GDP in 2011 to 3.5% by the end of 2012. However, the deficit is expected to expand in 2012 because of higher-than-projected current and capital expenditures, coupled with an increase in the state-funded pension in September 2012.

The current account deficit deteriorated in the first quarter of 2012 to 11.2% of GDP. This reflected a widening merchandise trade deficit to 24.5% of GDP. The *Update* narrows the current account deficit forecasts to 11.1% of GDP in 2012 and 10.3% in 2013, in anticipation of ongoing real exchange rate adjustments and further strengthening of the tradable sectors.

The IMF's precautionary credit line (established in 2012) and current gross international reserves of $2.8 billion, equal to over 4 months of imports, help insulate the economy from exogenous shocks. According to the IMF's debt sustainability analysis, the ratio of public debt to GDP is considered sustainable over the long term.

**3.1.3 Selected economic indicators, Georgia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.0 | 6.0 | 6.3 | 6.3 |
| Inflation | 4.8 | 2.1 | 6.2 | 6.2 |
| Current acct. bal. (share of GDP) | -12.5 | -11.1 | -12.0 | -10.3 |

*Source:* ADB estimates.

### *Kazakhstan*

GDP grew by 5.6% year on year in the first quarter of 2012, down from 6.6% a year earlier. This reflected sluggish trade with and investment from the euro area and the United States. Growth has been sustained by domestic demand associated with the ongoing state-led program to develop industry, but projections of growth are now lowered to 5.8% in 2012 and 6.3% in 2013. The government aims to expand domestic demand through fiscal stimulus funded by the National Oil Fund in the coming years.

To strengthen the finance sector, the central bank eased the policy rate to as low as 5.5% and imposed ceilings on deposits, in response to an expansion of bank deposits and credits in the first half of 2012 that increased the M3 money supply by 6.7%. Banking problems persist, with the share of nonperforming loans rising from 35% at the end of 2011 to 37% at mid-2012.

Year-on-year consumer price inflation eased to 5% in the first half of 2012. Although, food prices are expected to rise in the second half of

**3.1.4 Selected economic indicators, Kazakhstan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.0 | 5.8 | 6.5 | 6.3 |
| Inflation | 6.5 | 6.0 | 6.8 | 6.3 |
| Current acct. bal. (share of GDP) | 1.0 | 2.5 | 1.0 | 3.5 |

*Source:* ADB estimates.

2012 as a severe drought affects the domestic grain harvest, the weaker local and global economic outlook will moderate inflationary pressure, and inflation is now projected to reach only 6.0% in 2012 and only 6.3% in 2013.

Prudent fiscal policy in the first half of 2012 now supports a projected budget deficit not exceeding 2.5% of GDP. Net external reserves increased by more than 10%, and National Oil Fund assets grew by almost 18% in the first half of 2012. Total external debt increased to $129.3 billion (67.6% of GDP) at the end of March 2012, but public sector debt remained low at less than 3% of GDP.

External trade remains robust despite the deteriorating global environment. The current account surplus slightly narrowed to $7.5 billion in the first half of 2012, but the trade balance for the full year is projected to be unchanged from 2011. Given strong oil export revenue, the current account surplus is now projected to increase to 2.5% in 2012 and to widen further to 3.5% in 2013, with production commencing in the Kashagan oil field.

### *Kyrgyz Republic*

GDP declined by 6.6% in the first half of 2012 because gold production, which accounts for half of industrial production, was much lower than in previous years and lower than expected earlier this year. The reasons were geological factors delaying access to a high-grade zone of gold deposits and a labor strike at the Kumtor mine in February. This dragged industrial output down by 31.6% year on year in the first 6 months of 2012, even as the rest of the industry sector grew by 8.2%. Agriculture grew by 1.2% and services by 7.5%, with construction gaining substantially to grow by 20%. In light of weak gold production and a poor grain harvest, GDP growth is now expected to be nil in 2012. Gold production is expected to recover in 2013, supporting GDP growth at 5.5%, as projected by the *ADO 2012*.

The medium-term development program aims for fiscal consolidation, but the fiscal position for January–May suggests that the budget deficit will widen slightly over the year, from 4.8% of GDP in 2011, with continued increase in expenditures on education, health care, and subsidized loans to farmers. The impact of low gold production on government revenues has been limited by a revenue-smoothing arrangement between the government and the Kumtor mining company.

Lower food and fuel prices held inflation to 0.9% in the first half of 2012. Poor grain production in the Kyrgyz Republic and Kazakhstan, a major supplier of wheat, has prompted expectation of higher inflation in the remainder of the year, but the rate of 4.1% for the whole of 2012 is still lower than the *ADO 2012* forecast. As the impact of lower grain production is expected to continue into 2013, the *Update* raises the 2013 inflation forecast to 8.1%.

The trade deficit widened in the first quarter, with imports expanding at 37% and exports shrinking by 11%. As low gold production weakens exports, the *Update* widens the forecast for the current account deficit to 8.3% of GDP in 2012 and maintains the projection of 6.8% in 2013 on the assumption that gold exports recover.

**3.1.5 Selected economic indicators, Kyrgyz Republic (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.0 | 0.0 | 5.5 | 5.5 |
| Inflation | 5.0 | 4.1 | 5.5 | 8.1 |
| Current acct. bal. (share of GDP) | -6.6 | -8.3 | -6.8 | -6.8 |

*Source:* ADB estimates.

### Tajikistan

At 7.4%, Tajikistan's GDP growth rate in the first half of 2012 was slightly higher than in the first half of 2011. Higher remittances meant that services continued to be the main driver of growth, expanding by 19.6% in the first half of 2012. Industry grew by 12.1%, reflecting an increase of more than 18.0% in mining and a 12.7% expansion in processing industry. Agriculture grew by 10.1%.

This *Update* revises upward the GDP growth forecast for 2012 to 6.5%, largely because remittances have been higher than expected. Industry looks set to continue robust growth in 2012 with further expansion in mining, processing industries, electricity generation, and the transmission of surplus electricity to Afghanistan. In addition, the National Bank of Tajikistan has opted for pro-growth monetary policy by lowering the refinancing rate and minimum reserve requirements. However, production of aluminum and cotton, Tajikistan's main export commodities, is likely to shrink in response to lower international prices. The 2013 GDP growth forecast is maintained at 6.0%.

Average inflation continued to abate from 12.5% in 2011 to 4.6% in the first half of 2012, mainly reflecting lower food prices. The exchange rate remained stable over the same period, moderating inflationary expectations, but duties and a market monopoly have kept prices for imported oil products high, and electricity tariff hikes have pushed up energy prices. Additionally, trade disruption and higher rail transport tariffs in Uzbekistan at the beginning of 2012 highlight risks to import prices. The authorities remain committed to maintaining prudent fiscal and monetary policies while staying open to intervention if inflationary pressures rise higher than expected. Anticipating lower fuel prices, the *Update* revises downward the inflation forecast for 2012 to 7.5% and for 2013 to 8.5%.

Exports shrank by 2.5% year on year in the first 6 months of 2012, mainly reflecting decreased exports of aluminum and cotton. Imports rose by 15.1% over the same period, powered by remittances. The anticipation of lower import prices for fuel and increasing remittance inflows prompt this *Update* to halve the projection for the 2012 current account deficit to 3.5% of GDP and trim the 2013 projection to 5.0%.

**3.1.6 Selected economic indicators, Tajikistan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.5 | 6.5 | 6.0 | 6.0 |
| Inflation | 8.5 | 7.5 | 9.0 | 8.5 |
| Current acct. bal. (share of GDP) | -7.0 | -3.5 | -6.5 | -5.0 |

*Source:* ADB estimates.

### Turkmenistan

Turkmenistan has continued to record high growth in 2012 driven by strong hydrocarbon exports and public spending. The global slowdown nevertheless shaves a percentage point from GDP forecasts, and growth is now expected to be 9.0% in 2012 and 8.0% in 2013.

Turkmenistan's socioeconomic development program for 2012–2016 stipulates large public investments over the medium term. The state budget for 2012 generates a small deficit as it directs 77% of expenditures to the social sector. However, the bulk of public investment under the socioeconomic development program is financed through extra-budgetary funds that aggregate most fiscal revenues from hydrocarbons.

Inflation is now expected to be 7.0% in 2012 and 7.5% in 2013, but the rates are largely determined by regulated prices. The government has increased domestic prices for certain types of goods and services such as bread and airline flights, both domestic and international.

**3.1.7 Selected economic indicators, Turkmenistan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 10.0 | 9.0 | 9.0 | 8.0 |
| Inflation | 6.5 | 7.0 | 7.0 | 7.5 |
| Current acct. bal. (share of GDP) | 3.4 | 3.4 | 3.4 | 3.4 |

*Source:* ADB estimates.

Strong gas exports, especially to the PRC, are projected in 2012 and 2013. Agreement was reached with the Government of the PRC in April 2012 to expand the pipeline network and annual operational capacity from 30 billion cubic meters at present to 65 billion by 2020. The current account balance is still expected to be 3.4% of GDP in 2012 and 2013.

### *Uzbekistan*

GDP grew by 8.1% in the first half of 2012, slightly above the 8.0% recorded a year earlier. This was driven mainly by services, which grew by 16.2% thanks to the robust performance of finance and communications. Meanwhile, retail trade grew by 8.6% on strong consumer demand buoyed by increases in remittances and wages, as the average monthly salary in the public sector rose by 19.4% in nominal terms. Industry registered 7.0% growth on the back of government-directed lending and tax preferences, still slipping considerably from rates achieved in recent years. Ongoing state housing construction and industrial modernization programs boosted construction, which grew by 8.6%. In contrast with Kazakhstan and the Kyrgyz Republic, favorable weather and abundant water lifted agriculture by 7.1%, its highest growth rate since 2006. The *Update* maintains the projected growth rates of 8.0% in 2012 and 7.9% in 2013, backed by continued public investment.

**3.1.8 Selected economic indicators, Uzbekistan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 8.0 | 8.0 | 7.9 | 7.9 |
| Inflation | 9.5 | 9.5 | 9.0 | 9.0 |
| Current acct. bal. (share of GDP) | 7.5 | 7.0 | 6.0 | 6.0 |

*Source:* ADB estimates.

Inflation in the first 6 months of 2012 was 3.4%, as reported by the government and well within official targets. Inflationary pressures from wage increases and remittances were offset by deteriorating export performance, the monetary authority's slower accumulation of net foreign assets, and lower import costs. The *Update* nevertheless maintains the *ADO 2012* inflation forecasts of 9.5% in 2012 and 9.0% in 2013 in consideration of increasing domestic demand, nominal exchange rate depreciation, and robust growth in the money supply.

The government reported a budget surplus of 0.2% of GDP in the first half of 2012. However, the consolidated budget surplus—including the Fund for Reconstruction and Development, which is outside the budget—is estimated at 3.5% of GDP. Gross fixed capital formation increased by 7.6% mainly through public investment, and foreign investment declined to $1.0 billion in the first half of 2012 from $1.4 billion a year earlier. In April 2012, the government adopted additional measures to improve the country's investment climate, including tax and customs exemptions.

Exports posted a small increase of 1% in the first half of 2012. However, imports are estimated to have increased by 12% in the first half of 2012, mainly to meet sustained demand from infrastructure development and housing construction programs. Based on these data, the forecast of the current account surplus is reduced to 7.0% of GDP in 2012 but the 2013 forecast of 6.0% is maintained.

# East Asia

## Subregional assessment and prospects

East Asia will continue to expand more rapidly than other subregions in both 2012 and 2013 but more slowly than forecast in April in the

*ADO 2012*. Continuing economic difficulties in the euro area and weak economic recovery in the US are severely suppressing demand for East Asia's manufactured exports, requiring forecasts of aggregate GDP growth in the subregion to be revised downward to 6.5% in 2012 and 7.1% in 2013 (Figure 3.1.4). These rates are substantially lower than growth achieved in 2010 and 2011. The GDP growth rate in the PRC has continued to decelerate in 2012, slowing in the first half to 7.8% year on year. Although such growth is rapid relative to that of other major economies, it is a significant slowdown from growth in 2010 and 2011. Weak external demand, particularly from Europe, was the primary cause of the slowdown, but both investment and consumption also grew more slowly than in the corresponding period of 2011.

As the PRC is the predominant economy in the subregion and a major trading partner for the other four—Hong Kong, China; Mongolia; the Republic of Korea; and Taipei,China—the slowdown in the PRC in the first half of the year affected performance across the subregion. Growth at 13.2% in Mongolia in the first half of 2012 was the highest recorded in Asia and the Pacific but was considerably below the rate achieved in the previous year, largely reflecting a slowdown in the growth of exports to the PRC. Exports in the first half of 2012 were 13% higher than in the previous year but in July were 18% lower. Agriculture, which is important in terms of employment and income, grew strongly, and there was also significant growth in the industry and service sectors.

The Republic of Korea also felt the slowdown in the PRC, as well as weakness in the US and in domestic demand. Growth measured 2.5% in the first half of 2012, well below the rates set in the previous 2 years. In Hong Kong, China, private consumption was the main driver of growth in the first half of the year, but investment and government consumption also contributed. Exports declined, and net exports subtracted from GDP growth, which was only 0.9% in the first half.

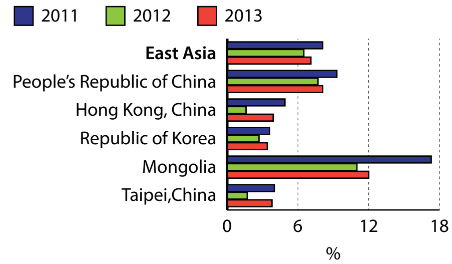
The global situation has had a large impact on the economy of Taipei,China. Private consumption expanded at a low rate in the first half of 2012, but investment declined and overall growth in GDP was just 0.1%.

The economy in the PRC is expected to grow in the second half of the year by 7.5%, supported by stimulus in the form of government expenditure on physical and social infrastructure. This should provide a more stable environment for other subregional economies, allowing growth in the second half of 2012 to be higher than in the first half for all but Mongolia, which will continue to be constrained by weak demand for minerals.

Developments in the global environment also require reduced growth forecasts for 2013. For the subregion as a whole the forecast is 7.1% growth, and, again, estimates are lowered for all five East Asian economies with the largest reduction for Mongolia, which is now projected to grow by 12.0%. GDP in the PRC is expected to grow by 8.1%.

Despite the introduction of stimulus measures and the easing of monetary policy, inflation in the PRC has declined steadily, reflecting bolstered supplies of foodstuffs. Inflation has also been low in Taipei,China but rose sharply in July and August because of damage to crops caused by heavy rainstorms. In Hong Kong, China, the rising consumer price index decelerated, largely because of declines in food

**3.1.4 GDP growth, East Asia**




*Source: Asian Development Outlook* database.

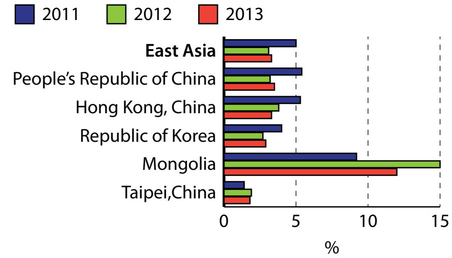
and housing prices but also because of electricity subsidies. Mongolia continues to experience relatively high inflation.

Inflation forecasts for all of 2012 are lower for the PRC and the Republic of Korea but unchanged for Mongolia and Hong Kong, China. For Taipei,China, the inflation estimate for 2012 is revised upward to accommodate damage to crops and an expected increase in electricity prices (Figure 1.3.5).

In 2013, global energy prices are expected to decline, but food prices are expected to increase. The expectation is that the subregion as a whole will see inflation pick up slightly from 2012 to 2013, reaching 3.3%. This estimate is, however, a downward revision from the forecast in the *ADO 2012*. By economy, inflation forecasts for the PRC and the Republic of Korea are reduced, for Mongolia and for Hong Kong, China unchanged, and for Taipei,China raised.

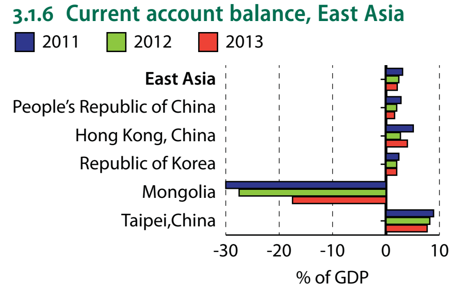
The forecasts of the current account balance in 2012 and 2013 for the subregion as a whole are slightly lower than those published in April. For individual countries, there is no change for the Republic of Korea and little change for the PRC or Taipei,China. However, the forecast of the current account surplus for Hong Kong, China is revised downward to 2.7% of GDP in 2012 and to 4.0% in 2013. The deficit forecast for Mongolia, the only East Asian economy that consistently has a current account deficit, is widened for both 2012 and 2013 (Figure 1.3.6).

**3.1.5 Inflation, East Asia**




*Source: Asian Development Outlook* database.

**3.1.6 Current account balance, East Asia**




*Source: Asian Development Outlook* database.

## Country highlights

### *People's Republic of China*

GDP growth slowed to 7.8% in the first half of 2012 from 9.6% in the same period a year ago. Weakening external demand, manifested as dwindling exports and moderation in domestic investment, were the major causes. Investment and consumption accounted for all growth in the first half of 2012, as net exports subtracted 0.6 percentage points from GDP growth.

The unfavorable global outlook affected trade flows. The value of external trade (imports plus exports) grew by 6% in the first 8 months of 2012, only a quarter of the 25% recorded in the same period of 2011. Exports declined following weak flows to Europe and emerging markets. Falling commodity prices and lower imports for processing are behind the lackluster import performance.

Agriculture was the only sector to experience higher growth. In the first 6 months of 2012, agricultural output increased by 4.3%, improving on 3.2% growth in the first half of 2011, primarily thanks to improved weather. Growth in services in the first half slowed to 7.7% from 9.2% a year earlier, driven down by sluggish real estate activity and modest consumption. Industry experienced the largest decline, with industrial output growth decelerating to 10.1% during the first 8 months of 2012 from 14.2% a year earlier. The weakness in manufacturing was reflected in the purchasing managers' index, a gauge of manufacturing activity, which fell to 49.2 in August, indicating that manufacturing in the PRC was contracting.

Inflation, as measured by the consumer price index, slowed in August to 2.0% from 4.5% in January, bringing average inflation in the first 8 months down to 3.0% from 5.6% a year earlier. Improved

**3.1.9 Selected economic indicators, People's Republic of China (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 8.5 | 7.7 | 8.7 | 8.1 |
| Inflation | 4.0 | 3.2 | 4.0 | 3.5 |
| Current acct. bal. (share of GDP) | 2.1 | 2.0 | 1.7 | 1.6 |

*Source:* ADB estimates.

supplies of vegetables and pork explained the contraction in food prices. The producer's price index has remained negative since March, reflecting sharper declines in commodity prices and less dynamism in the domestic market.

On the policy front, fiscal and monetary policies have both been countercyclical. Fiscal policy remained expansionary in line with government efforts to spur growth. In the first 8 months of 2012, government expenditure grew at 21.8%, doubling the 10.8% rate of revenue growth. Increased expenditure focused on education, health care, and social housing. Rapidly falling inflation has provided scope for easing monetary policy to support growth following months of monetary tightening in 2011.

Sluggish external demand compounded by a deceleration in domestic drivers of growth suggest that growth in all of 2012 will be lower than previously forecast. GDP growth in 2012 is now expected to be 7.7%, down from 8.5% in April. Domestic challenges and the volatile environment created by the global economic slowdown foretell growth in 2013 also slipping lower than earlier predicted. The revised estimate is 8.1%, down from the 8.7% forecast in April.

Fixed asset investment is projected to grow at about 20% and remain the major engine of growth in 2012, boosted by government efforts to accelerate large infrastructure projects earmarked in the 5-year plan. Rising wages, pensions, and consumption subsidies will support private consumption growth. On the external front, poor prospects in global markets suggest that export and import growth will remain subdued, such that net exports subtract from growth in 2012.

### *Hong Kong, China*

The continuing debt crisis in the euro area and weak economic recovery in the US have dampened growth in the small, open economy of Hong Kong, China. GDP grew by 0.9% year on year in the first half of 2012, compared with 6.4% in the same period of 2011. External trade was severely affected. Exports fell by 2.6% in the first half, reversing growth of 7.3% recorded a year earlier. In terms of value, the largest contractions in the first half were in exports to the euro area, India, and Taipei,China, while exports to the US, the PRC, and Japan grew moderately. Exports of services, which have traditionally been a bright spot in the local economy, decelerated to grow at only 2.3% in the first half of 2012, compared with 8.3% over the same period in 2011. Tourist spending, on the other hand, remained vibrant.

Domestic demand continues to sustain the economy. Private consumption expanded by 4.9% in the first half on the back of higher real wages. The volume of retail sales rose 9% in the first half, from higher sales of motor vehicles and parts and of miscellaneous consumer durables. Government consumption also intensified to grow by 3.0% in the same period, while investment spending grew modestly by 1.7%.

Inflation dropped from 6.1% in January to 3.7% in August, putting average inflation in January–August at 4.2%. Moderation in food and housing prices accounted for much of the decline. Changes in housing price indices averaged 6.9% in the first half of 2012, decelerating from 20.6% in 2011.

**3.1.10 Selected economic indicators, Hong Kong, China (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.0 | 1.6 | 4.5 | 3.9 |
| Inflation | 3.8 | 3.8 | 3.3 | 3.3 |
| Current acct. bal. (share of GDP) | 5.0 | 2.7 | 5.0 | 4.0 |

*Source:* ADB estimates.

The current account balance plunged in the first half of 2012 to a mild deficit equivalent to 0.4% of GDP, from a surplus of 6.1% in the same period of 2011. The reason was a bigger trade deficit that was not offset by surpluses in services and income.

Because of lower-than-expected output in the first half—and in anticipation of slower recovery in the euro area, US, and PRC—the GDP forecast for 2012 is halved to 1.6%. The authorities are expected to adopt countercyclical measures to keep the economy stable in 2012. For 2013, growth is seen picking up to 3.9%, a little more slowly than earlier forecast. The inflation forecast is unchanged, as tempered demand keeps prices stable despite renewed food price increases in the fourth quarter of 2012. The current account balance as a percentage of GDP is revised down to 2.7% for 2012 and to 4.0% in 2013.

### *Republic of Korea*

The slowdown in the economy of the Republic of Korea continued in the first half of 2012 with GDP growing by only 2.8% year on year in the first quarter—down from more than 4% in the first quarter of 2011 and more than 8% in the first quarter of 2010. Growth slipped further to 2.3% in the second quarter. The slowdown reflects the deteriorating global situation, which has had a predictably adverse impact on performance. The key negatives have been the slowdown in major export markets, particularly the PRC and the euro area, and the weak US recovery. In addition, growth has been dragged down by depressed domestic demand.

The decline in the manufacturing growth rate has continued. In the first quarter of 2012, manufacturing output was 4.1% higher than in 2011 and in the second quarter only 2.6% higher. The comparable figures for 2011 were 10.0% and 7.5%. In the first quarter of 2012, construction grew for the first time in more than 2 years, at 2.3%, but in the second quarter it once again declined, by 2.0%, reflecting continued sluggishness in the real estate market.

Weakness in construction has strongly influenced domestic demand. Although gross fixed investment was 4.6% higher in the first quarter than in the previous year, it declined in the second quarter by 2.1%. Private consumption has continued to grow, but the slowing trend that has been evident for the past couple of years continued in the first half of 2012. In the first quarter private consumption increased by 1.6% and in the second quarter by 1.1%. However, slack in investment and private consumption has been taken up in part by higher government expenditure, which increased by 4.7% in the first quarter—the highest rate in more than 2 years—and by 3.6% in the second quarter.

There has been a continuing weakening in the performance of the external sector. In the first quarter of 2012 exports grew by only 3.0%—only a tenth of the 29.6% growth recorded a year earlier—and in the second quarter they declined by 1.7%, reversing 18.6% growth in 2011. Weakness in exports is now expected to continue in the second half of 2012, given the problems in the euro area and uncertainty in the outlook for the economies of the US and the PRC. The trend in imports has been similar. In the first quarter of 2012, growth in imports was 7.7%, less than a third of the 26.3% recorded in 2011, and in the second quarter imports contracted by 2.6%, a reversal from 27.1% growth a year earlier.

**3.1.11 Selected economic indicators, Republic of Korea (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.4 | 2.7 | 4.0 | 3.4 |
| Inflation | 3.0 | 2.7 | 3.0 | 2.9 |
| Current acct. bal. (share of GDP) | 2.0 | 2.0 | 2.0 | 2.0 |

*Source:* ADB estimates.

The predictions for the current account balance in both 2012 and 2013 remain unchanged from April.

In response to the weak economic climate, the government introduced additional stimulus in September. Primarily aiming to increase domestic demand, measures reduced taxes on consumption and on the purchase of real estate. They further rationalized other taxes with the aim of increasing consumption expenditure. These measures have strengthened confidence, and international ratings agencies have raised the country's credit rating.

In light of the disappointing performance in the first half, the likely persistence of an unfavorable external environment, and depressed domestic demand, the GDP forecast for the Republic of Korea in 2012 is downgraded to 2.7%. Although the global outlook is still projected to improve in 2013, the Republic of Korea's GDP forecast is cut to 3.4%. These same factors will impinge on inflation, prompting the forecast for 2012 to be revised down to 2.7% and for 2013 to 2.9%.

### *Mongolia*

Worsening global economic conditions—in particular a surprisingly abrupt slowdown in the PRC, Mongolia's largest trading partner—have constrained exports, weakening economic growth and external balances. GDP growth slipped from 20.0% year on year in the fourth quarter of 2011 to 16.5% in the first quarter of 2012 and further to 11.0% in the second quarter. This left growth in the first half of 2012 at 13.2%, with agriculture expanding by 18.1%, services by 10.8%, and industry including mining and construction by 9.0%.

Although exports of goods and services in the first half of 2012 increased by 13.1% year on year, and imports by 21.6%, July 2012 exports were 18.3% lower than the July 2011 figure, and imports were 8.7% lower. During the first half of 2012, the current account deficit widened by 30% to $1.4 billion, while foreign direct investment grew by 2% to $1.9 billion.

The worsening economic environment is expected to continue to constrain demand for minerals, prompting a reduction in the GDP growth forecasts to 11.0% in 2012 to 12.0% in 2013. The current account deficit as a percentage of GDP is forecast to widen in both years.

Government spending growth has outpaced revenue growth, widening the fiscal deficit. Government expenditure was in nominal terms 53.4% higher year to date in July, with capital spending more than doubling, subsidies and transfers increasing by 50.9%, and wages and salaries up by 50.2%. Revenues, meanwhile, rose by only 20.1% in nominal terms in the first 7 months of 2012, mainly reflecting weaker growth in receipts from taxes on international trade and falling excise taxes, royalties, and dividends from mining. The withdrawal of customs tax on imported gasoline and diesel in May 2011, and of excise tax on these fuels the following November (leaving importers to pay only value-added tax), has eroded the tax base and undermined revenues. This has flipped the fiscal balance into a deficit of MNT574 billion in January–July from a surplus of MNT125 billion in the same period of 2011. (The budget deficit in 2011 was MNT391 billion, or 3.6% of GDP.) Budget estimates for 2012 report expenditure growth of 32% and revenue growth of 40%. A 2% structural deficit ceiling under the Fiscal Stability Law becomes binding

**3.1.12 Selected economic indicators, Mongolia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 15.0 | 11.0 | 17.5 | 12.0 |
| Inflation | 15.0 | 15.0 | 12.0 | 12.0 |
| Current acct. bal. (share of GDP) | -25.0 | -27.5 | -15.0 | -17.5 |

*Source:* ADB estimates.

in January 2013, but Mongolia will require substantial fiscal tightening in 2013 to achieve the target.

Inflation has been broadly in line with the forecast in *ADO 2012*, rising from 10.2% in January 2012 to 16.0% in April and falling back to 14.5% in July. As core inflation has been more stable in the range of 9%–11%, inflation forecasts are unchanged at 15.0% in 2012 and 12.0% in 2013.

Since the April release of the *ADO 2012*, the monetary policy rate has been raised by 0.50 percentage points to 13.25%. Tighter monetary policy explains why annual growth in commercial bank lending decelerated from 75% in November 2011 to 37% in July 2012.

### *Taipei,China*

The dismal global situation has continued to affect Taipei,China, which experienced growth of just 0.4% in the first quarter of 2012 and a decline of 0.2% in the second quarter. The major factor behind this slowdown is the performance of industry, which has been hurt by the decline in external demand for manufactured goods. Manufacturing, which provides approximately one-fifth of GDP, declined by 2.5% in the first quarter of 2012 and by 0.2% in the second quarter. July and August saw a slight increase in industrial production. Agriculture also declined in both the first and second quarter and was further affected by heavy rain in August, which severely damaged crops.

Uncertainty over global demand for information technology products has contributed to falling investment since the middle of 2011. Investment declined by 10.2% in the first quarter of 2012 from a year earlier and by 5.2% in the second quarter. This largely reflected the fall in private sector investment, but public sector investment also fell sharply. Despite improved employment, consumer confidence continued to decline, real wages stagnated, and private consumption expanded by a mere 1.4% in the first quarter of 2012 and by 0.8% in the second quarter.

Weak external demand caused a 5.6% contraction in exports in the first 8 months of the year. Imports also declined, by 5.7% over the same period, with reduced imports of agricultural products, raw materials, and capital goods.

In light of disappointing performance in the first half, and expectations of a slow upturn for the electronics industry, GDP is now expected to expand by only 1.7% in 2012. As the world economy recovers, external trade is expected to climb back and growth to be restored in the first half of 2013. These improvements will not be sufficient, however, to lift growth to the rate forecast in April. The growth projection for 2013 is reduced to 3.8%. Forecasts for the current account surplus are also revised to 8.2% in 2012 and 7.7% in 2013, in line with the trend in external demand.

Subdued demand has kept inflation low, and for the first 8 months of 2012 the average increase in the consumer price index was 1.8%. However, damaging rainstorms in August pushed up the price of vegetables and fruits, leaving the central bank less room to cut policy interest rates. The damage to crops and expected increases in electricity prices in the second half of the year will create upward pressure on domestic prices. The forecast for inflation is therefore revised up to 1.9% for 2012 before moderating to 1.8% in 2013 as global oil prices stabilize.

**3.1.13 Selected economic indicators, Taipei,China (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.4 | 1.7 | 4.6 | 3.8 |
| Inflation | 1.5 | 1.9 | 1.6 | 1.8 |
| Current acct. bal. (share of GDP) | 8.1 | 8.2 | 7.9 | 7.7 |

*Source:* ADB estimates.

# South Asia

## Subregional assessment and prospects

Economic growth in South Asia is under pressure from the continued weakening of the global economic environment and tight monetary policies adopted to rein in domestic inflation. Weak external demand has meant that monthly exports from most countries by mid-2012 were lower than a year earlier, placing downward pressure on both manufacturing and services. The late monsoon in June and July 2012 significantly disrupted crop sowing and will constrain agricultural production in India and Nepal, while drought in parts of Sri Lanka will curtail agricultural output and has caused cuts in hydropower generation. Systemic power shortages remain a major issue, particularly in Bangladesh, India, Nepal, and Pakistan, adversely affecting business conditions and economic growth, while restricting investment activity and adding to inflationary pressures.

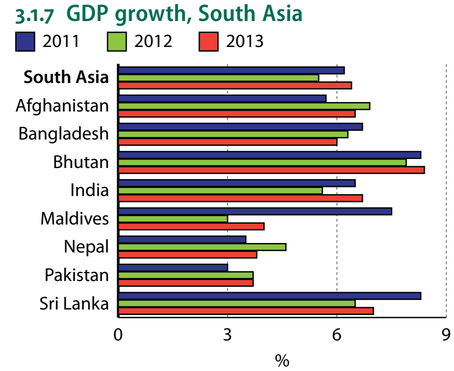
This *Update* revises growth forecasts slightly higher for Bangladesh, Nepal, and Pakistan, which have completed their fiscal years and so have available preliminary national accounts estimates. Bangladesh performed slightly better than expected despite weaker exports, underpinned by strong growth in small-scale manufacturing and construction, a recovery in remittance growth, and healthy credit flows. In Nepal, a favorable harvest and higher tourist arrivals and worker remittances supported a favorable outcome. Pakistan's economy recovered from the FY2011 floods with better performance in agriculture, which eased food prices, and a marked pickup in construction, mainly reflecting the rehabilitation of flooded areas.

The *Update* revises down the GDP growth forecasts for Afghanistan, Bhutan, India, the Maldives, and Sri Lanka. Afghanistan's slightly slower growth is due largely to weaker exports and the first impact of phased military withdrawal. In Bhutan, the construction of large hydropower projects will continue to drive very rapid growth, but measures to deal with short liquidity in Indian rupees and high inflation are expected to trim consumer spending and economic growth. In the case of India, a weaker external environment and a late monsoon added to the economic slowdown caused by tight monetary policy targeting persistently high inflation, proliferating subsidies that sustained a large budget deficit, and difficulties in achieving political consensus on how to tackle impediments to growth. In the Maldives, weaker than expected tourist arrivals and recent political unrest suggest softer growth. In Sri Lanka, economic growth is now expected to be slower than projected in April owing to drought, weaker external demand, and monetary tightening to address persistent inflation.

Projections for aggregated GDP growth in South Asia are revised downward to 5.5% in 2012 from 6.6%, and to 6.4% in 2013 from 7.1% (Figure 3.1.7). These revisions mainly reflect downward revisions for India, which accounts for four-fifths of South Asian GDP.

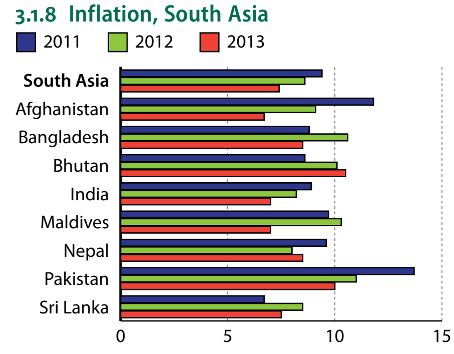
Inflation continues to be a major concern for South Asian economies. It keeps central banks from easing monetary policy to bolster domestic demand and counter the slowing pace of growth. While inflation is expected to ease in Afghanistan, India, Nepal, and Pakistan in 2012 from a year earlier, it remains high, as it is in the rest of the subregion. The main drivers behind persistently high inflation are overly expansive

**3.1.7 GDP growth, South Asia**




*Source: Asian Development Outlook* database.

**3.1.8 Inflation, South Asia**




*Source: Asian Development Outlook* database.

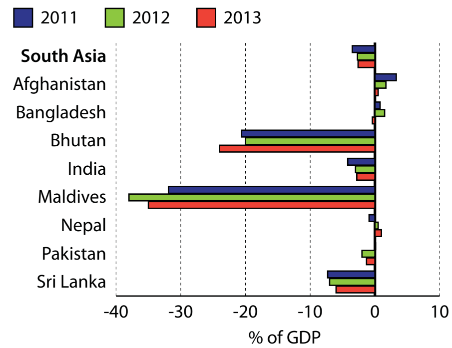
fiscal policies, some upward adjustments in administered domestic fuel and electricity prices to contain large subsidies, currency depreciation, and agricultural factors. The depreciation of domestic currencies across the South Asian subregion kept reductions in international prices for some commodities from being fully transmitted into domestic prices and, in some countries, placed further upward pressure on prices. A widening trade deficit caused by softening external demand for exports is partly responsible for the weakening of local currencies and the resultant high inflation.

This *Update* revises inflation projections from 7.7% to 8.6% in 2012 and from 6.9% to 7.4% in 2013, reflecting stronger-than-expected inflationary pressures in most South Asian countries (Figure 3.1.8).

South Asia's overall external position is forecast to improve in 2012. Slower growth in the global economy has depressed merchandise exports. Imports are weakening at a similar pace—reflecting weaker investment and growth, as well as relatively stable global commodity prices—but doing so from a larger base. Sustained, strong inflows of remittances to Bangladesh, India, Nepal, Pakistan, and Sri Lanka, as well as recovering tourism receipts in Bhutan, Nepal, and Sri Lanka, will help to bolster current account balances in these economies.

With almost all countries showing improvement or no change in their current account balances, the overall South Asia current account deficit as a share of GDP has improved. The projected deficits are revised from 3.1% of GDP to 2.7% in 2012 and from 2.9% to 2.6% in 2013 (Figure 3.1.9).

**3.1.9 Current account balance, South Asia**




*Source: Asian Development Outlook* database.

## *Afghanistan*

Economic growth slowed to 5.7% in FY2011 (ended 20 March 2012), mainly because of a sharp decline in agricultural output resulting from prolonged drought. Private consumption continued to be the main driver of growth, underpinned by high aid inflows, expenditures on security, and strong construction spending. Gross domestic investment declined to 25.3% of GDP in FY2011 from 26.5% a year earlier, mainly from a decline in public sector investment.

GDP is now projected to rebound and grow by 6.9% in FY2012 if a good harvest occurs as expected. However, growth is forecast to ease to 6.5% in FY2013 in view of the falloff in spending by foreign security forces as they gradually withdraw from the country. Revised forecasts see inflation brought down from 11.8% in FY2011 to 9.1% in FY2012 and then to 6.7% in FY2013, reflecting moderation in international commodity prices and a planned tightening of monetary policy. Estimates for the current account balance (including grants) are revised to surpluses of 1.7% of GDP in FY2012 and 0.5% in FY2013, on anticipated greater retention of domestic earnings from aid and security expenditures.

To help Afghanistan chart its future and assume full responsibility for security after 2014, development partners at the July 2012 International Tokyo Conference pledged $16 billion for development activities through 2015.

**3.1.14 Selected economic indicators, Afghanistan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.1 | 6.9 | 5.8 | 6.5 |
| Inflation | 4.6 | 9.1 | 5.0 | 6.7 |
| Current acct. bal. (share of GDP) | -1.1 | 1.7 | -2.5 | 0.5 |

*Source:* ADB estimates.

## *Bangladesh*

As officially estimated, GDP grew by 6.3% in FY2012, close to the *ADO 2012* projection of 6.2%. While export growth slowed sharply, private consumption held up well, supported by a recovery in remittance growth and healthy credit flows. Agricultural growth slowed to only 2.5% because of higher production costs, mainly from higher power, fuel, and fertilizer prices. Industry grew robustly by 9.5%, boosted by construction and small-scale manufacturing for the domestic market. Service sector growth stood at 6.1%. Electricity and gas shortages continued to hamper economic activity and discourage investment.

For FY2013, the *Update* retains the *ADO 2012* projections for growth (6.0%) and inflation (8.5%) but slightly narrows the projected current account deficit to 0.4%. Growth in garment exports is expected to be modest, but remittances will grow substantially as more workers leave for jobs in the Middle East.

As part of an economic program to adjust policies and make available additional external support, an extended credit facility from the International Monetary Fund aims to enhance macroeconomic stability, strengthen the balance of payments, and support faster and more inclusive economic growth. Under the program, and in line with Sixth Five-Year Plan priorities, the authorities are expected to follow more effective monetary and fiscal policies, initiate actions to expand fiscal space, stem reserve losses, streamline the finance sector, generate additional resources for boosting spending on the infrastructure and social sectors, address power shortages, and adopt policies that encourage investment and trade toward creating more jobs in producing exports.

**3.1.15 Selected economic indicators, Bangladesh (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.2 | 6.3 | 6.0 | 6.0 |
| Inflation | 11.0 | 10.6 | 8.5 | 8.5 |
| Current acct. bal. (share of GDP) | -0.5 | 1.5 | -1.0 | -0.4 |

*Source:* ADB estimates.

### *Bhutan*

Economic growth is expected to remain close to its long-term average of 8.5%. As in the past, construction on large hydropower projects will continue to be the main driver of the economy. India is the major market for and financier of Bhutan's hydropower sector. The service sector is expected to become firmer, however, owing to the increasing importance of tourism to the economy. Data from the Royal Monetary Authority (RMA) indicate that both the number of tourists and tourism revenues have improved by significant margins.

Though capital grants and loans have kept the overall balance of payments within positive territory, at 2.5% of GDP in FY2011, the current account deficit notably widened to 23.9% of GDP in FY2011 from 9.9% a year earlier, owing to a wider trade deficit with India. Consequently, the net Indian rupee balance available at the RMA fell to negative Rs9.2 billion as of early June 2012. The shortfall led the RMA to resort to a number of controls since the first quarter of 2012, including trade controls on selected import items. Notable among the controls is the government's conscious effort to curb imports of goods for housing construction and personal transportation, as they were seen to have significantly contributed to the trade deficit. The *Update* retains the forecast of the current account deficit at 20.0% of GDP in FY2012 and revises the FY2013 forecast from 22.2% to 24.0%, to account for the start of construction on six new power projects.

**3.1.16 Selected economic indicators, Bhutan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 8.0 | 7.9 | 8.5 | 8.4 |
| Inflation | 7.3 | 10.1 | 6.5 | 10.5 |
| Current acct. bal. (share of GDP) | -20.0 | -20.0 | -22.2 | -24.0 |

*Source:* ADB estimates.

The effect of the rupee shortfall and reduced availability of imports was felt in prices. Quarter-on-quarter inflation climbed sharply in the second quarter of calendar 2012, a likely result of trade controls on selected commodities, the lagged transmission of the price increases in

India, and rising local demand for goods as growth in personal income remains buoyant. In light of this, the inflation forecast is revised to 10.1% from 7.3% in FY2012 and to 10.5% from 6.5% in FY2013.

The rupee liquidity crunch is expected to affect economic activity through trade channels and bank revenues and become manifest as a softening of private construction and consumption. The *Update* marginally revises growth forecasts to 7.9% from 8.0% in FY2012 and to 8.4% from 8.5% in FY 2013. This is viewed as a short-term, minor setback, however, since major economic activities, such as the importation of hydropower-related goods, were spared government controls. Export revenue from plants under construction will, over time, relieve the liquidity crunch.

### *India*

Economic activity in the first quarter of FY2012 (ending 31 March 2013) grew by 5.5%, which again fell far short of potential and the strong performance of recent years. The downdraft began in FY2011, which saw a marked deceleration in each successive quarter that cut annual GDP growth in FY2011 to 6.5% from the 8.4% recorded in the prior 2 years. The slowdown has been concentrated in industry and driven by slumping investment, falling exports after September 2011, and an attendant weakening in personal income and consumer spending.

Inflation, which had stayed close to 10% for most of FY2010 and the first half of FY2011, has stabilized near 7% in 2012. The persistence in inflation was largely on account of higher prices for food, which reverted to near double digits after a brief respite. In contrast, a tight monetary policy and a slowing economy brought inflation for non-food manufactures (a proxy for core inflation) to near 5%.

The global slowdown markedly shrank merchandise trade in the first half of FY2012. Exports in the first 5 months fell by 6.7% from a year earlier despite a significantly weaker rupee. Imports also contracted by 6.6%, largely reflecting a sharp drop in gold and other imports excluding gold. While the surplus in services weakened along with the falloff in global demand, remittances continued to be healthy on account of liberalized interest rates for deposits.

For FY2012, the *Update* lowers the growth projections of *ADO 2012* to 5.6% due to continued weakness in the external environment, deficient monsoon rains in June and July, and the inability to ease monetary policy. The *Update* also raises inflation projections to 8.2% as poor weather is likely to spur food inflation. Finally, the current account deficit is expected to improve from the record level witnessed in FY2011.

A normal monsoon will help ease inflation to 7.0%, while somewhat improved growth in the advanced economies and some improvement in the investment climate is seen boosting GDP growth to 6.7% in FY2013, though this is less than projected in *ADO 2012*.

**3.1.17 Selected economic indicators, India (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.0 | 5.6 | 7.5 | 6.7 |
| Inflation | 7.0 | 8.2 | 6.5 | 7.0 |
| Current acct. bal. (share of GDP) | -3.3 | -3.0 | -3.0 | -2.8 |

*Source:* ADB estimates.

### *Maldives*

After political unrest in the first quarter of 2012, strains are evident in the run-up to a presidential election. The impact of the ongoing euro area crisis on tourism is worse than anticipated for the *ADO 2012*. The 2.8% year-on-year growth in tourist arrivals in January–July pales by comparison with the period's medium-term average of 10.0%, while tourist bed nights shrank by 1.0%, reversing 10.3% expansion a year earlier. Though there are more Asian visitors, they have not offset the loss in European traffic. These developments, along with concern over the swelling budget deficit, prompt lowering the GDP growth projection to 3.0% from 3.5% in 2012 and from 4.0% to 4.5% in 2013.

Consumer prices rose to 19.5% year on year in the fourth quarter of 2011, mainly owing to rufiyaa depreciation. Though inflation has eased, it averaged 15.7% through the first half of the year and remained elevated at 13.9% in July, reflecting high prices for fish and other foods. The inflation forecast is increased to 10.3% in 2012, moderating to 7.0% in the following year if elections go smoothly.

By the end of July, gross international reserves had dipped to $321.8 million, equivalent to only 2.5 months of import cover, reflecting the country's fragile external situation. The April forecast for the 2012 current account deficit is maintained at 38.0% of GDP, representing a large estimated deterioration from the deficit of 31.9% a year earlier. Improvement to 35% of GDP in 2013 is possible if tourism regains traction with better growth in Europe.

**3.1.18 Selected economic indicators, Maldives (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.5 | 3.0 | 4.5 | 4.0 |
| Inflation | 4.5 | 10.3 | 7.5 | 7.0 |
| Current acct. bal. (share of GDP) | -38.0 | -38.0 | -38.0 | -35.0 |

*Source:* ADB estimates.

### *Nepal*

GDP grew by 4.6% in FY2012 (ended in July 2012), up from 3.8% a year earlier. Good weather allowed a bountiful harvest, and robust increases in tourist arrivals and migrant worker remittances underpinned the recovery. Inflation moderated to 8.3% from near double digits in the previous year as food price hikes abated, but non-food inflation remained high, reflecting increases in the administered prices of fuels. Although banks' liquidity constraint eased, growth in credit was slow because there were few attractive investment opportunities. Political uncertainties continued, marked by the dissolution of the Constituent Assembly on 27 May without agreement on a new constitution. Revenue collection grew robustly, but there was under-spending on capital projects, reflecting limited implementation capability. The external position strengthened as remittances and tourism receipts offset a widening trade deficit.

In FY2013, GDP growth is expected to dip to 3.8%—falling below the *ADO 2012* forecast of 4.0%—as the late monsoon and fertilizer shortages undermine agriculture and as the inability to approve a budget for all of FY2013 creates fiscal drag. Remittance inflows and tourist arrivals will sustain expansion in services, but growth in industry will remain constrained by persistent power outages, sporadic fuel shortages, and long-standing structural bottlenecks and policy distortions.

Prices in FY2013 will be under pressure from needed upward adjustments to domestic fuel prices to limit losses at the Nepal Oil Corporation, and from continued high inflation in India mirrored in Nepal by the currency peg. The *Update* inflation forecast is raised to 8.5%. The current account balance is expected to improve moderately, as forecast in April.

**3.1.19 Selected economic indicators, Nepal (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.5 | 4.6 | 4.0 | 3.8 |
| Inflation | 8.0 | 8.3 | 7.0 | 8.5 |
| Current acct. bal. (share of GDP) | 0.5 | 0.5 | 1.0 | 1.0 |

*Source:* ADB estimates.

### *Pakistan*

The economy recovered modestly from severe floods a year earlier to grow by 3.7% in FY2012 (ended 30 June 2012). Agricultural growth picked up to 3.1%, markedly easing inflation. While the expansion of the service sector slowed slightly, its size meant it continued to account for most of GDP growth. Energy shortages intensified during the second half of the fiscal year, seriously crimping large-scale manufacturing, which expanded by only 1.2%. Unpredictable and severe load shedding is estimated to knock at least 2 percentage points off GDP growth annually. Investment declined for the fifth year in a row, dropping to 12.5% of GDP, compared with 22.5% in FY2007. Inflation slowed but only to 11%. The country's sustained double-digit inflation reflects the government's heavy borrowing from the State Bank of Pakistan to finance large budgetary spending and excessive deficits. In FY2012 the deficit was estimated at 8.5% of GDP, including government financing of power sector arrears. The current account deficit at $4.5 billion (2% of GDP), falling capital and financial inflows, and higher debt service payments drove official reserves down by $4.7 billion to $11.9 billion at the end of June 2012.

Macroeconomic imbalances and structural issues are expected to hold growth to 3.7% in FY2013, in line with the FY2012 outcome, as the energy shortage is expected to continue as a binding constraint throughout the year. Inflation is expected to remain at 10.0%, reflecting likely budget spillovers. Continued strong growth in remittances is expected to rein in the current account deficit to equal 1.3% of GDP.

Improving Pakistan's economic performance depends on taking difficult steps to address structural problems. Breaking out of recent doldrums crucially depends on the power sector becoming a reliable supplier of electricity so that there is incentive to substantially increase private investment. Most important for the breakout is to fundamentally improve the country's fiscal position by both eliminating subsidies and the drain on public finances imposed by loss-making state-owned enterprises, and to broaden the tax base to raise one of the lowest tax participation rates in the region, promote equity, and provide the revenues needed to fund necessary government functions.

**3.1.20 Selected economic indicators, Pakistan (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.6 | 3.7 | 4.0 | 3.7 |
| Inflation | 12.0 | 11.0 | 10.0 | 10.0 |
| Current acct. bal. (share of GDP) | -1.8 | -2.0 | -1.9 | -1.3 |

*Source:* ADB estimates.

### *Sri Lanka*

GDP growth remained high at 7.9% in the first quarter of 2012 owing to robust industrial expansion. It slowed markedly to 6.4% in the second quarter, however, dragged down by weak expansion in services at 4.5%, as import and export trade dropped sharply. In the first half of 2012, GDP growth was 7.2%. Trade continued to weaken in July with exports down by 17.4% from a year earlier and imports falling by 24.9%. Exports suffered from weakening external demand and lower prices, while the drop in imports reflected slowing domestic growth and currency depreciation. A poor monsoon has brought drought to some of the country's districts since March, which is affecting agricultural production and has hit hydropower generation.

Following energy price adjustments and monetary tightening in February and April 2012 that raised the repo rate by 50 basis points and then by 25 basis points, growth in domestic demand will slow in the second half of the year. Interest rates have gone up—the prime lending rate increased to 13.8% in August 2012 from 10.5% at the end of 2011—and credit to the private sector started to slow, though it was still high at 31.6% as of the end of June, against the central bank target of 18%. Industrial production is expected to

**3.1.21 Selected economic indicators, Sri Lanka (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.0 | 6.5 | 8.0 | 7.0 |
| Inflation | 8.0 | 8.5 | 7.0 | 7.5 |
| Current acct. bal. (share of GDP) | -6.4 | -7.0 | -6.0 | -6.0 |

*Source:* ADB estimates.

decelerate throughout the year owing to weak demand from Europe and the US, the main export destinations for garment exports.

Exports fell in the first 7 months of 2012 by 4.6% from a year earlier, while imports increased by 0.6%. Worker remittances and earnings from tourism have been buoyant and helped to offset the trade deficit that increased by 6.7%. This *Update* revises the projected current account deficit in 2012 upward to 7.0% of GDP. The $415.0 million final disbursement under an International Monetary Fund stand-by arrangement and a successful $1 billion sovereign bond issue in July 2012 pushed gross official reserves up to $7.1 billion at the end of July, covering about 4.2 months of imports.

Inflation picked up, reaching 9.5% in August 2012. Base effects from the energy price adjustment in February continue to keep the year-on-year inflation rate high. Currency depreciation of about 15% in the first 7 months of 2012 put further pressure on prices. Food inflation is higher than projected in the *ADO 2012* and is expected to trend higher as a result of drought in some parts of the country. This *Update* therefore revises forecast inflation higher by half of a percentage point in both 2012 and 2013 to 8.5% and 7.5%, respectively.

Monetary tightening will likely need to continue longer than earlier expected to address inflation. This will moderate the economic recovery predicted in April. If fiscal deficit and credit targets are to be met, expenditure and credit will need to fall sharply later this year, further braking economic growth. Against this backdrop, this *Update* reduces growth projections for the next 2 years to 6.5% in 2012 and 7.0% in 2013.

# Southeast Asia

## Subregional assessment and prospects

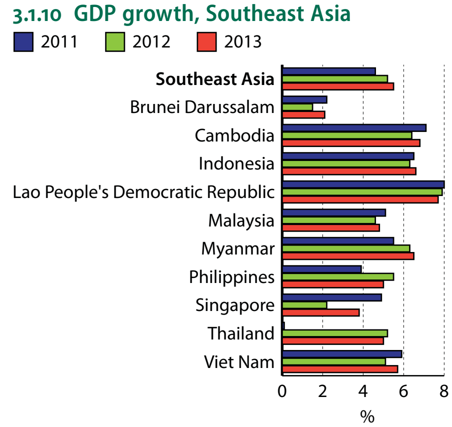
A rebound in Thailand from severe flooding in 2011 and a recovery in Philippine investment in infrastructure are driving stronger aggregate growth in Southeast Asia, as anticipated in April's *ADO 2012*. This is the only subregion expected to achieve higher growth this year than in 2011. Aggregate GDP for the 10 countries in Southeast Asia is forecast to accelerate to 5.2% from 4.6% last year (Figure 3.1.10).

While the forecast for higher subregional growth is unchanged from the *ADO 2012*, it masks expected slowing of growth in just over half the economies, as well as downgrades in their growth forecasts published in April.

Sizeable reductions are made to growth forecasts for Viet Nam, where policy tightening in 2011 to stabilize the economy subdued GDP growth into the first half of 2012, and for Singapore, a trade-dependent economy that is being buffeted by global headwinds that are stronger and more persistent than predicted. Brunei Darussalam is now expected to grow at a more modest pace in light of lower oil production in the first half of this year. Forecasts for Cambodia, Indonesia, and Thailand are lightly shaved from those in the *ADO 2012*, largely because the sluggish global environment is weighing on their exports.

Indonesia, the biggest economy in Southeast Asia, is still expanding by over 6%, propelled by a rise in investment, buoyant

**3.1.10 GDP growth, Southeast Asia**




*Source: Asian Development Outlook* database.

private consumption, and higher government spending that reflects improvements in budget execution. These factors largely offset softer exports this year.

Growth prospects for 2012 are upgraded for Malaysia and the Philippines, owing to unexpectedly strong domestic demand in both countries spurred by government spending. The forecast for Myanmar is edged up following policy changes that improved its outlook for investment and exports. That for the Lao People's Democratic Republic (PDR), which continues to benefit from expansion in mining and hydropower, is maintained from April.

Several factors contributed to suppressing Southeast Asia's economic growth in 2011, in addition to the severe floods in Thailand and the contraction in government spending in the Philippines. The March 2011 earthquake and tsunami in Japan disrupted global supply chains for several months, curbing manufacturing production notably in Malaysia, the Philippines, and Thailand. Further, the bigger economies tightened monetary policy in the first half of 2011 to combat inflation. This year, the impact of these constraints has faded, setting the stage, along with receding inflation and consequently lowered interest rates, for growth recovery.

In part to mitigate the impact of global headwinds in 2012, countries including Indonesia, Malaysia and Thailand adopted accommodative fiscal stances.

Strong growth in fixed capital investment is a welcome development this year in four of the bigger economies. In Malaysia, fixed capital investment surged by 21.3% in the first 6 months, in Indonesia it climbed by 11.2%, and solid increases were recorded in the Philippines (6.0%) and Thailand (7.7%). Governments in these countries have ramped up spending on infrastructure and improved the investment environment, although much more needs to be done on both accounts.

Private consumption, too, was buoyant in Indonesia (up by 5.0% in the first 6 months), Malaysia (8.1%), the Philippines (5.4%), and Thailand (4.1%). Drivers of consumption growth included increases in employment and incomes, government transfers and tax breaks, and, in the Philippines, remittances from overseas workers.

By contrast, exports have been lackluster in many Southeast Asian economies, stemming from unexpectedly weak demand from some major industrial economies and from slowdowns in the PRC and India. Lower global prices for export commodities have also dented export receipts.

Southeast Asia's GDP is forecast to edge up to 5.5% in 2013, in tandem with better growth projected for most major trading partners. Indonesia is expected to register 6.6%, its highest growth in 15 years. Nevertheless, forecasts for most subregional economies are trimmed from April, principally because the global pickup is now seen as more subdued. Myanmar's forecast for next year is raised slightly in light of the policy reforms already undertaken and in anticipation of further improvements that will pave the way for stronger development in that economy. The projections for 2013 published in the *ADO 2012* for the Lao PDR and the Philippines still stand.

In Viet Nam the government is turning its attention to strains in the banking system, notably an increase in nonperforming loans, that have curtailed credit and are a risk to the economic outlook if not addressed decisively.

Inflation has decelerated more quickly than anticipated in most of these economies, although it has been slow to recede in Singapore. Lower food price inflation has been an important influence, with better harvests in a number of Southeast Asian countries. Subdued global demand has exerted downward pressure on prices of many commodities. The postponement of price increases for subsidized fuel in Indonesia and Malaysia is suppressing their inflation, but at a high and rising cost to government budgets.

Compared with 2011, inflation is projected to slow in all countries this year, with the exception of Myanmar. Downward revisions to Indonesia's inflation forecasts, to 4.4% and 4.5%, play a role in lowering the projection for the subregion as a whole to 3.9% in 2012 and to 4.0% in 2013 (Figure 3.1.11). Viet Nam has tamped down inflation from very high rates—18.7% in 2011—to about 9% this year and is now expected to maintain single-digit inflation next year.

External current account surpluses are declining in Malaysia, the Philippines, Singapore, and Thailand, while deficits are widening in Cambodia, the Lao PDR, and Myanmar. Surpluses recorded last year by Indonesia and Viet Nam are seen turning to deficits in 2012, albeit relatively small ones. This reflects weaker-than-expected global demand for Southeast Asia's exports, lower prices for many export commodities, and relatively robust imports stemming from the expansion of investment. The projected subregional current account surplus in 2012 is revised to 3.0% of GDP (maintaining a downward trend since 2009), and to 3.2% in 2013 (Figure 3.1.12). Thailand is seen joining the deficit countries next year when it is likely to accelerate imports of capital goods.

## Country highlights

### *Indonesia*

The economy grew by 6.3% year on year in the first half of 2012, driven by buoyant consumer spending, a rise in fixed capital investment, and higher government spending. Fixed investment showed the biggest increase in 4 years. Stronger domestic demand largely offset external weakness as exports sagged while imports of capital equipment stayed firm.

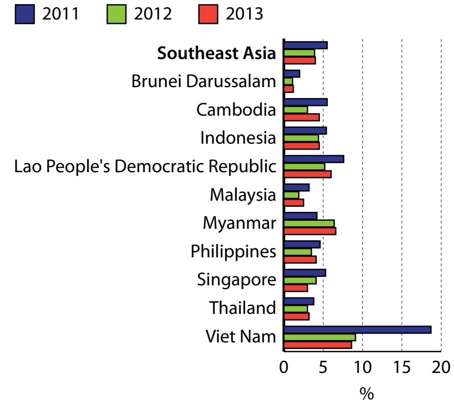
Growth in investment is expected to be sustained through the forecast period by the improved business climate, growth in bank credit, lower interest rates, and the development of infrastructure. Private consumption will continue to benefit from growth in employment, moderate inflation, and reduced income tax. Merchandise exports are seen stabilizing during the second half of this year and trending up in 2013.

GDP is forecast to grow by 6.3% this year and to pick up in 2013, though these projections are trimmed from those in April's *ADO 2012* owing to the downgrade in the global outlook since then.

With good harvests and the postponement of price rises for subsidized fuel, average inflation in 2012 may be the lowest in 12 years. Inflation forecasts are lowered from those in the *ADO 2012*.

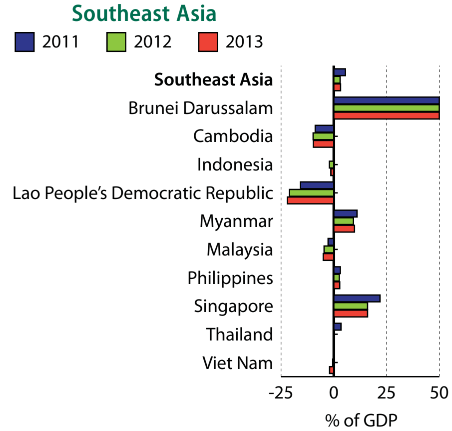
A shrinking trade surplus and deficits in income and services together produced a current account deficit equivalent to 2.3% of GDP in

**3.1.11 Inflation, Southeast Asia**




*Source: Asian Development Outlook* database.

**3.1.12 Current account balance, Southeast Asia**




*Source: Asian Development Outlook* database.

**3.1.22 Selected economic indicators, Indonesia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.4 | 6.3 | 6.7 | 6.6 |
| Inflation | 5.5 | 4.4 | 5.0 | 4.5 |
| Current acct. bal. (share of GDP) | -0.1 | -2.1 | 0.2 | -1.4 |

*Source:* ADB estimates.

the first 6 months. The deficit for the year as a whole will be deeper than anticipated in April, and a deficit now is projected for 2013.

### *Malaysia*

A surge in fixed investment and brisk consumption spending, both benefitting from fiscal stimulus, propelled unexpectedly high economic growth at 5.1% in January–June 2012. Investment in fixed capital accelerated at just over 21%, contributing more to GDP growth than did private consumption. Both private and public sector investment climbed.

Private consumption was supported by growth in employment and incomes, supplemented by cash transfers from the government. The external sector was a drag on growth because of lackluster demand for exports coupled with rising imports of capital equipment and consumer goods.

Growth is expected to moderate in the second half of 2012 as external drag intensifies. Nevertheless, the forecast for full-year growth is raised to 4.6% to accommodate sustained strength in domestic demand. Next year, growth is projected to edge higher as the global recovery picks up, though the forecast for Malaysia is pared from the *ADO 2012* because the global recovery is now projected to be more subdued.

Decelerating food and fuel prices brought inflation down to just 1.4% year on year in August, a steeper decline than anticipated. Further economic growth next year and the introduction of a minimum wage in January will put some upward pressure on prices, but forecasts for inflation are lowered.

Exports will likely stay soft this year, recovering to some degree in 2013 as world trade picks up. Imports are projected to maintain a steady upward rise. Current account surpluses will be substantial but below those forecast in April.

**3.1.23 Selected economic indicators, Malaysia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.0 | 4.6 | 5.0 | 4.8 |
| Inflation | 2.4 | 1.9 | 2.8 | 2.5 |
| Current acct. bal. (share of GDP) | 12.1 | 9.3 | 11.9 | 9.8 |

*Source:* ADB estimates.

### *Philippines*

This economy grew by 6.1% in the first half of 2012, a stronger pace than forecast in the *ADO 2012*. The expansion was broadly based, coming from buoyant private consumption, higher fixed capital investment, and positive net exports. A rebound in government spending from relatively low levels in 2011 was an important factor in strong growth performance in the first half.

In view of the performance so far this year, and taking into account more moderate expansion expected for the second half, the GDP growth forecast is revised up to 5.5%. The forecast for next year is kept at 5.0%.

Upgrades in indicators of competitiveness and sovereign ratings reflect an improved investment environment. Progress on the government's public–private partnership projects has been slow, however.

Inflation ebbed to 3.2% in July, a percentage point lower than at the end of 2011, even with the uptrend in domestic demand. The forecast for inflation this year is trimmed to 3.5%. Sustained growth in domestic demand in 2013, together with higher prices for imported food, will push inflation up enough to keep the April forecast of 4.1%.

Current account surpluses are projected for both years, generated largely by remittances from overseas Filipinos climbing by 5.3% to

**3.1.24 Selected economic indicators, Philippines (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.8 | 5.5 | 5.0 | 5.0 |
| Inflation | 3.7 | 3.5 | 4.1 | 4.1 |
| Current acct. bal. (share of GDP) | 2.1 | 2.6 | 2.3 | 2.8 |

*Source:* ADB estimates.

$11.3 billion in the first half of 2012 and receipts from business process outsourcing, whose revenue rose to $11.0 billion in 2011 and is expected to increase by 20% annually through 2016.

### Singapore

Economic growth of 1.7% in the first 6 months of 2012 was more subdued than expected. From April to June the trade-dependent economy shrank by 0.7% on an annualized quarter-on-quarter basis. This contraction largely reflected a decline in export-oriented electronics manufacturing and weakening services. Financial services were hurt by heightened risk aversion in global financial markets, and tourism-related services sagged. Wholesale and retail trading fell in the first half, reflecting weaker external demand and a slowdown in retail sales.

Signaling a subdued outlook, the composite leading economic indicator declined in April–June on a quarter-on-quarter basis. Taking into account these developments, forecasts of GDP growth are lowered for this year and next.

Rising costs of housing and transportation kept inflation elevated at 5% year on year in January–June, before it eased to 3.9% in August. The labor market remained tight, with solid growth in employment and a low 2.0% unemployment rate at midyear. Growth in nominal wages slowed from 2011, though. From April, the monetary authorities allowed a faster appreciation of the Singapore dollar to contain imported inflation. The residential property market appeared to be cooling.

In light of persistent inflationary pressures in the first 6 months, forecasts for year-average inflation are raised from the *ADO 2012*.

Exports have tended to weaken as the year progressed. The current account surplus fell by 23% in the first half to $21.5 billion, equal to 16.3% of GDP. Current account surpluses will remain substantial through the forecast period, though smaller this year than projected in the *ADO 2012*.

**3.1.25 Selected economic indicators, Singapore (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 2.8 | 2.2 | 4.5 | 3.8 |
| Inflation | 3.0 | 4.1 | 2.5 | 3.0 |
| Current acct. bal. (share of GDP) | 18.0 | 16.0 | 16.0 | 16.0 |

*Source:* ADB estimates.

### Thailand

Recovering from last year's damaging floods, the economy grew by 2.3% in the first half of this year, supported by fiscal stimulus and lower interest rates. Investment and private consumption rebounded from a steep drop late in 2011 when flooding disrupted the economy. However, exports were virtually flat compared with the first half of 2011 owing to sluggish export demand and the incomplete restoration of some factories damaged during the floods.

Domestic demand is projected to remain robust through the forecast period. Investment will be bolstered by government plans for public investment on flood prevention and water management funded by off-budget borrowing. Fiscal and monetary policies are expected to be supportive of economic growth.

External demand is weaker than anticipated in the *ADO 2012*, and the outlook for Thailand's major trading partners is downgraded from April in this Update. The economy is still expected to record solid growth in 2012 and 2013, but the forecasts are lowered mainly owing to external weakness.

During the floods prices rose for food and other goods temporarily in short supply. By August this year, inflation had abated to 2.7%, which was

**3.1.26 Selected economic indicators, Thailand (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.5 | 5.2 | 5.5 | 5.0 |
| Inflation | 3.4 | 3.0 | 3.3 | 3.2 |
| Current acct. bal. (share of GDP) | 0.5 | 0.1 | -0.5 | -0.1 |

*Source:* ADB estimates.

lower than anticipated. Inflation projections for the full year, as well as for 2013, are trimmed from those in the *ADO 2012*.

Forecasts of the current account are revised down a little owing to the weakness in exports. In addition to the soft demand for some manufactured exports, rice exports have slumped. A government program to support farmers by purchasing unmilled rice at prices above the market has reduced the competitiveness of Thai rice and left the government holding large stockpiles.

### *Viet Nam*

After tightening policies in 2011 to suppress inflation and stabilize the economy, the government has relaxed its fiscal and monetary stance this year to revive growth. Curbs on both credit and government spending dampened construction in particular last year, and that impact carried into 2012 when GDP growth slowed to 4.0% year on year in the first quarter.

Growth has picked up since then but the forecast for 2012 is lowered to 5.1% in light of the subdued performance in the first half and continuing sluggish expansion of credit. The pace of economic growth is seen stepping up to 5.7% in 2013 with policy easing and a modest pickup expected in external markets.

Declines in food prices and much lower credit growth brought down inflation from very high rates last year to 6.5% in September 2012. Inflation is expected to quicken in 2013 but to stay below double digits. Forecasts are lowered for this year and next owing to the suppression of price pressures this year and the downward revision for GDP growth next year—and assuming that government policy easing is at a prudent pace. The dong has stabilized this year within its official exchange rate band.

Stronger external accounts have enabled the central bank to rebuild international reserves to more comfortable levels. The current account deficit this year is projected to be narrower than anticipated in April because the export performance has been better than expected. Next year, the current account deficit is seen widening, albeit slightly less than projected in the *ADO 2012*.

The government has started to address risks in the finance sector that cloud the outlook. In July the central bank acknowledged that the percentage of nonperforming loans could be double the officially published figure of 4.5%. The government approved reform plans for the finance sector and for state-owned enterprises, but progress on them has been slow.

**3.1.27 Selected economic indicators, Viet Nam (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.7 | 5.1 | 6.2 | 5.7 |
| Inflation | 9.5 | 9.1 | 11.5 | 8.6 |
| Current acct. bal. (share of GDP) | -1.5 | -0.5 | -2.2 | -2.0 |

*Source:* ADB estimates.

## Other economies

### *Brunei Darussalam*

GDP grew by 2.2% in 2011, below the 2.9% estimate in the *ADO 2012*. Growth slowed significantly in the fourth quarter, mainly owing to a decline in crude oil output.

The oil and gas sector, which accounts for two-thirds of nominal GDP, remained subdued in the first half of 2012, while the economy outside this sector, comprising mainly government services funded by oil revenue, contributed to modest GDP growth estimated at 0.8%. Production of oil and gas is expected to pick up, but in light of the lower

**3.1.28 Selected economic indicators, Brunei Darussalam (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 2.6 | 1.5 | 3.2 | 2.1 |
| Inflation | 1.8 | 1.1 | 2.0 | 1.2 |
| Current acct. bal. (share of GDP) | 50.0 | 50.0 | 50.0 | 50.0 |

*Source:* ADB estimates.

production than expected in January–June, forecasts for full-year GDP growth are revised down to 1.5% for 2012 and to 2.1% for 2013.

Inflation has subsided more rapidly than expected, to 0.3% year on year in June, after an increase in excise tax drove inflation up in 2011. The inflation forecasts are lowered from those in the *ADO 2012*.

The value of merchandise exports rose by about 27% in the first quarter of 2012, propelled by high prices for crude oil, liquefied natural gas, and methanol. Imports surged by 33%, but the trade surplus nevertheless increased as the value of exports is more than four times that of imports. Exports, together with income from investments abroad, are expected to underpin strong fiscal and current account positions during the forecast period.

### *Cambodia*

Demand in Europe and the US for Cambodia's garment and footwear exports has softened this year, indicating that the industry sector will grow at a slower pace than anticipated in the *ADO 2012*. US imports of garments and footwear from Cambodia rose by 2.6% to $1.5 billion in the first 7 months of 2012, and imports to the EU increased by 20.9% to $798.0 million in the first 6 months, both decelerating sharply.

In agriculture, dry weather has hurt production in some provinces. By contrast, the outlook for construction is stronger than anticipated. Approved investment in construction jumped by almost 85% to $1.4 billion in the first 7 months. Bank credit for construction rose by 27% to $349.3 million by mid-year. Tourist arrivals jumped by 27% to 1.8 million in January–June. Other services to perform well included transport and finance (growth in bank credit was running at about 31% in June).

Taking these factors into account, together with downgrades in prospects for Cambodia's major trading partners, forecasts for GDP growth are edged down for both 2012 and 2013.

Inflation slowed from 5.8% year on year in January 2012 to 1.3% in July, brought down by more moderate price increases for food (particularly fish and pork) and fuel than in 2011. Forecasts for inflation are lowered for both this year and next.

Current account deficits are now expected to be wider than previously anticipated, in light of upward revision of the 2011 current account gap and the more softer export outlook. Gross official reserves increased by 6.6% to $3.2 billion in the first half, covering 4.3 months of imports of goods and services.

**3.1.29 Selected economic indicators, Cambodia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.5 | 6.4 | 7.0 | 6.8 |
| Inflation | 5.0 | 3.0 | 5.0 | 4.5 |
| Current acct. bal. (share of GDP) | -7.6 | -9.8 | -7.0 | -9.7 |

*Source:* ADB estimates.

### *Lao People's Democratic Republic*

Construction for mining, hydropower, and other projects continues to drive economic growth. The country's two biggest mining companies are expanding production capacity. The large Hongsa lignite thermal power project, several hydropower stations, and various projects in the capital city are under construction.

Agriculture is recovering from severe flooding in 2011. Irrigation systems have been repaired and the weather has generally been favorable for agriculture. Also, tourist arrivals rose by 17% to 1.8 million in the first half of 2012. However, US import data show that garment imports from the Lao PDR fell sharply in the first 7 months of 2012 while imports

**3.1.30 Selected economic indicators, Lao People's Democratic Republic (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.9 | 7.9 | 7.7 | 7.7 |
| Inflation | 6.7 | 5.2 | 6.0 | 6.0 |
| Current acct. bal. (share of GDP) | -21.0 | -21.0 | -22.0 | -22.0 |

*Source:* ADB estimates.

by the European Union were little changed in the first half from the year-earlier period.

Inflation decelerated from 7.7% year on year in December 2011 to 3.4% in August 2012, receding largely because of a better harvest of paddy rice, restrictions on rice exports, and moderating fuel price inflation.

GDP growth is still seen at 7.9% this year, easing in 2013 as some construction projects reach completion. The weaker global economic outlook and volatility in copper prices could dampen investment next year. Inflation is now forecast to average 5.2% this year, lower than in the *ADO 2012*. In 2013, higher world food prices are expected to contribute to a pickup in inflation.

Forecasts in April that the external current account deficits would widen are maintained, based on lackluster growth in export markets coupled with robust imports of capital equipment. Gross international reserves rose to $811 million in August, sufficient for 3 months of imports other than for resource development. The Lao PDR is expected to join the World Trade Organization by the end of this year.

### *Myanmar*

This economy is benefiting from investment in oil, natural gas, and power, as well as from growth in tourism, construction, and exports. The investment environment has improved following reforms to unify multiple exchange rates and as industrial countries ease their economic sanctions on Myanmar.

The kyat depreciated against the dollar to about MK870 in August 2012 from MK820 in April, largely the result of relaxed import controls to accommodate a government program to replace old vehicles. The depreciation improved prospects for a recovery in exports of garments, beans, pulses, and other goods that were hurt when the currency appreciated in the previous 2 years.

Tourist arrivals were particularly strong in the first half of this year, surging by 31% from the year-earlier period.

Forecasts for GDP growth in FY2012 (ending 31 March 2013) and FY2013 are edged up from April's *ADO 2012*. The current account deficit this year is projected to be narrower than previously anticipated, reflecting stronger export performance fueled by the weaker kyat and slightly higher receipts from natural gas exports to Thailand. Next year, the current account deficit is expected to widen when import licensing and foreign exchange controls are relaxed.

Forecasts for average inflation in both years are raised slightly from April. Rice prices are expected to increase owing to flooding in August 2012 in the Irrawaddy region and Shan State. Prices of electricity, water supply, and diesel are also likely to rise. Currency depreciation has slightly pushed up retail prices.

**3.1.31 Selected economic indicators, Myanmar (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.0 | 6.3 | 6.3 | 6.5 |
| Inflation | 6.2 | 6.4 | 6.3 | 6.6 |
| Current acct. bal. (share of GDP) | -4.8 | -4.6 | -5.0 | -5.0 |

*Source:* ADB estimates.

## The Pacific

### Subregional assessment and prospects

Growth in the Pacific subregion is projected at 6.0%, as in the *ADO 2012*, slowing by 1 percentage point from 2011. Despite declines in many international commodity prices during the year, 2012 growth projections are unchanged for the subregion's larger, resource-rich economies—Papua New Guinea, Solomon Islands, and Timor-Leste—because they continue to benefit from infrastructure development, other capital projects, and higher export volumes that offset any price declines.

The performance of smaller Pacific island economies in 2012 is mixed when compared with projections published in April in the *ADO 2012*. Growth in the Cook Islands and Samoa has fallen short of expectations, largely owing to capital expenditures proceeding at a slower pace than budgeted. Declines in remittances to Tuvalu, mostly from seafarers, and delays in implementing infrastructure projects in Vanuatu have prompted modest downgrades from 2012 growth projections for these two countries.

On the positive side, Fiji's growth prospects have improved, despite successive floods at the start of 2012. The better outlook reflects stronger growth in the mining sector and increased outlays from infrastructure projects funded by development partners. Economic growth in Palau also appears to be higher than initially projected because tourism has been stronger than expected.

The subregion is expected to be only indirectly affected by diminished global growth prospects for 2012 and 2013, while aggregate growth is projected to moderate to 4.2% in 2013 (Figure 3.1.13). This is largely driven by the scheduled completion of major infrastructure projects in the subregion's larger economies, rather than fallout from slower global growth. Overall, the outlook for the Pacific is relatively robust, although that would change if euro area economies deteriorate significantly or the growth outlook for the People's Republic of China (PRC) worsens substantially. As a key export market for Australia, the PRC influences growth in Australia, which, in turn, plays a large role in driving growth in many Pacific countries.

Inflation in the Pacific in 2012 is projected at 6.3%, slightly lower than forecast in April primarily because of downward revision of the projection for Papua New Guinea (Figure 3.1.14). This is about 2 percentage points lower than subregional inflation in 2011. Inflation is seen easing further in 2013, to 5.4%, owing to expectations of reduced pressure on prices in the subregion's three largest economies: Fiji, as prices elevated by flooding fall; Papua New Guinea, whose currency has strengthened; and Timor-Leste, as supply bottlenecks ease.

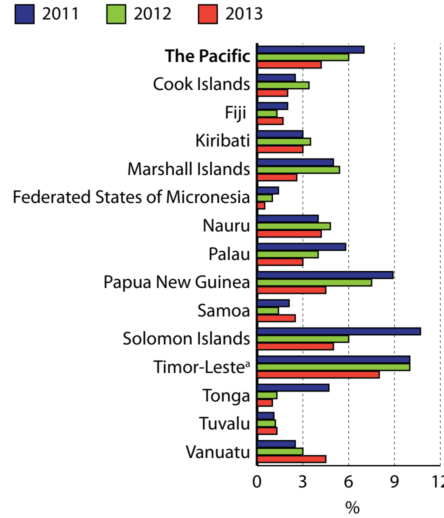
While most Pacific economies record current account deficits, income that Timor-Leste earns from offshore petroleum operations generates a current account surplus for that country large enough to lift the subregion as a whole into surplus. The current account is seen declining during the forecast period, then picking up when Papua New Guinea starts to export liquefied natural gas (Figure 3.1.15).

## Country highlights

### *Fiji*

Prospects for this year have improved since April, despite severe floods in the first quarter. Tourist arrivals increased by 3.7% year on year in the first 3 months of 2012, and gold production rose by 13.9% in the first 5 months.

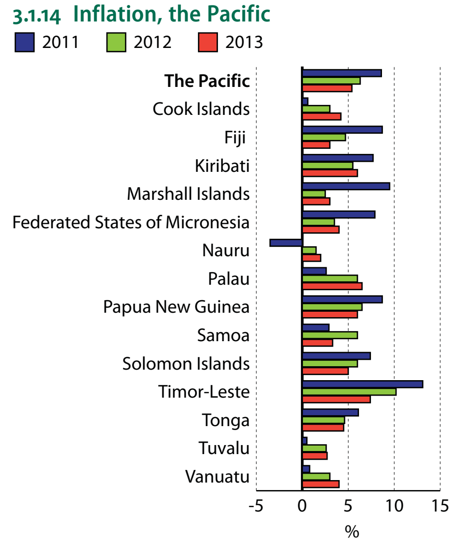
**3.1.13 GDP growth, the Pacific**




a non-oil GDP.

*Source: Asian Development Outlook* database.

**3.1.14 Inflation, the Pacific**




[a] non-oil GDP.

*Source: Asian Development Outlook* database.

**3.1.32 Selected economic indicators, Fiji (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 1.0 | 1.3 | 1.2 | 1.7 |
| Inflation | 5.1 | 4.7 | 3.0 | 3.0 |
| Current acct. bal. (share of GDP) | -9.6 | -9.6 | -11.6 | -11.6 |

*Source:* ADB estimates.

The GDP growth forecast for this year edges up to 1.3% on these plusses: the start of bauxite mining in Nawailevu, additional internationally funded construction, and flood recovery activities. These factors are expected to offset lower agricultural output caused by the floods.

GDP growth is forecast to accelerate to 1.7% in 2013 on the back of continued growth in construction, mining, and tourism.

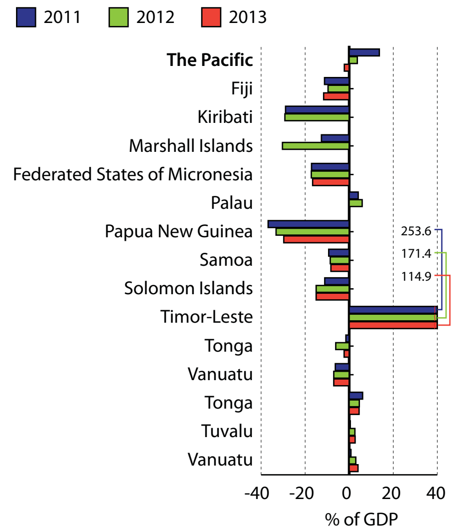
These forecasts take into account short- and medium-term challenges to fiscal sustainability, particularly those posed by growing government debt, which is estimated at 52% of GDP and could constrain public development spending and reduce growth prospects. External factors, particularly a slowdown in the PRC or a worsening economic situation in Europe, pose serious downside risks to these forecasts.

Business confidence and investment remain low, though improvements in Fiji's relations with some of its key development partners should lift prospects for private sector growth. Steps taken toward the new constitution and the 2014 national elections could catalyze spending and help make the country more attractive to investors.

Inflation averaged 5.1% in the first 8 months of 2012, easing from 8.6% a year earlier. Lower inflation was realized despite rises in food prices, particularly prices of locally produced fruits and vegetables, following the floods early this year. Declining commodity prices and controls on public sector wages are expected to drive inflation even lower. The forecast for inflation is revised down to 4.7% for 2012, and price pressures are seen moderating further in 2013.

The current account deficit is still expected to narrow to 9.6% of GDP in 2012, before widening to 11.6% next year as mining, post-flood reconstruction, and election-related spending stimulate demand for imports without a corresponding increase in government receipts or exports. As of August 2012, foreign reserves were sufficient for 5.6 months of imports, slightly lower than the 5.7 months at the end of 2011.

**3.1.15 Current account balance, the Pacific**




*Source: Asian Development Outlook* database.

## *Papua New Guinea*

The economy maintains strong growth driven by the construction of a $16 billion liquefied natural gas (LNG) project and high government spending. As the LNG project entered its peak development phase in 2012, the economy is seen growing by 7.5%, as forecast earlier. Commodity exports are expected to remain robust as global prices for gold, copper, and a number of agricultural products are high despite declines this year.

Growth is expected to moderate to 4.5% in 2013 as LNG facility construction winds down and on the expectation that crude oil production will fall by 17% next year. These developments will dampen government revenue and spending, as slowing mining and oil operations are expected to drive domestic government revenue, adjusted for inflation, down by 8% between now and 2014. Income from LNG exports will raise government revenues beginning in 2015, but overall revenue growth is nevertheless expected to remain slow over the medium term.

Inflation eased to 4.0% year on year in the first quarter of 2012, from 6.9% in the fourth quarter of 2011. For the year as a whole, inflation is now projected to average 6.5%, decelerating more sharply than was projected in the *ADO 2012* and driven by the kina's appreciation against

**3.1.33 Selected economic indicators, Papua New Guinea (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.5 | 7.5 | 4.5 | 4.5 |
| Inflation | 7.0 | 6.5 | 6.0 | 6.0 |
| Current acct. bal. (share of GDP) | -33.2 | -33.2 | -29.7 | -29.7 |

*Source:* ADB estimates.

the Australian dollar by 31%, and against the US dollar by 27%, since the beginning of 2011. The stronger kina has helped lower prices of imported goods, while monetary policy tightening by the Bank of Papua New Guinea has helped tame domestic inflationary pressures. Next year, inflation is expected to slow further, to 6.0%, as the winding down of construction on the LNG project further reduces demand pressures.

As construction is completed, 8,000 local workers employed on the LNG project will be laid off. Groups representing communities near project construction sites have highlighted the potential for social unrest in the absence of alternative employment. In addition, continued kina appreciation could depress incomes for the large rural population dependent on growing cash crops for export. Tax concessions offered to resource extraction projects reduce government revenue and constrain funding to address the country's large infrastructure and public service investment shortfalls. These developments carry serious implications for inclusive economic growth.

Official data show a current account deficit equivalent to 1.3% of GDP in the first quarter of 2012. Official figures largely exclude imports of capital equipment for new resource projects. Taking these imports into account, the current account is projected, as in the *ADO 2012*, to record deficits of about 30% of GDP in 2012 and 2013. Gross foreign exchange reserves have remained equivalent to 11 months of import cover. While current account deficits are generally viewed as indicating unsustainable macroeconomic balances, countries such as Papua New Guinea with substantial overseas liabilities have significant net factor payments, and historical experience shows large current account deficits being sustained with little harm to economic performance.

### *Timor-Leste*

Government expenditure, the primary driver of economic growth, has remained high on the back of stronger-than-expected public revenue from offshore petroleum production. Public spending rose by 18.0% to $620 million in the first half of 2012, an increase of 18.0% over the same period a year ago and equivalent to about 60% of annual nonpetroleum GDP (excluding the contribution to GDP from the petroleum sector). Of this spending, cash transfers accounted for $110 million, injecting significant purchasing power into the economy that benefitted mainly rural areas.

In view of this, the economy is still expected to grow by about 10% in 2012. The pace of expansion is seen easing to 8% in 2013, following a projected slowdown in government spending and planned completion of the United Nations peacekeeping mission and the International Stabilization Force by the end of 2012. The departure of these security forces is expected to directly reduce nonpetroleum GDP by 5% through its impact on local employment and consumption. However, outlays on a national electrification program and other major infrastructure upgrades suggest that government expenditure will continue to be a major contributor to growth over the medium term.

Inflation remained high, averaging 12.1% in the first 7 months of 2012, owing to shortages of key consumer goods and additional demand arising from midyear election spending. As price pressures are expected to

**3.1.34 Selected economic indicators, Timor-Leste (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 10.0 | 10.0 | 8.0 | 8.0 |
| Inflation | 10.2 | 10.2 | 7.4 | 7.4 |
| Current acct. bal. (share of GDP) | 229.4 | 171.4 | 153.7 | 114.9 |

*Source:* ADB estimates.

soften over the rest of this year, the 2012 inflation forecast is maintained at 10.2%. Next year, inflation is projected to decelerate to 7.4% as supply bottlenecks ease.

As in previous years, income from petroleum operations will drive large current account surpluses, equivalent to about 171% of nonpetroleum GDP this year and 115% next year. These forecasts are lower than in the *ADO 2012* because of revisions to national accounts data.

Spurring private sector development by creating a business-friendly environment remains a priority to deepen the economy and mitigate its current heavy reliance on government spending funded by petroleum revenue. A vibrant private sector would improve prospects for sustaining high growth rates over the long term, as well as help protect and augment recent improvements in the standard of living.

**3.1.35 Selected economic indicators, Solomon Islands (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.0 | 6.0 | 5.0 | 5.0 |
| Inflation | 5.5 | 6.0 | 5.0 | 5.0 |
| Current acct. bal. (share of GDP) | -15.0 | -15.0 | -15.0 | -15.0 |

*Source:* ADB estimates.

## *Solomon Islands*

Economic growth accelerated to 10.7% in 2011, exceeding the *ADO 2012* estimate of 9.3%. Expanded forestry output accounted for an estimated 42% of this growth, and mining for 16%. This expansion helped boost related sectors such as construction, transport, and communications. Agriculture and fisheries benefited from favorable weather and high commodity prices.

Growth forecasts are maintained at 6% for this year and 5% for 2013. During the first 5 months of 2012, forestry and mining continued the strong performances the sectors have recorded in recent years. The volume of log production increased by 12.5% on the same period last year and gold exports for the 5 months of 2012 matched production levels for all of 2011. The fish catch rose by 18%, but copra production declined by 7% and cocoa by 16% over this same period. GDP growth moderated from the 2011 level as the boost from the recommencement of gold production in April 2011 has dissipated.

Inflation abated from a 30-month peak of 10.8% in November 2011 to 7.9% in April 2012, brought down in large part by the central bank's revaluation of the Solomon Islands dollar against the US dollar from SI$8.02 to SI$7.36 in 2011 and the decline in the price of rice, which is the main staple and an important consumption item for poorer households. Nevertheless, the forecast for average inflation in 2012 is raised to 6% owing to wage hikes and an increase in the tax-free income threshold effective from January 2012. Both of these changes are expected to spur consumer demand and raise prices. The inflation forecast for 2013 remains at 5%.

Higher earnings from exports of logs and gold contributed to a trade surplus equivalent to 2.3% of GDP in the first quarter of 2012. Increased exports outpaced higher payments for imported food, fuel, and machinery, but currency appreciation is expected to dampen exports, encourage imports, and so erode the trade surplus. Forecasts of current account deficits are maintained from April.

## *South Pacific States*

Economic performance in the South Pacific economies of the Cook Islands, Samoa, Tonga, and Vanuatu in 2012 has failed to meet expectations, largely because of lower-than-budgeted spending on infrastructure development. The weak performance is occurring despite the relative resilience of tourist arrivals from Australia and New Zealand, which are the two main source markets for South Pacific destinations. Total tourist departures from Australia and New Zealand to the four countries each grew by about 4% in the first 7 months of 2012.

The Cook Islands GDP grew by an estimated 3.4% in FY2012 (ended 30 June 2012), falling short of the *ADO 2012* forecast of 5.4% mainly because public capital expenditure and tourist spending were both lower than projected. Nonetheless, the revised growth figure is nearly a percentage point higher than the growth achieved in FY2011.

Tourism accounts for roughly 65% of economic activity in the Cook Islands. Arrivals increased by 6.2% in the first 10 months of FY2012, supported in part by government underwriting of some flights, and net value-added tax revenue from accommodation grew by 11.7% through the third quarter of FY2012. However, net collection of value-added tax from wholesale and retail trade fell by 26.0% over the same period, suggesting that average spending per tourist declined.

The GDP growth forecast for FY2013 is lowered to 2.0%, reflecting expected softness in earnings from tourism.

Merchandise exports fell by 40.9% in the first half of FY2012 due mainly to a sharp drop of 34.6% in shipments of fresh fish. Imports fell by 11.4%, only a third as much, but because imports are 25 times exports by value, the trade deficit narrowed to $37.8 million from $47.2 million in the first half of FY2011. This deficit is equivalent to 13% of GDP.

Inflation in FY2012 is estimated at 3.0% and projected to rise to average 4.2% in FY2013, driven largely by lagged effects of higher fuel prices.

In Samoa, the economy decelerated more sharply than expected and is estimated to have grown by just 1.4% in FY2012 (ended 30 June 2012). This compares with 2.1% growth registered in FY2011. Factors contributing to the slowdown include the winding down of reconstruction following the tsunami of September 2009, and declining agriculture and fishery output caused by a weaker export market. Tourism accounts for roughly 25% of Samoa's economy, and over most of FY2012 visitor arrivals declined relative to a year earlier. However, arrivals picked up in the last 4 months of the fiscal year, drawn by discounted accommodation rates, such that total arrivals for the year were 3.7% higher. Tourist spending also increased at the end of the fiscal year, pushing up total tourism receipts by 8.5%. Celebrations of the 50th anniversary of independence provided some temporary economic stimulus.

Remittance inflows, which generate about a quarter of GDP, rose by 10% in the first 8 months of FY2012, with remittances from New Zealand, the US, Australia, and American Samoa all increasing. This bucks a broader subregional trend of lower remittances. A possible explanation is that Samoans working overseas are more likely than overseas workers from other island states in the subregion to be first-generation migrants and so remit a higher portion of their income. This growth is expected to stall from late 2012 owing to subdued growth prospects in New Zealand, the main host country for Samoan workers overseas.

GDP growth in FY2013 is projected at 2.5%, with development partner support for strengthened public financial management expected

**3.1.36 Selected economic indicators, Cook Islands (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.4 | 3.4 | 3.0 | 2.0 |
| Inflation | 3.0 | 3.0 | 4.2 | 4.2 |
| Current acct. bal. (share of GDP) | ... | ... | ... | ... |

*Source:* ADB estimates.

**3.1.37 Selected economic indicators, Samoa (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 2.5 | 1.4 | 2.4 | 2.5 |
| Inflation | 5.0 | 6.0 | 3.3 | 3.3 |
| Current acct. bal. (share of GDP) | -8.6 | -8.6 | -8.3 | -8.3 |

*Source:* ADB estimates.

to encourage investment. The outlook is subject to significant risks, particularly if global growth is weaker than assumed, which could spill over into Samoa through constrained remittances, tourism, and exports.

Fuel price increases in the first half of FY2012 pushed inflation to 6.0%, above the *ADO 2012* forecast. A glut of domestically harvested fruit and vegetables moderated inflationary pressures toward the end of the period. Inflation is projected to ease to 3.3% in FY2013. The current account deficit is still forecast to narrow slightly.

Tonga grew by an estimated 1.3% in FY2012 (ended 30 June 2012), which was better than previously estimated but down from 4.7% in FY2011. The slower growth was mainly due to the winding down of infrastructure projects financed by development partners. The government revised upward its estimates of growth for recent years, as it factored into national accounts the value of capital projects funded with in-kind assistance from development partners and returns from previously unmeasured public and private transport enterprises.

Growth in FY2012 was driven by grants and infrastructure projects with development partner funding, particularly loans from the PRC's export–import bank. Remittances, which account for some 20% of GDP, fell by 23.0% in the first 10 months of FY2012, as 80% of remittances come from Tongans in the US, where unemployment remains high. Further, about 40% of Tongan migrants in the US are in California, where the unemployment rate is higher than the national average. Tourism receipts fell by 7.9% through the first 3 quarters of FY2012, even as departures from Australia and New Zealand to Tonga increased. These contradictory trends could reflect shorter stays and price discounting by tourism operators.

In FY2013, growth is projected to slow to 1.0% with expected declines in infrastructure construction and continued weakness in the private sector. The downside risks to the growth estimate are the likely tightening of the fiscal situation and lower remittances, tourism, and exports because of continued weakness in global demand. Despite evidence of ample liquidity in the finance system and low interest rates, loans were down in July 2012 from a year earlier, to businesses by 18.9% and to households by 2.9%.

Inflation decelerated to 4.6% in FY2012 as import price declined following the appreciation of the pa'anga against the currencies of Tonga's major trading partners. For FY2013, inflation is expected to remain at about this pace. Forecasts of current account deficits are narrowed, in part owing to lower imports.

In Vanuatu, growth in the past 2 years has been revised down, largely because of lower estimates for construction and tourism, as well as lower prices for the key agricultural exports copra and coconut. Growth in 2010 has been revised to 1.5% from 2.2%, while 2011 growth has been revised to 2.5% from 4.3%. Domestic copra prices fell by a third in 2011, which depressed output and prompted the introduction of government subsidies to support prices.

The growth forecast for 2012 is lowered to 3.0% in light of continued weakness in export prices and the postponement of public works projects. Tourism has been a bright spot this year, as air arrivals rose by 16.3% in the first half of 2012, reversing a decline in 2011. The number of visitors

**3.1.38 Selected economic indicators, Tonga (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 0.4 | 1.3 | 0.2 | 1.0 |
| Inflation | 6.0 | 4.6 | 7.5 | 4.5 |
| Current acct. bal. (share of GDP) | -11.7 | -6.1 | -10.7 | -2.3 |

*Source:* ADB estimates.

**3.1.39 Selected economic indicators, Vanuatu (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.5 | 3.0 | 5.0 | 4.5 |
| Inflation | 3.0 | 3.0 | 4.0 | 4.0 |
| Current acct. bal. (share of GDP) | -6.3 | -7.0 | -6.5 | -7.0 |

*Source:* ADB estimates.

arriving in Vanuatu aboard cruise ships, mainly from Australia, has also been higher, increasing by 24.7% over the same period.

Foreign grants dropped by 45.7% in 2011, causing a comparable fall in development expenditure. Lower grants contributed to a budget deficit equivalent to 2.2% of GDP, more than three times the target, which was financed by domestic borrowing. To enable the financing of a general election in October 2012, and of Vanuatu's hosting of the African Caribbean Pacific/European Union Conference in June 2012, the 2012 budget incorporates a higher deficit target of 2.6% of GDP.

GDP growth is expected to pick up to 4.5% in 2013, once a number of construction projects commence.

Easier credit for businesses and election-related spending are expected to put upward pressure on prices, lifting inflation to 3% this year. Higher global food prices and domestic economic growth are seen generating inflation at 4% in 2013.

Current account deficits are projected to be wider than previously forecast, reflecting wider trade deficits. Vanuatu ratified its accession to the World Trade Organization in July 2012, which could prompt the government to seek new sources of tax income to offset reduced tariff revenue.

### *North Pacific States*

Infrastructure projects generally play key roles in driving GDP growth in North Pacific economies. They create opportunities for employment on construction crews and promise long-term benefits if the infrastructure is well planned and constructed. Recent growth in the Federated States of Micronesia (FSM) and the Marshall Islands has tracked the progress of infrastructure booms in these countries. Infrastructure upgrades will soon be needed in Palau to sustain tourist arrivals and economic growth.

The winding down of major public works projects slowed GDP growth in the FSM to an estimated 1.0% in FY2012 (ended 30 September 2012). Growth is expected to decelerate further in FY2013 as more projects are finished.

Economic growth in the Marshall Islands likewise benefited from an upgrade of Amata Kabua International Airport in Majuro, but the approaching completion of this project is expected to halve growth from 5.4% in FY2012 (ended 30 September 2012) to 2.6% in FY2013.

Scheduled declines in grants to the Marshall Islands and the FSM under their respective compacts of free association with the US will further constrain growth over the next 10 years.

Inflation in the Marshall Islands and the FSM tends to follow global food and fuel price movements. After rising during the period of volatile commodity prices in FY2011, inflation in the Marshall Islands slowed to an estimated 2.5% in FY2012 and is expected to edge up to 3% in FY2013. Likewise, inflation in the FSM eased to an estimated 3.5% in FY2012 but is projected to pick up in FY2013.

The dependence of these two economies on public spending highlights the need to promote private investment to mitigate the effects of declining grants from the US and maintain GDP growth. The private sector in the FSM has accounted for a steady 25% of GDP over the past 20 years. In the Marshall Islands, emigration has shrunk the labor force by almost 12% since 1999. Besides upgrading infrastructure, these countries need to craft business-friendly regulations, reduce the transaction costs

**3.1.40 Selected economic indicators, Federated States of Micronesia (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 1.0 | 1.0 | 0.5 | 0.5 |
| Inflation | 3.5 | 3.5 | 4.0 | 4.0 |
| Current acct. bal. (share of GDP) | -17.2 | -17.2 | -16.6 | -16.6 |

*Source:* ADB estimates.

**3.1.41 Selected economic indicators, Marshall Islands (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.4 | 5.4 | 2.6 | 2.6 |
| Inflation | 2.5 | 2.5 | 3.0 | 3.0 |
| Current acct. bal. (share of GDP) | -30.3 | -30.3 | ... | ... |

*Source:* ADB estimates.

**3.1.42 Selected economic indicators, Palau (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.0 | 4.0 | 2.0 | 3.0 |
| Inflation | 2.0 | 6.0 | 2.5 | 6.5 |
| Current acct. bal. (share of GDP) | 5.9 | 5.9 | ... | ... |

*Source:* ADB estimates.

of doing business, and develop labor skills to support private sector development and generate employment.

In Palau, tourism accounts for half of GDP and has supported GDP growth stronger than expected. Visitor arrivals rose to a record in FY2011 (ended 30 September 2011) and increased further, by 22.6%, in the first 7 months of FY2012. This contributed to GDP growth estimated at 4.0% for FY2012, a percentage point higher than previously forecast.

Economic growth is projected to moderate to about 3% in FY2013 (still a percentage point above the *ADO 2012* forecast) because the limited capacity of tourism facilities and infrastructure will likely dampen the recent high growth in visitor arrivals.

Growth in tourism-related sectors boosted domestic demand for goods and services in Palau. Together with supply constraints, this exerted upward pressure on inflation, which jumped from 2.6% in FY2011 to 8.7% in the first quarter of FY2012. Inflation is now estimated at 6.0% for FY2012 and slightly above that rate in FY2013.

A concerted effort from both the public and private sectors is required to sustain tourism's growth and its benefits to Palau's economy. Improvements to infrastructure and the delivery of public services are essential in creating an enabling environment for tourism-related activity. This is because tourism development depends heavily on the provision of public goods like a clean environment and an efficient transport system. In addition, procedures relating to tourism investments need to be streamlined to facilitate the development of new tourism infrastructure and enterprises.

### *Small Island States*

Fiscal sustainability remains a concern in the small island states of the Pacific, even as infrastructure spending funded by development partners supports relatively good rates of growth in Kiribati and Tuvalu, and strong phosphate exports continue to drive the expansion of Nauru's economy. While trust funds in Kiribati and Tuvalu and resource exploitation in Nauru successfully fund current expenditures and promote growth in these countries, they also raise concerns about the sustainability of growth and intergenerational equity. Sovereign investment funds in Kiribati and Tuvalu are being tapped at alarmingly high rates, and Nauru's reserves of phosphate are being depleted.

Fiscal policy adjustments to better protect future generations by restoring savings and focusing on investments would address sustainability and equity concerns. Following through on recent progress in reforming state-owned enterprises would help to sustain growth and broaden the narrow economic bases of the small island states. Private sector growth could be fostered by using scarce public resources more efficiently and creating a business environment conducive to investment. Sustained economic growth would alleviate longer-term fiscal pressures, but promising sources of growth are few and private sector development in these areas is often hampered by unfavorable business environments. However, governments in some of the small island states are pursing long term investments to capitalize on opportunities, such as investments in higher education to provide skills that workers need to find work abroad.

**3.1.43 Selected economic indicators, Kiribati (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.5 | 3.5 | 3.0 | 3.0 |
| Inflation | 5.5 | 5.5 | 6.0 | 6.0 |
| Current acct. bal. (share of GDP) | -29.2 | -29.2 | ... | ... |

*Source:* ADB estimates.

Kiribati is expected to grow by 3.5% in 2012 thanks to projects financed by development partners, including airport and seaport reconstruction and road works. This is 0.5% slower than growth in 2011, and growth is still projected to slow further in 2013 as construction reaches completion. Inflation is forecast to average 5.5% in 2012 and to quicken in 2013 because of higher prices for imported commodities, particularly food.

Higher infrastructure spending unmatched by higher revenue is projected to produce a fiscal deficit equal to 18.1% of GDP in 2012. To finance the deficit, the budget provides for an A$22.5 million drawdown from the Revenue Equalization Reserve Fund, which exceeds the government's own target ceiling of A$15 million annually in 2013–2015. The inflation-adjusted value of the fund is expected to fall to A$3,500 per capita, about A$1,000 below the government's target value. To achieve fund targets, and in light of recent drawdowns, the deficit must be slashed to 3%–5% of GDP beyond 2015.

Nauru's phosphate exports grew strongly to 519,000 tons in FY2012 (ended 30 June 2012), supporting GDP growth estimated at 4.8%. This was the highest production recorded since phosphate production resumed in 2006. Phosphate exports are seen moderating in FY2013 as mining focuses on deeper secondary reserves. However, the impact on GDP is expected to be largely offset by increased spending associated with the reopening of the Australian offshore processing center for asylum seekers.

The first segment of the expected initial group of 500 asylum seekers to be housed on Nauru arrived in September 2012. Up to 1,500 asylum seekers may eventually be housed on Nauru.

In late 2011, moderate inflation at 1% emerged following years of price deflation. Average inflation in FY2012 is estimated at 1.5%. This is projected to rise to about 2% in FY2013, driven by higher spending associated with the offshore processing center.

Tuvalu is now projected to grow by 1.2% in 2012, trimming the *ADO 2012* forecast. Expanded activity in retail and education services, and an upgraded international airport, will support growth and likely offset lower seafarers' remittances undercut by weak global trade. A similar rate of economic growth is forecast for 2013. Inflation is seen picking up to 2.6% in 2012 and 2.7% next year.

The budget deficit is projected to deepen sharply from 3.0% of GDP in 2012 to 7.5% in 2013 if corrective policy is not implemented. A one-time grant from Australia in May 2012 relieved immediate fiscal pressure, but the medium-term fiscal outlook remains uncertain because of heavy reliance on external sources of revenue. The Tuvalu Trust Fund is below its prescribed maintained value and has yet to recapitalize the Consolidated Investment Fund, through which budget deficits are financed. If present fiscal trends continue, the investment fund will be exhausted by the end of 2012.

**3.1.44 Selected economic indicators, Nauru (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.8 | 4.8 | 4.2 | 4.2 |
| Inflation | 1.5 | 1.5 | 2.0 | 2.0 |
| Current acct. bal. (share of GDP) | ... | ... | ... | ... |

*Source:* ADB estimates.

**3.1.45 Selected economic indicators, Tuvalu (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 1.4 | 1.2 | 1.3 | 1.3 |
| Inflation | 2.6 | 2.6 | 3.0 | 2.7 |
| Current acct. bal. (share of GDP) | ... | ... | ... | ... |

*Source:* ADB estimates.

# Bangladesh

Growth in FY2012 was close to *ADO 2012* projections, despite trade flows slowing by more than expected. Inflation stayed high as forecast, but the current account posted a surplus rather than a deficit. For FY2013, this *Update* retains *ADO 2012* growth and inflation projections but revises down the current account deficit. A comprehensive medium-term program supported by the IMF was adopted to counter emerging economic imbalances and foster rapid, sustainable, and inclusive growth. An immediate challenge is to cut subsidies by raising fuel and electricity prices as planned, to switch spending toward building badly needed infrastructure.

## Updated assessment

As officially estimated, GDP in FY2012 (ended June 2012) grew by 6.3% (Figure 3.2.1), close to the projection of 6.2% in the *Asian Development Outlook 2012 (ADO 2012)*, released in April this year, but lower than 6.7% in FY2011. Weak global demand caused growth in exports and imports to slow sharply, such that the net export position subtracted from growth. Private consumption held up well, supported by a strong expansion in worker remittances and sizeable credit flows.

Investment, little changed in recent years, rose only slightly to 25.5% of GDP. Foreign direct investment inflows reached $1 billion but, at only 0.9% of GDP, did little to boost investment overall. Capacity constraints in government line agencies, while lessened, nevertheless held public investment below budget expectations. Electricity and gas shortages, though alleviated, continued to hamper economic activity and discourage major new business projects.

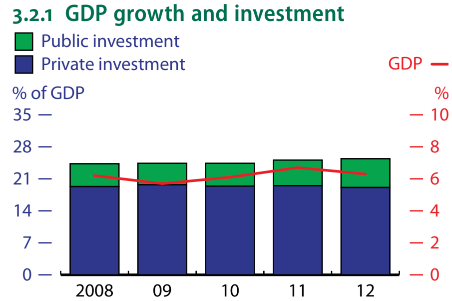
Agricultural growth dropped to only 2.5%, lower than the projected 4.4% in *ADO 2012* and 5.1% in FY2011, because higher electricity, fuel, and fertilizer prices raised production costs, and acreage for *aman* (monsoon crop) production was reduced. Services growth eased to 6.1%, affected by slower export and import activity.

Industry expanded robustly by 9.5%—higher than the 7.8% projected in *ADO 2012* and 8.2% in FY2011—aided by a boost in construction and a pickup in small-scale manufacturing oriented toward domestic goods, which benefited from a reduced turnover tax and better credit conditions in line with the central bank's efforts to promote financial inclusion.

Year-on-year inflation rose steadily during the first 7 months of FY2012, reaching 11.6% in January 2012 and reflecting rapid growth in credit, upward adjustments in government-administered domestic fuel and electricity prices, and higher import prices because of sharp taka depreciation (Figure 3.2.2). Inflation moderated from February, to reach 8.6% in June 2012, as food price pressure eased following the harvest and

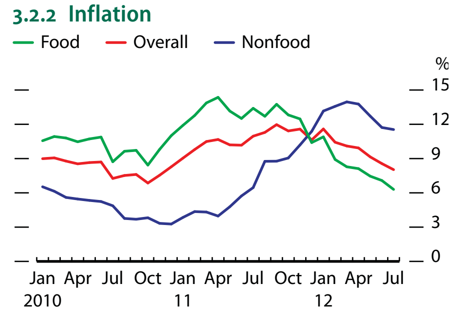
This chapter was written by Mohammad Zahid Hossain, Md. Golam Mortaza, Shamsur Rahman, and Barun K. Dey of the Bangladesh Resident Mission, ADB, Dhaka.

**3.2.1 GDP growth and investment**




*Source:* Bangladesh Bureau of Statistics. 2012. *National Accounts Statistics*. May.

**3.2.2 Inflation**




*Source:* Bangladesh Bank. 2012. *Monthly Economic Trends*. August. http://www.bangladesh-bank.org central bank measures to tighten credit began to take hold. Food inflation fell to 7.1% in June 2012, but nonfood inflation was much higher at 11.7%. Annual average inflation rose to 10.6% from 8.8% in FY2011.

Money supply and credit growth moderated in FY2012 as the year unfolded. Money supply (M2) grew year on year by 17.4% in June 2012, exceeding slightly the central bank's annual program target of 17.0% (Figure 3.2.3). Growth in net credit to government fell to 25.2% by June 2012 from 73.5% in December 2011, reflecting upward adjustments in fuel and electricity prices and the reduced need to finance subsidies. The advance in private credit also slowed to 19.7% by June 2012 but remained well above the target of 16.0%.

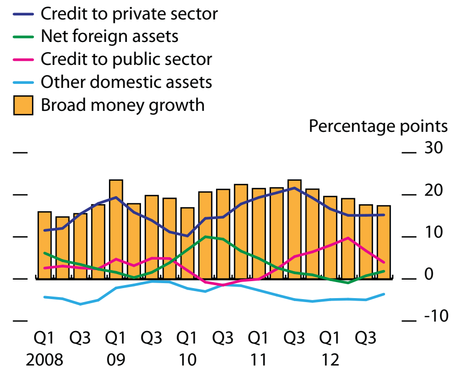
The central bank tightened monetary policy in FY2012, lifting repo and reverse repo rates by 100 basis points. It became more vigilant in ensuring that commercial banks maintained their credit-to-deposit ratios within the permissible limit, and it removed caps on bank lending rates except for agriculture and pre-shipment export credit. These measures boosted average lending rates, slowing private credit expansion. Banks raised their deposit rates, which nevertheless remained negative in real terms.

Revenue collection rose to 12.6% of GDP in FY2012 from the previous year's 11.7% as tax compliance improved. Total spending rose to 17.6% of GDP from 16.1% in the previous year. While higher subsidy spending at 3.3% of GDP, up from 2.0% in FY2011, pushed up recurrent spending, a shortfall in development spending limited the deficit to 5.1% of GDP, only slightly above the budget target of 5.0%. Domestic financing, at 3.8% of GDP, came mostly from the banking system, the remainder being foreign financing, mostly through aid projects.

At 37.2% of GDP at the end of FY2011, Bangladesh's government debt is moderate. External debt, mostly concessional aid, fell to 19.7% of GDP from 20.3% a year earlier while costlier domestic debt rose to 17.5% of GDP from 16.8% (Figure 3.2.4). Budget data indicate that domestic debt will be higher again at the end of FY2012, when updated figures become available. Bangladesh's external debt service ratio is low at 2.5% of foreign exchange earnings from exports and remittances.

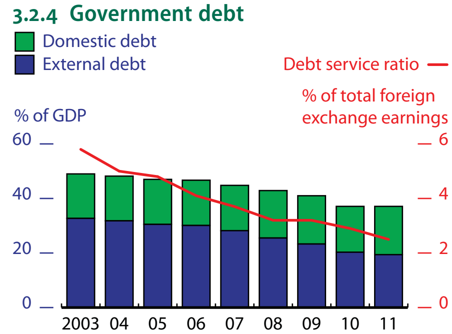
The net losses of the 48 nonfinancial state-owned enterprises expanded markedly to $2.1 billion in FY2012 from the previous year's $1.2 billion. The Bangladesh Petroleum Corporation (BPC) recorded the largest loss, at $2.0 billion, reflecting increased oil imports, needed to run the numerous small rental power plants that came on line, and reflecting that BPC was not allowed to pass through higher international oil prices in full (Figure 3.2.5). The Bangladesh Power Development Board (BPDB) loss grew by $0.4 billion to $1.1 billion, despite several adjustments in power tariffs. The increase stemmed from higher volumes of power purchased at higher prices, because of increased fuel costs, from the rental power plants. The $3.1 billion combined loss of BPC and BPDB absorbed just a little over four-fifths of government subsidy spending for the year, equaling 2.7% of GDP. During the fiscal year, the government released $1.9 billion to enable BPC and BPDB to settle part of their past liabilities to banks and other creditors. Large profits of $740 million earned by the Bangladesh Telecommunications Regulatory Commission helped to narrow the enterprise sector's overall loss.

**3.2.3 Contributions to broad money growth**



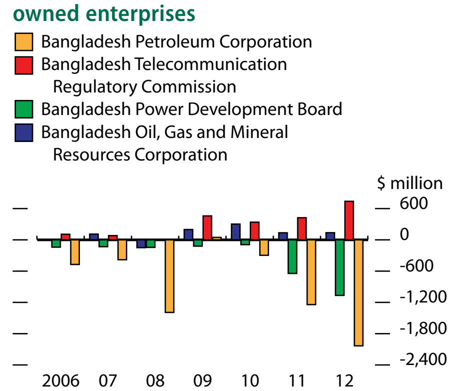

*Source:* Bangladesh Bank. 2012. *Monthly Economic Trends*. August. http://www.bangladesh-bank.org

**3.2.4 Government debt**




*Source:* Bangladesh Bank. *Annual Report 2010–2011*. http://www.bangladesh-bank.org

**3.2.5 Profit and losses at selected state-owned enterprises**




*Source:* Ministry of Finance. *Bangladesh Economic Review 2012*.

To cut BPC losses, the government in FY2012 raised diesel, kerosene, and gasoline prices by 19.0%–32.6%, and furnace oil, mostly used in power generation, by 42.9%. The government also raised bulk power tariffs by 52.9% and retail tariffs by 27.9% to reduce BPDB losses, as well as the price of compressed natural gas used by vehicles by 20.0%. Despite these measures, the government will need to implement further substantial price increases in FY2013 to meet the budget target for subsidy spending.

Export growth dropped to only 6.2% in FY2012 from 39.2% in FY2011 (Figure 3.2.6). Garment exports, providing over three-fourths of earnings, grew by only 6.6%, from 43.4% a year earlier. This downdraft in exports partly reflected the reversal of the large spike in cotton prices a year earlier, partly weak demand in the European Union (EU) and US, and partly, as export volume declined, buyers aggressively seeking lower prices. Export growth for other products also tracked dropping demand. Overdependence on garment exports and sales concentrated in the EU and US markets exposes Bangladesh to risks from sudden changes in demand. Garment exports to new markets have been growing, but their share is still quite small.

Imports grew by only 5.3% in FY2012, slowing from 41.8% a year earlier (Figure 3.2.7). As the garment industry depends heavily on imported inputs, lower prices for cotton and other raw materials were important contributing factors, as were easing prices for petroleum products during the fiscal year. Moreover, food grain imports declined sharply because of the earlier high buildup of stocks. Only imports of consumer goods—a small share of total imports consisting mainly of sugar, milk, edible oil, and oil seeds—grew rapidly.

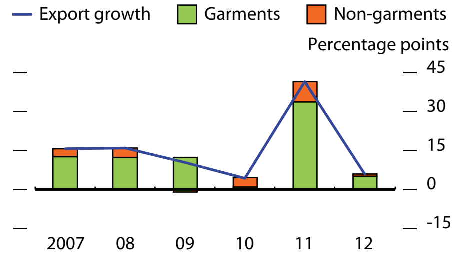
Workers' remittances, a major source of foreign earnings, grew by 10.2% in FY2012, up from 6.0% in the previous year, as the number of Bangladeshi workers going abroad escalated by 57.4%. The United Arab Emirates and Oman provided the largest number of jobs.

The trade deficit widened slightly to $7.9 billion in FY2012, from $7.7 billion a year earlier, as imports, even with lower growth, exceeded exports. However, higher remittances almost doubled the current account surplus to $1.7 billion (1.5% of GDP) from $885.0 million (0.8%) in FY2011 (Figure 3.2.8).

The combined capital and financial accounts recorded a deficit of $486.0 million in FY2012, a sharp drop from the deficit of $1.3 billion in FY2011, because of much smaller outflows on account of trade finance and higher foreign direct investment. The overall balance (including errors and omissions) showed a surplus of $494.0 million in FY2012, reversing the deficit of $656.0 million in FY2011. Gross foreign exchange reserves declined, when adjusted for valuation changes, by about $0.5 billion to $10.4 billion, which covers 3.3 months of import payments.

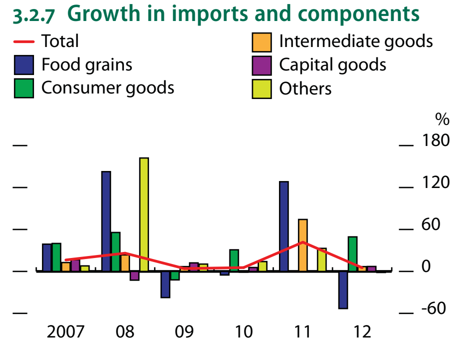
The taka–dollar exchange rate has been under pressure since January 2011 because of rapidly growing imports in the face of slower growth in exports and remittances. Although the rate stabilized in the second half of FY2012 in conjunction with monetary tightening, the taka depreciated by 9.4% over the fiscal year. The real effective exchange rate appreciated by 1.0% year on year at the end of June 2012 because domestic inflation exceeded that of Bangladesh's trading partners, indicating some erosion in export competitiveness (Figure 3.2.9).

**3.2.6 Contributions to export growth**



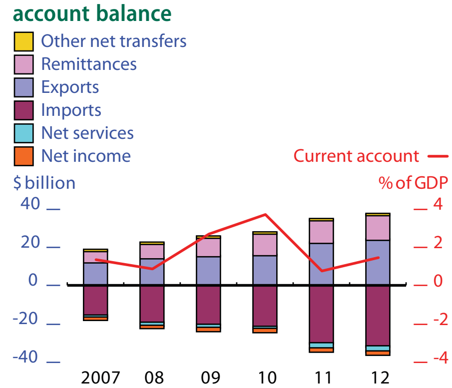
*Sources:* Export Promotion Bureau; ADB estimates.

**3.2.7 Growth in imports and components**



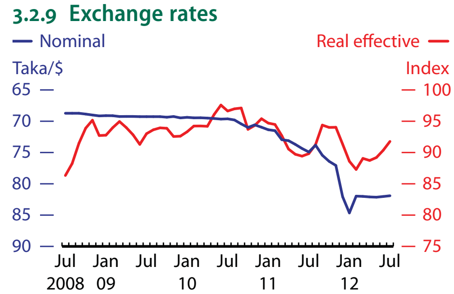
*Source:* Bangladesh Bank. Economic data. http://www.bangladesh-bank.org (accessed 3 September 2012).

**3.2.8 Components of the current account balance**



*Sources:* Bangladesh Bank. *Annual Report 2010–2011*; Economic data. http://www.bangladesh-bank.org (accessed 3 September 2012).

**3.2.9 Exchange rates**



*Source:* Bangladesh Bank. 2012. *Monthly Economic Trends*. July. http://www.bangladesh-bank.org

## Prospects

The forecast for FY2013 makes a number of assumptions. The projections are now underpinned by the agreement of the International Monetary Fund (IMF) in April 2012 to support the authorities' comprehensive program of economic policies (Box 3.2.1). Following the monetary policy statement issued in late July, central bank policy actions are expected to curb inflationary pressures and, at the same time, ensure adequate credit flows to the private sector. It is assumed that the government will raise fuel and electricity prices to cut subsidy costs, thus containing its bank borrowing, and that targeted budget revenue and foreign financing will be achieved. Finally, it is assumed that political stability and good weather will prevail.

### 3.2.1 Extended Credit Facility

Macroeconomic imbalances started surfacing in late 2010 because of adverse trade terms owing mainly to escalating oil prices, higher oil imports needed for power generation, and expansionary fiscal and monetary policies. A surge in subsidy costs, mainly for fuel, intensified fiscal pressures and spurred a rapid rise in domestic borrowing. Inflation reached a multiyear high, and the current account and reserves weakened. The unfavorable global outlook, with export growth slowing and oil prices staying high, created uncertainty regarding the balance of payments and Bangladesh's prospects for sustaining rapid economic growth. The concentration of export markets in the euro area and US, together providing close to three-fourths of earnings, accentuated vulnerability, with the euro area experiencing a protracted sovereign debt crisis and the US a sluggish recovery. Foreign direct investment remained low because of a weak business climate, poor infrastructure, and a restrictive trade regime. These developments worsened the risk of further reserve losses and deepened the economy's vulnerability to external shocks and a possible payment crisis.

Part of an economic program to adjust policies and make available additional external support, an extended credit facility (ECF) from the IMF aims to enhance macroeconomic stability, strengthen the balance of payments, and support faster and more inclusive economic growth. Under the ECF-supported program, and in line with Sixth Five-Year Plan priorities, the authorities are expected to follow more effective monetary and fiscal policies, initiate actions to expand fiscal space, stem reserve losses, streamline the finance sector, generate additional resources for boosting spending on infrastructure and social sectors, address power shortages, and encourage investment and adapt trade policies toward creating more jobs in the export sector.

The ECF-supported program is built around four pillars of reform: fiscal policy, monetary and exchange rate policy, the finance sector, and trade and investment.

Fiscal policy reform will support moderate fiscal consolidation over the medium term by boosting tax revenue and phasing out the off-budget financing of the quasi-fiscal losses of state-owned enterprises. Tax policy and revenue administration reform will be accelerated by introducing a new value-added tax law, and subsidy costs will be contained by allowing more energy and fertilizer costs to be passed through to end users. Public financial management will be strengthened, and annual development program implementation and public–private partnerships mechanisms will be improved. Social spending and safety nets will be safeguarded and debt management strengthened.

Monetary and exchange rate policy reform will aim to contain aggregate demand pressures, stabilize inflation expectations, and reduce reserve losses, while ensuring steady flows of credit to the private sector. Liquidity management and monetary transmission mechanisms will be strengthened, greater exchange rate flexibility allowed, and foreign exchange market operations and central bank financial operations improved.

Finance sector reform will seek to improve risk management and support growth by strengthening bank governance and oversight, improving the central bank's supervisory and enforcement capacity, and containing risks posed by equity markets.

The objectives of trade and investment reforms will be to minimize trade distortions and anti-export biases, and to enhance regional integration through rationalized trade barriers and a more favorable investment climate achieved by maintaining a stable macroeconomic framework, developing a modern and transparent tax regime, ensuring a well-regulated finance system, and expanding physical and social infrastructure.

GDP growth in FY2013 is projected at 6.0%, unchanged from the *ADO 2012* forecast, as exports and domestic demand are slowing as expected (Figure 3.2.10). While relaxed rules of origin under the EU's Generalized System of Preferences from January 2011 give Bangladesh an advantage over regional competitors, the EU market is seen as highly volatile because of the euro area sovereign debt crisis. Growth in domestic demand will remain limited owing to the central bank's continued credit tightening, while the expected rise in remittances is not strong enough to fully offset it.

Industry growth is expected to slow to 7.5%, reflecting weaker domestic demand, modest export growth, and expected growth-retarding increases in electricity prices. Agriculture growth will accelerate to 4.5% on the previous year's low base in response to more intensive policy support, especially for input supply and extension services. Services growth is projected to slow slightly to 6.0% because of weaker performance by industry and trade services.

The main thrust of budget policy is to create fiscal space by strengthening tax revenue collection and containing subsidy costs by raising fuel, power, and fertilizer prices. To sharpen focus on higher revenue collection, an indicative floor on tax revenue has been set as part of the ECF-supported program. A ceiling on the banking system's net credit to the government will limit bank financing of the budget. Improving the government's capacity to effectively implement the annual development program and attract more external assistance is an important component of policy efforts.

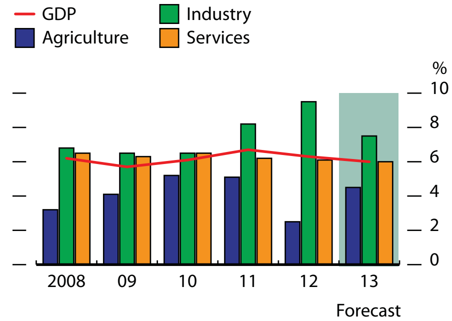
The FY2013 budget targets 21.3% growth in tax revenue, raising the revenue-to-GDP ratio by 0.8 percentage points. Attaining this target will be a challenge in the face of the budget's forecast 13.8% advance in nominal GDP. New measures target gains from adjusted income tax brackets, the expanded scope of tax withholding including on export earnings, and the use of alternative mechanisms to resolve and minimize disputes related to revenues. A new draft law on value-added tax, expected to take effect in 2015, was submitted to Parliament in July as a fiscal effort under the economic program. In the meantime, to boost revenue, existing reforms to income and value-added taxes are to be sustained and tax administration strengthened.

Under the ECF-supported program, the government is expected to adopt by December 2012 a mechanism to automatically adjust domestic fuel prices to ensure the full pass-through of international price changes. In addition, an indicative ceiling has been set on state-owned commercial banks' lending to state-owned enterprises in energy and fertilizers.

Fiscal policy will remain expansionary, with public spending growing by 18.9%. The budget deficit is projected at 5.0% of GDP, slightly lower than 5.1% in FY2012 (Figure 3.2.11). The deficit is expected to be financed by domestic borrowing equal to 3.2% of GDP and external financing equal to 1.8% of GDP—a mix that lessens domestic financing from the year earlier.

To achieve monetary policy objectives, a ceiling on the central bank's net domestic assets—its key operating target supported by an indicative ceiling on reserve money—has been set as a nominal anchor. New guidelines on loan classification and provisioning will strengthen the

**3.2.10 GDP growth by sector**



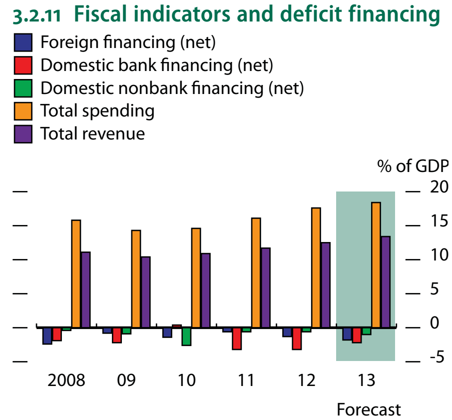

*Source:* Bangladesh Bureau of Statistics. 2012. *National Accounts Statistics.* May.

**3.2.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.2 | 6.3 | 6.0 | 6.0 |
| Inflation | 11.0 | 10.6 | 8.5 | 8.5 |
| Current acct. bal. (share of GDP) | -0.5 | 1.5 | -1.0 | -0.4 |

*Source:* ADB estimates.

**3.2.11 Fiscal indicators and deficit financing**




*Source: Asian Development Outlook* database.

finance sector and make the monetary transmission mechanism more effective. Liquidity management will also be strengthened by ensuring that policy rates and Treasury bill yields align with market conditions.

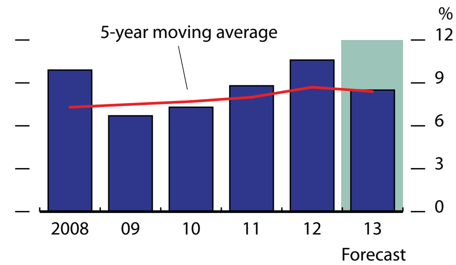
This update retains the *ADO 2012* average inflation projection of 8.5% for FY2013 (Figure 3.2.12). Upward adjustments in domestic fuel and electricity prices will lift nonfood inflation, but inflationary pressures will be contained as the central bank's tighter monetary policy takes hold, while international prices for commodities, including fuel, are expected to be broadly stable. Food prices are expected to fall in the first half with comfortable domestic supply and rise in the second half, as drought in a number of major agricultural exporters cuts global supplies.

Imports are expected to rise by 10.0%. The food import bill will remain moderate. Fuel imports will rise, pushing up the overall import bill in nominal terms, as the government tries to address electricity shortages by running rental plants at or near full capacity and commissioning new plants. Exports are projected to grow by 8.0%, reflecting a declining trend in the first half of FY2013 and expansion in the second half, as euro area economies contract in 2012 and then see a modest recovery in 2013.

Remittances are expected to grow by 12.0% as more workers leave for the Middle East. Prevailing oil prices support the construction projects that engage the bulk of unskilled Bangladeshi workers overseas. The current account balance is forecast to move to a small deficit equal to 0.4% of GDP in FY2013, as remittance growth proves inadequate to neutralize a widening trade deficit combined with the growing deficit in services and income payments (Figure 3.2.13).

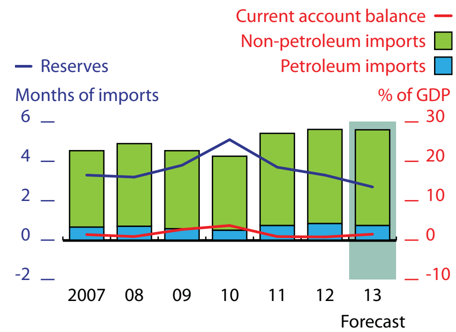
Several downside risks could upset projections. Fiscal management could come under pressure if the revenue target is not realized, planned foreign financing does not materialize, or political pressures quash the expected increases in fuel and electricity prices. Monetary discipline could be undermined if the government increases bank borrowing to finance subsidy spending. Finally, unfavorable weather (always a wildcard in Bangladesh) or political unrest could affect economic activity.

**3.2.12 Annual inflation**




*Sources:* Bangladesh Bank. 2012. *Monthly Economic Trends*. July. http://www.bangladesh-bank.org; ADB estimates.

**3.2.13 Current account balance**




*Sources:* Bangladesh Bank. *Annual Report 2010–2011*; Economic data. http://www.bangladesh-bank.org (accessed 5 August 2012); ADB estimates.

# People’s Republic of China

Global economic deceleration has exacerbated the domestic challenges. Growth slowed in the first half of 2012 because of lackluster trade flows and decelerating investment. The government has responded to the challenges with expansionary policy intended to stimulate growth in the second half of the year. This response, together with the country’s strong fiscal position, should ensure a soft landing.

## Updated assessment

GDP growth slowed to 7.8% in the first half of 2012 from 9.6% in the same period a year earlier (Figure 3.3.1). Both domestic and external factors contributed to the lower growth. A contraction of real estate investment and a reduction in the pace of infrastructure development are behind the lackluster performance of domestic drivers of growth. Anecdotal evidence suggests the slowdown is undermining the job market, which is not as tight as in 2011.

External demand is weaker than anticipated because the worsening global economic outlook has severely constrained trade flows. As a result, net exports took 0.6 percentage points off GDP growth, leaving investment and consumption to account for all growth in the first half of 2012, despite both being less buoyant than in 2011.

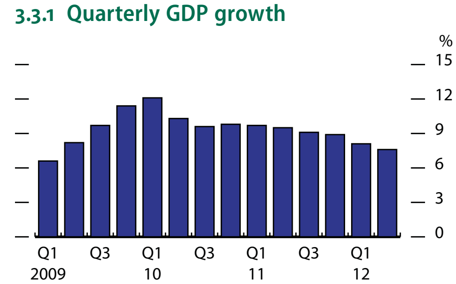
Growth in fixed asset investment, the main economic driver, slowed in the first 8 months of 2012 to 20.2%, about 5 percentage points lower than in the same period in 2011. This reflected a decline of 16% in real estate investment, and slower growth in investment in manufacturing and infrastructure, in particular railways.

Consumption also slowed from a year earlier because of deepening uncertainty about the economy. This was reflected in a decline in housing sales. Growth in retail sales backed off to 14.1% in the first 8 months of 2012 from 16.9% in the same period in 2011 (Figure 3.3.2).

Property prices and related activity continued to decelerate in the first 8 months of 2012 in response to government efforts to curb excesses in the real estate market. A slowdown in private sector activity has, however, been partly offset by an ambitious government program to develop 36 million units of low-cost housing from 2011 to 2015. A slight increase in property sales and property prices since July has intensified government concerns about a property bubble, and reignited the debate about the merits of introducing nationwide a broad-based property tax now being tested in pilot schemes in Shanghai and Chongqing.

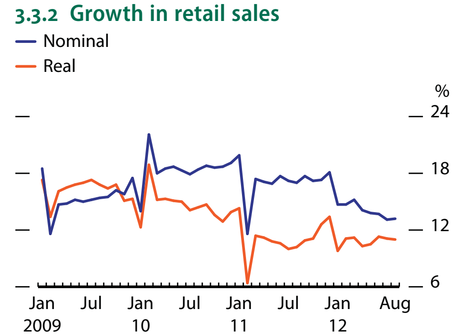
The unfavorable global situation has depressed trade flows, limiting the growth of external trade (both imports and exports) to about 6% in

**3.3.1 Quarterly GDP growth**




*Source:* CEIC Data Company (accessed 13 September 2012).

**3.3.2 Growth in retail sales**




*Source:* CEIC Data Company (accessed 13 September 2012).

This chapter was written by Yolanda Fernandez Lommen and Jian Zhuang of the People’s Republic of China Resident Mission, ADB, Beijing.

the first 8 months of 2012, sharply down from 25% in 2011 (Figure 3.3.3). Export growth declined largely because exports to the European Union fell by about 5% from January to August, reversing an 18% increase in 2011. In addition, export growth to emerging markets decelerated sharply—from 39.4% to 13.3% for the Russian Federation and from 38.1% to 1.7% for Brazil—and even turned negative in the case of India, plunging to –3.3% from 24.3% in 2011. Exports to two important markets in the region, Japan and the Republic of Korea, still managed to show modest positive growth but nothing like the 24.1% recorded in 2011. In contrast, exports to the United States held up better at 10.2%, and to members of the Association of Southeast Asian Nations at 15.4%, but still moderated from a year earlier. By product, reduced sales of labor-intensive goods—in particular textiles, clothing, and toys—drove the downward trend.

Falling commodity prices and lower imports of intermediate goods such as oil, steel, and copper are behind the lackluster import performance. Import growth remained below market expectations through the first 8 months of the year and even contracted in August by 2.7%. Averaging a mere 5.3% growth since January, sluggish imports reflect weak growth momentum, tracking to some extent plummeting exports because half of all imports are intermediate goods that feed into the export cycle.

By sector, agricultural output increased by 4.3% in the first half of 2012, up from 3.2% growth in the first half of 2011 and underpinned by improved weather that allowed the eighth consecutive good harvest. This and government measures in 2011 to stimulate pig production have strengthened supplies of key foodstuffs. Agriculture was the only sector to grow more rapidly in the first half of 2012 than in the same period of 2011.

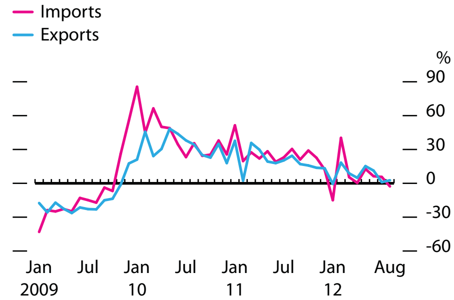
Industry experienced the largest decline, trimming industrial output growth to 10.1% in the first 8 months of 2012 from 14.2% a year earlier. In August 2012, growth in the sector was 8.9%, which was the lowest recorded in more than 3 years. The slowdown reflects the combined impact of slowing investment and weakening export demand. The purchasing managers' index, a gauge of manufacturing activity, fell to 49.2 in August, indicating that manufacturing in the PRC was contracting (Figure 3.3.4). Inventories in the industry sector remain close to historic highs, signaling that industrial growth may not pick up quickly. Growth in services slowed to 7.7% from 9.2% a year earlier, sapped by declining real estate activity and less buoyant consumption.

The stock exchange reflected turmoil in global markets. The Shanghai A-share stock index fell by 6.9% from January to August of 2012 as investors exited risky assets because of concern about the worsening growth outlook and the poor earnings prospects of listed companies.

Inflation continued to decelerate from the peak of 6.5% reached in mid-2011. Measured by the consumer price index, inflation from January to August stood at about 3.0%, almost halved from 5.6% a year earlier (Figure 3.3.5). The non-food component of the index has been fairly stable, but food prices declined steeply as supplies of vegetables and pork firmed. The producer's price index has remained negative since March, reflecting falling commodity prices and rapidly contracting producer prices.

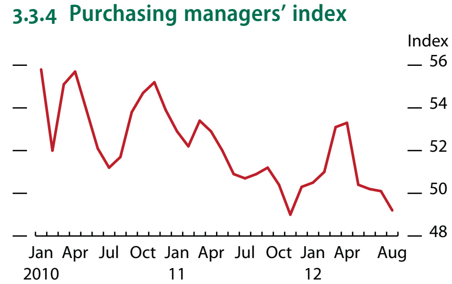
Fiscal and monetary policies have been countercyclical. Government

**3.3.3 Growth in trade indicators**



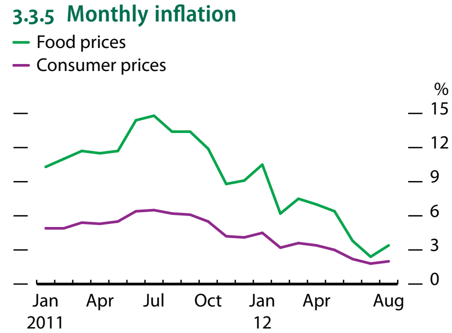

*Source:* CEIC Data Company (accessed 13 September 2012).

**3.3.4 Purchasing managers' index**




*Source:* CEIC Data Company (accessed 13 September 2012).

**3.3.5 Monthly inflation**




*Source:* CEIC Data Company (accessed 13 September 2012).

expenditure in the first 8 months of 2012—principally on education, health care, and social housing projects—increased by 21.8%, double the pace of revenue growth. A CNY1 trillion fiscal surplus as of August indicates there is room for further fiscal stimulus later in the year if needed.

The government has been actively fine-tuning fiscal reforms to support economic activity and announced in July a plan to expand the value-added tax pilot program implemented in Shanghai to eight additional jurisdictions, including Beijing, Tianjin, Guangdong, and Shenzhen. The expanded pilot program, running from August to December 2012, further targets selected services, including transport. Replacing the business tax levied on gross revenue with the value-added tax during the pilot period eliminates double taxation. The measure is expected to boost export competitiveness and reduce pressure on shrinking profit margins. The program is foreseen gradually expanding to other regions and sectors.

In late May the government introduced additional stimulus measures that aimed to combine short-term action with longer-term economic restructuring by advancing major infrastructure projects, boosting consumption with targeted subsidies on appliances and cars, fostering innovation through tax reductions, and encouraging greater private investment in the economy. In September further stimulus measures were announced, including 13 rail projects and 12 rail feasibility studies in major urban hubs requiring an estimated investment of CNY800 billion. In addition, some local governments have announced major infrastructure-related stimulus plans.

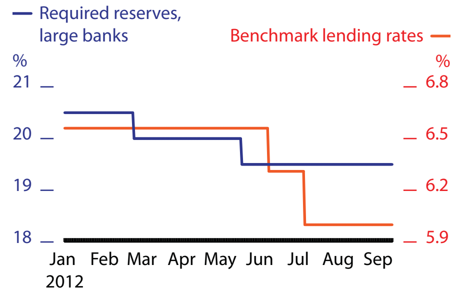
Decelerating inflation provided room for easing monetary policy to support growth after months of monetary tightening in 2011. Lower inflation prompted the People's Bank of China (the central bank) to reconsider the 1-year benchmark interest rate and the reserve requirement ratio—cutting each twice in 2012 (Figure 3.3.6). In 2012, the M2 money supply grew by 13.5% up to the end of August, which is closer to the government target of 14% for the year (Figure 3.3.7). Bank lending in the first 8 months of 2012 was almost 17% higher than a year earlier.

In June the central bank introduced greater interest rate flexibility by allowing banks to set maximum deposit rates up to 10% above the benchmark. Similarly, the minimum lending interest rate has been lowered to 70% of the benchmark, but the authorities' efforts to cool the real estate sector exclude mortgages from the discount.

Two other developments in monetary policy are notable. First, in March the government moved to address informal lending by launching a pilot program in Wenzhou to allow private lenders to offer deposit and loan services. Second, a pilot project was introduced under which banks in Shenzhen and in Hong Kong, China are allowed to offer loans denominated in renminbi directly to clients in the other city. The initiative is considered to be a first step toward full currency convertibility.

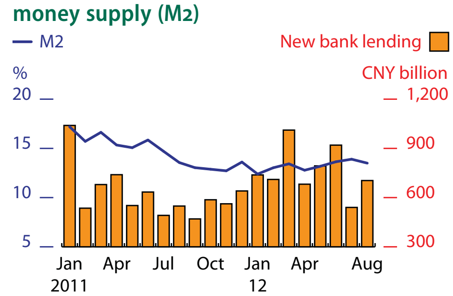
Although trade was subdued in the first part of 2012, export growth at 7.1% outpaced import growth of 5.1% enough to run up a trade surplus of $122 billion in the first 8 months of 2012, the largest such surplus since 2009. Nonetheless, the current account surplus slid by 5.2% in absolute

**3.3.6 Monetary indicators**




*Source:* CEIC Data Company (accessed 13 September 2012).

**3.3.7 New bank lending and growth in money supply (M2)**

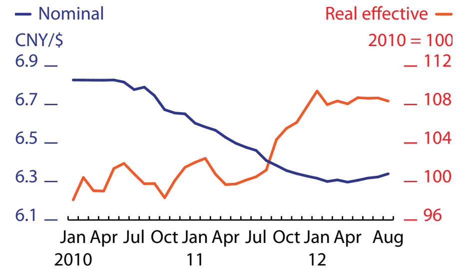



*Source:* CEIC Data Company (accessed 13 September 2012).

terms to 2.3% of GDP in the first half of 2012, down from 2.8% in the same period of 2011. Uncertainty in global markets slowed foreign direct investment by 3.6% in the first 7 months of 2012. The trend is explained by declining inflows from investors in the United States and the European Union amid growing global uncertainty but also reflects fewer investment opportunities in real estate in the PRC.

With exports moderating and uncertainty deepening as to how the external environment will evolve, the appreciation of the renminbi was slower than in 2011. In real effective terms, the currency appreciated by 0.5% over the first 8 months (Figure 3.3.8). The yuan appreciated by 5.7% against the euro but depreciated by 0.2% against the US dollar. Foreign exchange reserves increased only modestly in the first half of the year, as an unusual $65 billion dip in the second quarter of 2012 reflected a contraction in foreign direct investment inflows suppressed by worsening global uncertainty, and increased capital outflows prompted by a dearth of domestic investment opportunities following the government clampdown on real estate last year.

**3.3.8 Exchange rates**



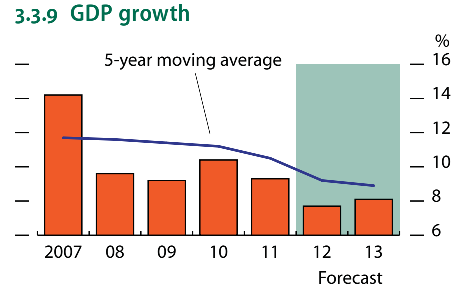

*Source:* CEIC Data Company (accessed 17 September 2012).

## Prospects

Vulnerability to increasingly sluggish external demand compounded by deceleration in domestic drivers of growth caused slower-than-expected GDP growth in the first half of the year. This has prompted a downward revision of the growth forecasts for the PRC published in the *ADO 2012* in April. GDP growth in 2012 is now expected to ease to 7.7%, down from the 8.5% forecast in April. The forecast of growth in 2013 has also been revised downward from 8.7% to 8.1% (Figure 3.3.9). The higher growth forecast in 2013 is justified by the expected positive effect of continued countercyclical fiscal policies already adopted, as well as by perceived improvements in the global economy.

Growth in fixed asset investment of about 20% is projected to remain the major engine of growth in the forecast period, boosted by government expenditure on infrastructure projects and increased social spending on public housing, education, and health care. Rising wages, pensions, and consumption subsidies will support growth in private consumption. Despite the expansionary fiscal bias, the overall budget deficit should be contained at 1.7% of GDP in 2012. Poor prospects in global markets suggest that export and import growth will remain subdued, and net exports will therefore subtract from growth in 2012.

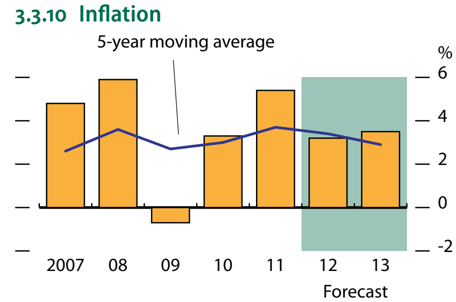
**3.3.9 GDP growth**




*Source: Asian Development Outlook* database.

Inflation is forecast to be 3.2% in 2012, which is a downward revision from the April forecast of 4% (Figure 3.3.10). The moderating trend in consumer price index escalation should be sustained throughout 2012 as weak world economic growth depresses global commodity prices, mitigating non-food inflationary pressures. Lower residential inflation stemming from policy tightening on property markets will further control inflation. However, planned reforms to raise utility prices closer to their market values, and improved economic dynamism, will push inflation to 3.5% in 2013, still below the government target of 4%.

**3.3.10 Inflation**




*Source: Asian Development Outlook* database.

In light of decelerating inflation, monetary policy is likely to remain accommodating throughout 2012, and the government target of a 14% increase in the money supply by the end of the 2012 is expected to be met. New lending from January to August reached CNY6 trillion, which is consistent with government plans to maintain lending at about CNY8 trillion–CNY8.5 trillion for the year as a whole to support growth while avoiding the excesses of the monetary stimulus in 2009 and 2010.

The economy will remain vulnerable to developments in the European Union, which is the PRC's largest trading partner. Any deterioration will constrain the PRC's exports, employment, and ultimately GDP growth.

External trade (exports and imports) is expected to grow by 8% in 2012 and by 10% in 2013. In the rest of this year the trade surplus should moderate from the current figure. Combined with a deficit in the balance of services, this will slightly narrow the forecast of the current account surplus to 2% of GDP in 2012 from the 2.1% forecast in April (Figure 3.3.11). The forecast current account surplus in 2013 has also been reduced slightly.

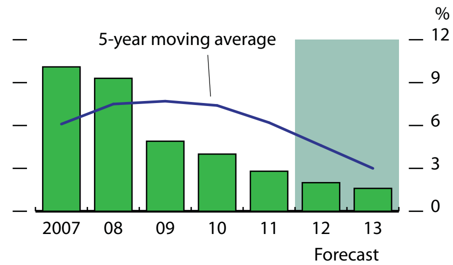
Domestically, while loan-to-deposit and capital adequacy ratios are comfortably within regulatory requirements, asset quality appears to be deteriorating largely because of short-term loans that are troubled but not yet classified as nonperforming. This will be compounded by mounting pressure on local governments to embark on large infrastructure projects to arrest the economic slowdown, which may cause nonperforming loans to proliferate locally, exacerbating debt-sustainability issues and exerting pressure on banks to curtail lending.

Weather-induced food price volatility remains a risk. Rising labor costs in light of government efforts to raise living standards and foster consumption, and inflationary pressures arising from efforts to liberalize administered prices for utilities and selected natural resources, may force up the consumer price index.

Looking forward, the PRC's fiscal position remains strong, and receding inflation gives confidence that there is scope for further monetary expansion if needed. Together, these should ensure a soft-landing of the economy. However, it is essential for policy makers to move rapidly on the economic reforms set out in the Twelfth Five-Year Plan, 2011–2015. Failure to implement the reform agenda decisively could jeopardize the sustainability of growth.

As the PRC economy will remain exposed to the global economic recession, reform should focus on rebalancing domestic sources of growth and fostering employment opportunities. One key reform in this regard would be to eliminate constraints on the development of the PRC's service sector—an area with great growth potential but one in which the PRC lags behind its peers. Turning services into an efficient and competitive sector would strengthen domestic sources of growth, and the sector's labor-intensive nature would strengthen employment generation amid the current economic slowdown (Box 3.3.1).

**3.3.11 Current account balance**




*Source: Asian Development Outlook* database.

**3.3.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 8.5 | 7.7 | 8.7 | 8.1 |
| Inflation | 4.0 | 3.2 | 4.0 | 3.5 |
| Current acct. bal. (share of GDP) | 2.1 | 2.0 | 1.7 | 1.6 |

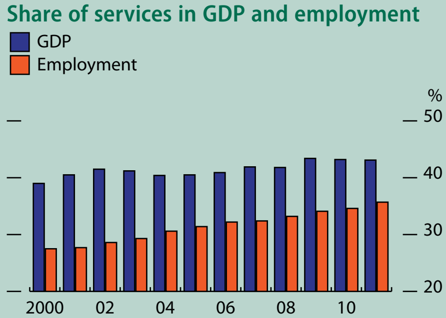
*Source:* ADB estimates.

### 3.3.1 Challenges in the People's Republic of China service sector

The global economic crisis and the collapse of external demand have diminished the role of exports as a major driver of growth. Expanding services will offset those losses by strengthening the domestic engine of growth. However, unlocking the potential of services requires far-reaching reforms and policy actions to address the existing challenges and constraints highlighted below.

The service sector in the PRC is relatively small. It has expanded rapidly since economic reforms were launched and in particular since the PRC's accession to the World Trade Organization in 2001, but it is still smaller than expected given the country's per capita income. The share of services in middle-income countries averages about 55% of GDP and 54% of total employment, but services in the PRC provided in 2011 only 43% of GDP and only 36% of employment (box figure).

**Share of services in GDP and employment**




*Source:* CEIC Data Company (accessed 13 September 2012).

An explanation for this is formidable barriers to entry. Despite the PRC's commitment to wide-ranging services liberalization to meet requirements for access to the World Trade Organization, the implementation and enforcement of reforms remain weak. This means that state-owned enterprises continue to dominate the provision of services and market concentration remains high.

Government policies have favored manufacturing with a particular focus on manufactured exports. Subsidies, tax exemptions, and privileged access to finance enable manufacturers to retain resources that might otherwise be available to the service sector. Further, manufacturing has benefited from liberalization brought about by the successful open door policy, but openness has been limited in the service sector. Restricted opportunity for foreign direct investment in services and the technological transfer it would likely entail have limited the expansion of the sector and the quality of services provided. Restrictions have also constrained the potential for trading services, which explains the PRC's persistent deficit in services trade.

The finance sector is heavily regulated, and small and medium-sized enterprises have had difficulty obtaining finance through official channels. State-owned enterprises have therefore remained the dominant providers of services. While significant progress has been achieved in liberalizing the finance sector, the current system remains biased toward these large enterprises, which absorb the largest share of credit. Capital markets' embryonic status aggravates uneven access to credit.

Investment in human capital is low and the labor market rigid. Low education expenditures and severe shortages of specialized skills constrain the development of services and in particular knowledge-intensive service industries. Rigidities in the labor market, including restricted labor mobility under the *hukou* household registration system and limited portability of labor-related benefits, further hinder the development of services. Imperfect labor mobility mismatches demand in the labor market and the actual deployment of labor, hindering the expansion of services and perpetuating income inequality and regional disparity.

The protection of intellectual property rights is weak. This especially disadvantages the service sector, in which secure trademarks are essential. Notwithstanding improvements in the intellectual property rights regime, implementation and enforcement remain weak. The near absence of strengthened intellectual property rights protection discourages foreign companies from transferring technology to the PRC and dampens any propensity of domestic firms to innovate. This slows the expansion of services.

*Source:* ADB. 2009. *Rebalancing Growth in the PRC: Services Sector Development*. Observations & Suggestions No. 2009-7. Manila. http://www.adb.org/publications/rebalancing-growth-prc-services-sector-development

# India

**The economy faltered under a tight monetary policy aiming to counter persistently high inflation, weak global growth, proliferating subsidies that raised the budget deficit, and difficulties in obtaining political consensus on measures tackling impediments to growth. Initiatives announced in September have raised hopes that comprehensive policy reforms would follow. Nevertheless, this *Update* lowers earlier projections of growth for this year and the next, and sees inflation moderating somewhat more slowly than previously forecast. Reaching agreement on difficult and long-standing structural issues is essential if the country is to recapture its earlier dynamic performance.**

## Updated assessment

Macroeconomic challenges have become more complex since the release of the *ADO 2012* in April. New headwinds include slower growth in the industrial economies, a delayed summer monsoon, the revision of India's sovereign outlook from *stable* to *negative* by two major credit rating agencies, and foreign portfolio investors' concerns over the tax status of their investments.

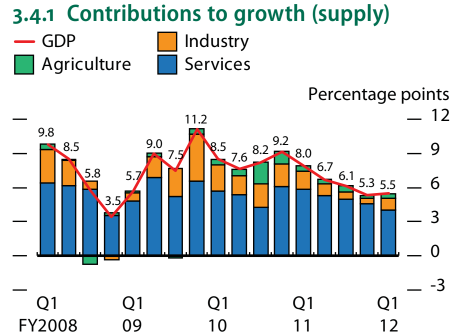
Economic activity in the first quarter of FY2012 (ending 31 March 2013) grew by 5.5%—well below potential and the strong performance of recent years (Figure 3.4.1). The downdraft began in FY2011, which saw a marked deceleration in each successive quarter that cut annual GDP growth in FY2011 to 6.5% from the 8.4% recorded in the prior 2 years. The slowdown has been concentrated in industry and driven by slumping investment, falling exports after September 2011, and an attendant weakening in personal income and consumer spending.

GDP growth of 5.3% in the fourth quarter of FY2011 and 5.5% in the first quarter of FY2012 marked the weakest advance since the fourth quarter of FY2008. A continuing large fiscal deficit and persistently high inflation limit the fiscal and monetary policy space available to stimulate the economy. Moreover, the authorities' hands are further tied by the current account deficit rising to an all-time high of 4.2% of GDP in FY2011.

High interest rates, a weakening currency, and a frail macroeconomic environment dented consumer confidence, subduing expansion in their spending to 4% in the first quarter of FY2012. Government consumption expenditure rose by 9%, the highest in five quarters, indicating a rising risk of fiscal slippage.

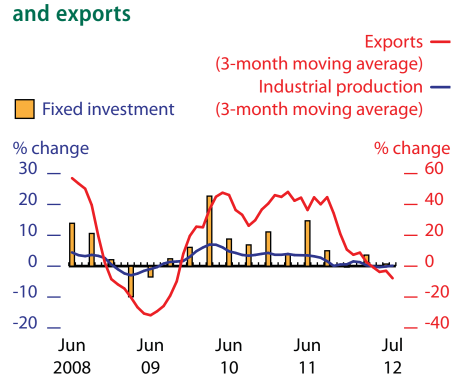
Trends in fixed investment are more worrisome because activity continued to be depressed, growing by only 0.7% in the first quarter of FY2012, extending a broad retreat that began 8 quarters earlier (Figure 3.4.2). Investment is plagued by delays in obtaining regulatory clearances, especially for applications concerning land acquisition and

**3.4.1 Contributions to growth (supply)**




*Source:* Ministry of Statistics and Programme Implementation. http://mospi.nic.in (accessed 31 August 2012).

**3.4.2 Investment, industrial production, and exports**




*Sources:* Ministry of Statistics and Programme Implementation. http://mospi.nic.in (accessed 31 August 2012); CEIC Data Company (accessed 13 September 2012).

This chapter was written by Abhijit Sen Gupta of the India Resident Mission, ADB, New Delhi.

the environment, and is further stunted by the inability to arrive at a consensus on further liberalizing the foreign direct investment (FDI) regime. High input costs and interest rates also add to deteriorating investor sentiment.

Driven by a healthy winter harvest, including record production of wheat, agriculture grew by 2.9% in the first quarter of FY2012. However, the southwest monsoon's late onset and unfavorable progress in the critical months of June and July adversely affected the sowing of summer crops. With only one third of the crop area irrigated, an untimely monsoon can cripple agriculture production.

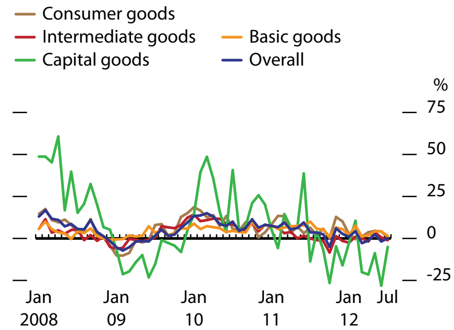
Industry grew by 3.6% in the first quarter of FY2012, registering a slight improvement over the previous two quarters. This gain was driven by the 10.9% increase in construction, helped by drier weather than usual. Manufacturing output, having contracted by 0.3% in the last quarter of FY2011, crept up marginally by 0.2% in the first quarter of FY2012. The lackluster performance was driven by a 20% contraction in capital goods production, indicating subdued investment (Figure 3.4.3). Basic, intermediate, and consumer nondurable goods continued to experience sluggish growth, the last affected by disposable income in rural areas being squeezed by weak rains. Mining output remained in a slump owing to environmental and regulatory concerns that hamper coal mining. A drop in hydroelectricity generation and a decline in natural gas production also contributed to the industrial slowdown.

The service sector also witnessed moderation in growth for the fifth consecutive quarter, as the rate of expansion dropped to 6.9% in the first quarter of FY2012. The downturn in merchandise trade and a weak industrial scenario caused a slowdown in freight traffic at ports and on railways. Ebbing tourist arrivals and a falloff in new cellular subscribers also dented service sector growth.

Inflation, which hovered close to 10% for about 2 years in FY2010 and FY2011, stabilized near 7% in 2012 (Figure 3.4.4). The persistence of inflation was largely on account of high food prices, which, after dipping briefly in December 2011 and January 2012, reverted to double digits. In contrast, a slowing economy brought down non-food manufactures inflation (a proxy for core inflation) to near 5%.

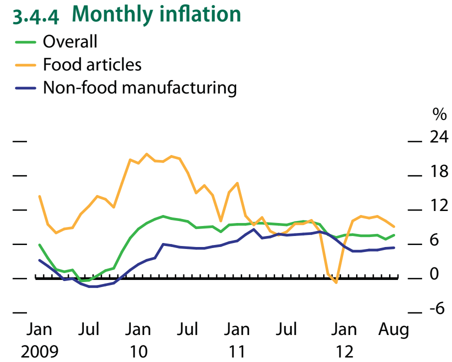
After maintaining a tight monetary stance to contain high inflation and inflation expectations, the Reserve Bank of India (the central bank) cut policy interest rates by 50 basis points in April 2012 to promote growth with the expectation of a less expansive fiscal policy and steps to remove impediments that have stifled the supply side response (Figure 3.4.5). However, the lack of progress on these fronts (including failure to cut large fuel subsidies), inflationary concerns raised by the delayed monsoon, a weakening currency, and sustained wage pressures caused the central bank subsequently to leave policy rates unchanged. However, at its mid-quarter review in September, the central bank cut the cash reserve ratio by 25 basis points to 4.5%. Since reserves are unremunerated, this change offers some scope for banks to reduce their prime lending rate or to selectively reduce lending rates for, say, automobiles or motorcycles, which have suffered slack sales. With weak overall demand for credit, banks are keen to boost lending to maintain earnings.

**3.4.3 Growth in industrial production**




*Source:* CEIC Data Company (accessed 24 September 2012).

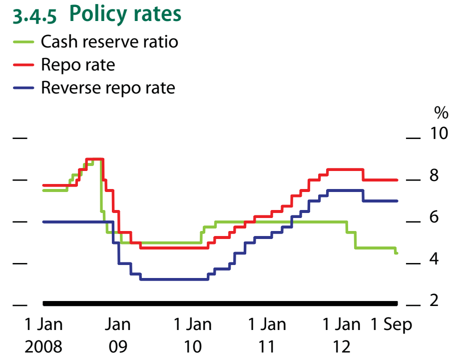
**3.4.4 Monthly inflation**




*Note:* Based on wholesale price index.

*Source:* Ministry of Industry and Commerce.

**3.4.5 Policy rates**




*Source:* Reserve Bank of India. http://www.rbi.org.in (accessed 24 September 2012).

In FY2011 the central government's deficit increased sharply to 5.8% of GDP, substantially overshooting its 4.6% target, owing to a shortfall in revenue on account of the faltering economy and a sharp boost in subsidies (Figure 3.4.6). The deficit is targeted to narrow to 5.1% of GDP in FY2012, mainly resulting from the widening of the tax net, higher tax rates, and the capping of subsidies at a much lower level.

Government finances for the first 4 months of FY2012, from April to July, indicate strong revenue growth reflecting buoyant income, corporate and service tax collection that has benefitted from much lower refunds this year than last, and the widening of the service tax net. However, tepid excise and customs collections reflect the poor performance of manufacturing. The first half of FY2012 also did not witness any significant progress in disinvestment of public corporation stock—an important planned source of nontax revenue. Nevertheless, higher-than-targeted expenditure, in part because only limited adjustment was made to fuel prices toward reducing subsidies, brought the deficit to over half of the annual target in just the first 4 months of the fiscal year.

Exports grew by 23.7% in FY2011 despite a marked slowdown in the second half of the year. A 31.1% surge in imports boosted by sharply higher oil prices along with large gold purchases widened the merchandise trade deficit to 10.2% of GDP. The large trade deficit more than offset improved surpluses in services and remittances, leaving the current account deficit at an all-time high of 4.2% of GDP (Figure 3.4.7).

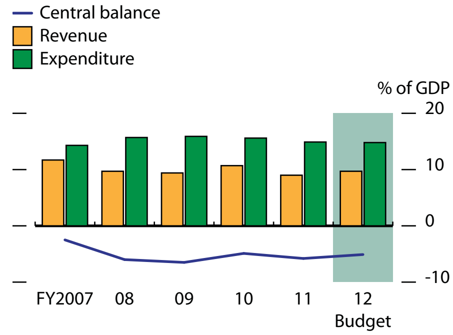
The global slowdown markedly shrank merchandise trade in the first half of FY2012. Exports in the first 5 months fell by 6.7% from a year earlier despite a significantly weaker rupee (Figure 3.4.8). Imports also contracted by 6.6%, largely reflecting a sharp drop in gold and non-oil imports. While the surplus in services weakened along with the fall off in global demand, remittances continued to be healthy on account of liberalized interest rates for deposits.

Although net capital inflows improved by 9.3% to $68 billion in FY2011, they showed weak portfolio investment. While net FDI inflow improved from the low level observed a year earlier, there was a distinct slowdown in the fourth quarter of FY2011 as inflows fell off and repatriation picked up. The first quarter of FY2012 witnessed very weak trends in capital flows, with both FDI and portfolio flows being a fraction of previous quarters. External commercial borrowing and short-term trade credit inflows were also muted. Nevertheless, foreign exchange reserves through mid-September increased slightly, by $1.1 billion, in FY2012 (Figure 3.4.9).

A widening current account deficit, weak capital flows, and deteriorating macroeconomic fundamentals put significant downward pressure on the rupee, which depreciated by 18% against the US dollar in the year to August 2012 (Figure 3.4.10). Because India has higher inflation than its trading partners, the real effective exchange rate depreciated by about 9%, improving competitiveness.

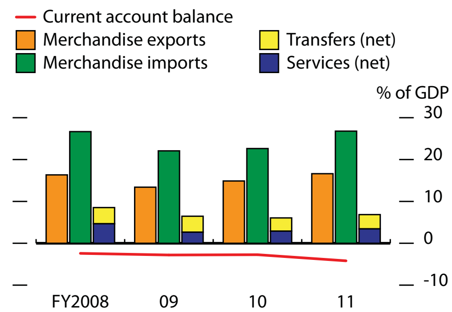
Stock market prices drifted lower for most of FY2011, strengthening temporarily in early 2012 with the help of large portfolio inflows, but then drifting lower through May on weak portfolio investment that reflects, in part, uncertainty over tax issues raised by anti-avoidance legislation

**3.4.6 Central government budget indicators**



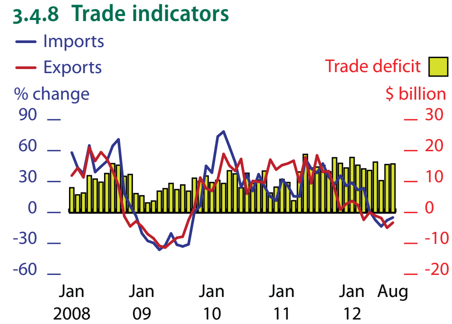

*Source:* Ministry of Finance.

**3.4.7 Current account indicators**



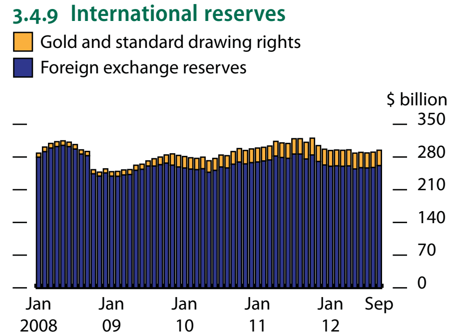

*Source:* Reserve Bank of India, *RBI Monthly Bulletin*. Various issues.

**3.4.8 Trade indicators**




*Source:* CEIC Data Company (accessed 19 September 2012).

**3.4.9 International reserves**




*Note:* September data is as of 14 September 2012.

*Source:* Reserve Bank of India. http://www.rbi.org.in (accessed 24 September 2012).

(Figure 3.4.11). After the implementation of this measure was postponed, stock prices moved higher through September, when initiatives to check the fiscal deficit and open new areas to FDI further boosted market sentiment. Reflecting these developments, the BSE Sensex rose by about 15% from the start of June to late September.

## Prospects

The forecasts for FY2012 and FY2013 in the *ADO 2012* assumed sustained recovery in the major industrial economies, a normal monsoon, moves toward monetary easing along with actions to reduce the budget deficit, and the resolution of some of the structural bottlenecks that have stifled supply response. This *Update* now takes into account a delayed monsoon, slower growth in the advanced economies, the limited scope of fiscal consolidation and monetary easing, and limited progress on tackling structural policy issues.

Growth in private consumption, which accounts for about 60% of GDP, is expected to edge marginally lower. Delayed rainfall is expected to hold down rural incomes and consequently consumer spending—which, however, is unlikely to slump as it will be supported by drought relief measures, rising rural wages, increased crop support prices, and social welfare schemes, including an extensive employment scheme for rural households. Urban consumption is likely to remain muted by weak income growth, high interest rates, elevated prices, and declining consumer confidence.

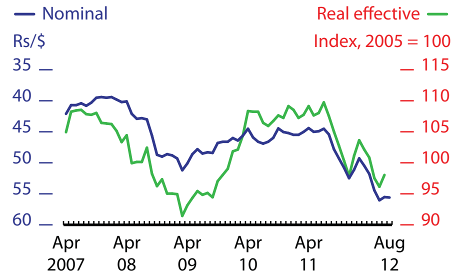
A resurgence of investment is imperative for restoring growth. However, the continued slowdown in the announcement of new projects and the sharp increase in the number of shelved projects indicate that investment will be weak (Figure 3.4.12). A proposed National Investment Board, to be headed by the Prime Minister, is intended to expedite all government clearances for large projects. The implementation of this initiative could help to pull investment rates up.

While high nominal interest rates have deterred new investment, the central bank has pointed out that real rates are no higher than in earlier periods when investment was high and that quantitative analysis found only a third of the slowdown attributable to the interest rate, with the balance caused by a combination of other factors, domestic and global. Domestic factors encompass structural bottlenecks identified in the *ADO 2012*, including fuel and power shortages driven by the unavailability of raw materials, especially coal; delays in environmental clearances; and other policy hurdles. The lack of political consensus on dealing with these issues has increasingly hampered new investment.

In some areas, signs of policy momentum have emerged. The committee examining the guidelines of General Anti-Avoidance Rules has recommended deferring the rules for 3 years and grandfathering in all investments extant on the date they come into effect. This appears to have assuaged investor concerns. The government said it would unveil a planned path of fiscal consolidation with the burden shared by all stakeholders.

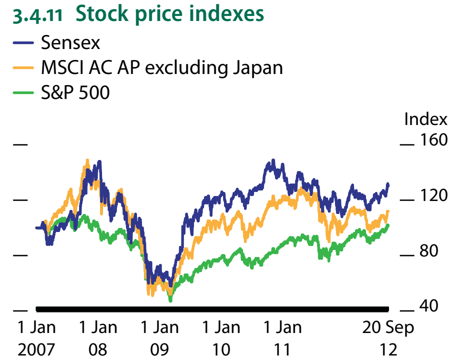
In September, diesel prices were hiked by 12% and a cap was imposed on the use of subsidized liquefied petroleum gas to help contain the fiscal deficit. Decisions to permit FDI of up to 51% in multibrand retail trading,

**3.4.10 Exchange rates**




*Sources:* CEIC Data Company; Bank for International Settlements. http://www.bis.org (both accessed 5 September 2012).

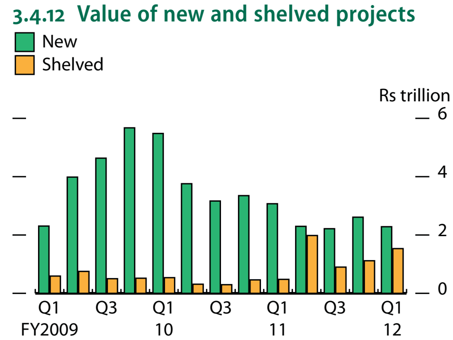
**3.4.11 Stock price indexes**




MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific. S&P = Standard & Poor's.

*Source:* Bloomberg (accessed 21 September 2012).

**3.4.12 Value of new and shelved projects**




*Source:* Centre for Monitoring Indian Economy.

(subject to approval from the state government), open domestic airlines to investment by foreign carriers up to 49%, allow foreign investment up to 49% in power trading exchanges, and raise the foreign investment cap in the broadcasting sector have boosted business sentiment and raised hopes for further policy action.

By sector, the delayed monsoon will hit agricultural output, with the greatest impact felt in the second and third quarters of FY2012. While the revival of the monsoon since August will be unable to reverse the damage to the summer crop, it augurs well for the winter crop. The recovery in the monsoon has helped restore water reservoir levels to close to normal. A normal winter crop will help to prop up agricultural growth to some extent in FY2012. Going forward, in FY2013 a low base will likely bolster agricultural growth, assuming a normal monsoon.

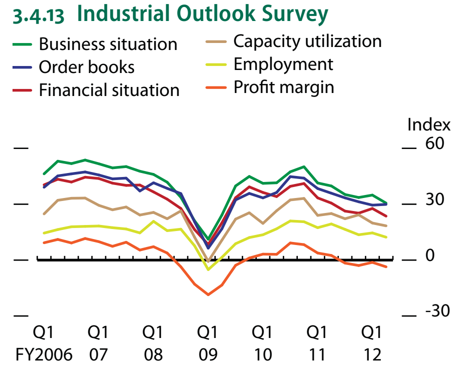
Industrial growth is expected to remain subdued in FY2012 and improve only modestly in FY2013. The revival of the sector from the current downturn is dampened by a number of factors. Despite the positive effects of currency depreciation, export growth, which is normally a major driver of industrial production, will be more anemic than projected in the *ADO 2012* because of weaker global demand. Consumer demand will also weaken.

The power deficit is emerging as a major constraint, with a number of states experiencing power shortages. High interest rates and continued policy gridlock will also keep industry trends subdued. Weakness in the industry sector is reflected in several surveys. The central bank's Industrial Outlook Survey reports business expectations moderating for the fourth successive quarter, with expectations on profit margins, employment, production, and capacity utilization less positive than in previous quarters (Figure 3.4.13). The HSBC/Markit manufacturing purchasing managers' index dropped to its lowest reading in almost a year because of persistent weakness in new orders (Figure 3.4.14).

The deterioration in Europe's economic outlook compared with the one assumed in the *ADO 2012* foretells a slowdown in information technology services, as Europe accounts for 20%–25% of the industry's exports. Outsourced business and financial services will be affected by the slowdown in the advanced economies. The purchasing managers' index for services has been more resilient than for manufacturing, but it has started to exhibit slippage in recent months amid a weak industrial scenario and faltering demand from major trading partners.

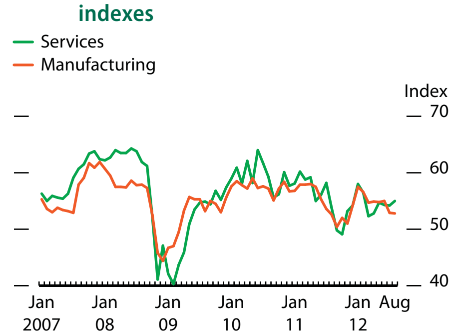
In line with this outlook, this *Update* revises GDP growth to 5.6% in FY2012, significantly lower than the 7.0% projected in the *ADO 2012*. Much of the downward revision reflects the weak monsoon, which by allowing only negligible growth in agricultural GDP could shave 50–80 basis points from overall GDP growth. The delay in easing monetary policy will crimp industrial growth, and the persistent downturn in the industrial countries will do the same to services growth. Finally, continued weakness in the investment climate caused by fuel shortages and limited progress on reforms intended to alleviate infrastructure bottlenecks dampen growth prospects. A normal monsoon, somewhat improved growth in the advanced economies, lower interest rates, and some improvement in investment climate will likely boost GDP growth in FY2013 to 6.7%, though less than the 7.5% projected in the *ADO 2012*.

**3.4.13 Industrial Outlook Survey**




*Source:* Reserve Bank of India.

**3.4.14 HSBC/Markit purchasing managers' indexes**




*Source:* Bloomberg (accessed 24 September 2012).

**3.4.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 7.0 | 5.6 | 7.5 | 6.7 |
| Inflation | 7.0 | 8.2 | 6.5 | 7.0 |
| Current acct. bal. (share of GDP) | -3.3 | -3.0 | -3.0 | -2.8 |

*Source:* ADB estimates.

The delayed monsoon and higher global food prices are likely to saddle FY2012 with higher food inflation, which is already trending higher due to supply–demand mismatches and hikes in crop support prices. Higher prices for diesel and liquefied petroleum gas in September are likely to have a combined upward effect of some 100 basis points on inflation. On the external front, the interplay between changes in currency values and commodity prices will affect inflation. With these considerations, this *Update* raises projected inflation to 8.2% in FY2012, from the earlier forecast of 7.0%, then forecasts a downward trend to 7.0% in FY2013 (Figure 3.4.15).

The persistence of high inflation along with limited steps toward fiscal consolidation and addressing supply-side constraints will likely slow the pace of monetary easing.

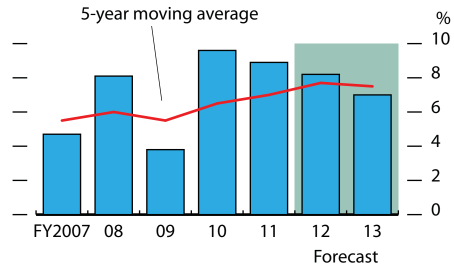
Realizing the importance of reining in an excessive budget deficit to stimulate lending for private investment, the FY2012 budget proposed moves toward fiscal consolidation. However, meeting the fiscal deficit target will be a stiff challenge in the current economic environment. While the widening of the service tax net and increase in excise duties and service tax rates will provide a buffer, lower growth will take a toll on tax revenue. Despite the initiatives announced in September, meeting the disinvestment target will be difficult under present market conditions. With reduced subsidies being a main plank of the program to lower the deficit, the outlook will be determined by the will to raise prices for the regulated commodities such as fuel and fertilizer in a difficult political environment. September's hike in fuel prices, though a step in the right direction, will have only marginal impact on the deficit. Various drought-relief measures and increased crop support prices are likely to add pressure on expenditures. Consequently, the deficit target faces considerable risks.

The slowdown in industrialized countries is likely to take its toll on exports. In particular, exports of engineering goods, gems and jewelry, and software services are likely to experience a slowdown. Consequently, exports are expected to increase by only 7.5% in FY2012. Tax measures introduced to curb the import of gold are likely to reduce imports in FY2012. The domestic slowdown will suppress other non-oil imports. However, oil imports will continue to remain high as prices remain elevated. Overall, imports are expected to increase only marginally, by 2.5%, in FY2012, which will help bring the current account deficit to down to 3% of GDP (Figure 3.4.16).

Somewhat improved growth prospects in the industrial economies from the year earlier are expected to lift exports by 15% in FY2013. The modest revival of domestic economic activity will support import growth by 13%. Remittances and exports of services are also likely to increase with improved economic activity in the advanced economies, improving the current account deficit to 2.8% of GDP in FY2013.

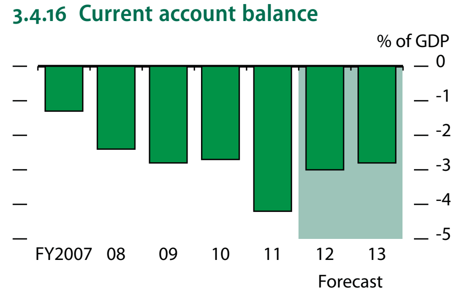
The projections above are subject to a number of risks. On the global front, the economic environment continues to be feeble, and a major shock such as the US fiscal cliff or a systemic event in the euro area would hit growth through both trade and financial channels. Delays in resolving the policy impasse on vital issues and limited progress on fiscal consolidation would not only dampen investor sentiment further but also delay the easing of monetary policy.

**3.4.15 Inflation**




*Source: Asian Development Outlook* database.

**3.4.16 Current account balance**




*Source: Asian Development Outlook* database.

# Indonesia

Stronger contributions to growth from investment and government spending, supported by robust private consumption, have largely offset the impact of weaker exports. Forecasts for GDP growth this year and next are shaved from the *ADO 2012*, published in April. The lower trajectory of exports has prompted downward revisions to forecasts of the external current account. Inflation has been lower than anticipated, prompting trimmed projections for this year and next.

## Updated assessment

GDP growth accelerated to 6.4% year on year in the second quarter of 2012 from 6.3% in the first, putting the first-half expansion at 6.3%. The main drivers were investment, private consumption, and government spending (Figure 3.5.1).

Fixed capital investment rose by 11.2% in the January–June period, the strongest increase in 4 years (Figure 3.5.2). Actual foreign direct investment (FDI) increased by 30.3% from the year-earlier period, according to data from the Investment Coordinating Board. This welcome surge in investment was underpinned by improvements in the domestic investment climate, a record of solid economic growth over recent years, and expanded credit. Gross fixed investment as a percentage of GDP edged higher to 32.3%.

Consumer spending remained robust in the first half, bolstered by relatively benign inflation, good harvests that supported farmers' incomes, and a firm labor market. Private consumption rose by 5.0% over the 6 months, slightly outpacing the 2011 figure.

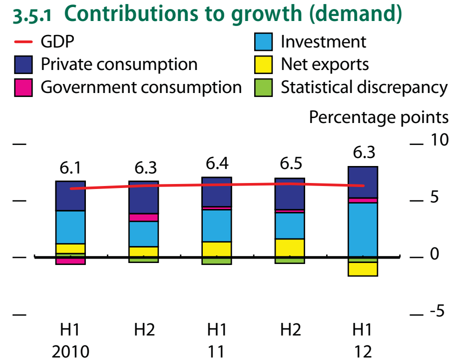
Government consumption spending accelerated to 6.5%, reflecting better execution of budget projects. While significant challenges remain, budget disbursement rates have gradually increased with improved budget procedures and procurement capacity in ministries, as well as enhanced monitoring and coordination.

However, the sluggish global environment caused exports of goods and services to turn down sharply, while imports held relatively firm because of buoyant investment. As a consequence, net exports acted as a drag on GDP growth in the first half.

From the supply side, services and manufacturing fueled GDP growth. Continued rapid expansion of communications contributed to growth in services. Manufacturing grew by 5.5%, only a little below the year-earlier pace despite the weakening of exports. Agriculture and mining increased output moderately.

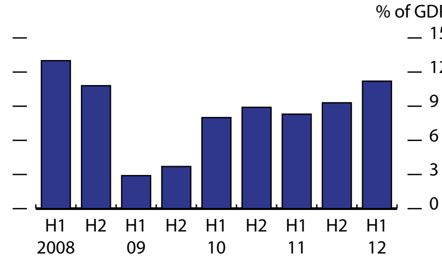
Inflation has been more subdued than anticipated, rising gradually to 4.6% year on year in August and averaging 4.2% over the first 8 months

**3.5.1 Contributions to growth (demand)**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 28 August 2012).

**3.5.2 Fixed investment growth**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 28 August 2012).

---

This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

(Figure 3.5.3). Inflationary expectations rose in the first quarter, reflecting government plans to hike administered fuel prices in April. However, that proposal was put on hold when Parliament decided that fuel prices could be raised only if Indonesian crude oil exceeded $120.80/barrel over a 6-month period, which did not happen. With the postponement of fuel price increases, core inflation settled at just over 4% from March to August.

Bank Indonesia lowered its policy interest rate to 5.75% in February 2012, as inflation eased and the global outlook dimmed. The central bank then maintained this rate through September. In August, it raised the rate on funds that banks deposit overnight in the central bank, to drain excess liquidity from the banking system.

Bank credit continued to grow at a rapid pace. Total credit increased by 25.2% year on year in July, with loans for investment up by nearly 30% (Figure 3.5.4).

In external accounts, a shrinking trade surplus and deficits in income and services together produced a current account deficit of $10.1 billion in the first half, equivalent to 2.3% of GDP. Merchandise exports in nominal US dollar terms contracted by 1.5% (Figure 3.5.5), a result of weaker demand abroad and falling prices for exports such as coal and palm oil. Imports rose by 14.7%, driven mainly by capital equipment to support robust investment and intermediate goods for manufacturing.

FDI worth $8.8 billion in the first half maintained the improving performance seen over the past 3 years. Net portfolio investment inflows recorded a $6.5 billion surplus, turning around from net outflows of $4.3 billion in the second half of 2011. Nevertheless, the current account deficit put the overall balance of payments into deficit by $3.8 billion (Figure 3.5.6). Gross international reserves shrank by $1.1 billion in the first 8 months to $109.0 billion, which is sufficient to cover 5.9 months of imports of goods and services.

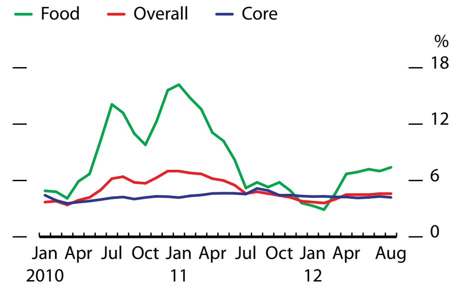
The rupiah depreciated by 5.5% against the US dollar during January–August, mainly reflecting global risk aversion and weakness in exports.

Budget disbursement quickened compared with sluggish performance in the previous 2 years. The budget recorded a deficit of 0.9% of GDP in the first half as it provided support to economic growth. Spending increased significantly, including for fuel and electricity subsidies, and the realization of capital projects improved. On the revenue side, tax collection increased more quickly than expected.

Robust economic growth generated more and better jobs. About 1.5 million new jobs were created in the 12 months to the end of February 2012, exceeding by half the 1.0 million new entrants to the workforce during that period. The quality of employment improved as 4.0 million people joined the formal sector, mostly in trading, finance, construction, and manufacturing. Employment in the informal sector fell by 2.4 million, as workers left agriculture.

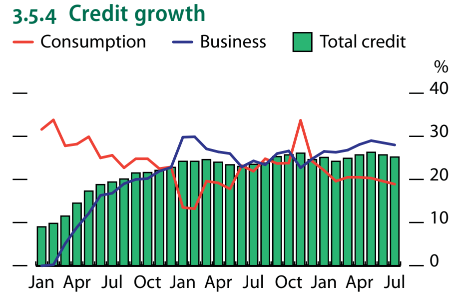
Still, generating employment remains a large challenge, as 62.7% of the employed labor force, or 70.7 million people, work in the informal sector, where wages are low and job security weak. The poverty incidence fell to 12.0% in March 2012 from 12.5% in March 2011.

**3.5.3 Inflation rates**



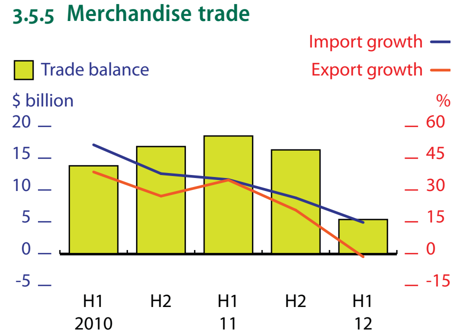

*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 12 September 2012).

**3.5.4 Credit growth**



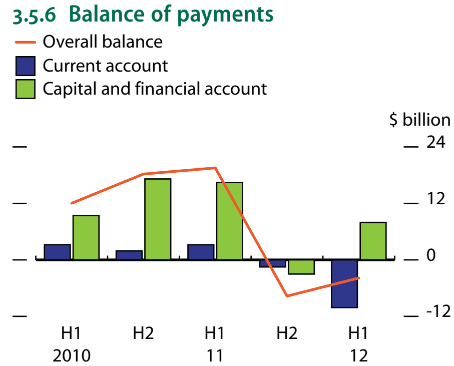

*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 12 September 2012).

**3.5.5 Merchandise trade**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 28 August 2012).

**3.5.6 Balance of payments**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 28 August 2012).

## Prospects

Projections for this year and next assume the government will maintain its efforts to improve the investment climate for the private sector and make further progress on implementing budget projects.

The fiscal stance is expected to remain accommodative in light of subdued global prospects. To allow for additional spending the government widened the 2012 fiscal deficit target in March to 2.2% of GDP, up from the originally planned 1.5% and doubling the actual 1.1% deficit in 2011. Despite larger-than-budgeted spending on subsidies, the deficit is expected to be close to the target thanks to stronger revenue collection.

For 2013, the government proposes a budget with a deficit target of 1.6% of GDP. This plan includes a further 19.8% increase in spending on infrastructure.

The government has issued an implementing regulation for the new land-acquisition law that was approved by Parliament in December 2011. This law aims to make land acquisition for infrastructure projects more certain.

As for monetary policy, inflation is expected to be within the central bank's target range of 3.5%–5.5%. Room for policy easing is constrained, though, by the widening current account deficit and the softer exchange rate.

Private consumption is forecast to remain buoyant against the backdrop of a firm labor market and lower income taxes for low-income earners effective from early 2013. Consumer confidence flagged in February–April as the government planned to raise fuel prices, but it bounced back when the price hike was put on hold (Figure 3.5.7). Retail sales have trended up during this year.

Investment has been stronger than expected and is likely to remain robust. The improved investment climate, lower interest rates, increases in public capital outlays, and upgrades in sovereign ratings underpin prospects for investment. The new land law eases a serious constraint on infrastructure investment. The authorities also simplified business regulations administered by local governments.

Lending interest rates have declined, and this trend is expected to continue because of heightened competition and improved bank efficiency (Figure 3.5.8). As noted above, credit expanded rapidly through July. With regard to sovereign ratings, Moody's Investors Service raised Indonesia's rating to investment grade (Baa3) in January 2012, reflecting the country's macroeconomic performance.

A Bank Indonesia Business Survey conducted in the first half of 2012 showed businesses optimistic and planning to expand. With regard to investment from abroad, Indonesia moved up to fourth position in the global ranking of attractive destinations for foreign direct investment in the 2012 survey of major international corporations conducted by the United Nations Conference on Trade and Development.

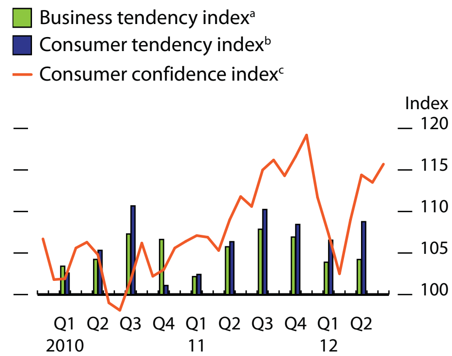
Merchandise exports have been considerably weaker than expected but are foreseen stabilizing during the second half of 2012—in part reflecting a base effect caused by a sharp slowdown in exports in the last 4 months of 2011. Data for July suggested a tentative recovery of exports to the European Union and Japan, as well as an increase to the People's

**3.5.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 6.4 | 6.3 | 6.7 | 6.6 |
| Inflation | 5.5 | 4.4 | 5.0 | 4.5 |
| Current acct. bal. (share of GDP) | -0.1 | -2.1 | 0.2 | -1.4 |

*Source:* ADB estimates.

**3.5.7 Business and consumer confidence indexes**



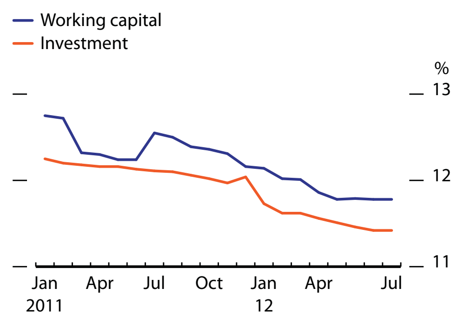

[a] From a Statistics Indonesia quarterly survey among business executives.

[b] From a Statistics Indonesia quarterly survey among middle- and upper-income households. [c] From a Bank Indonesia monthly survey among households.

*Note:* A score above 100 means that respondents are optimistic.

*Source: Asian Development Outlook* database.

**3.5.8 Average lending rates of commercial banks**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 12 September 2012).

Republic of China. In 2013, exports are projected to benefit from better prospects for growth in major trading partners and in world trade.

In summary, stronger investment this year, coupled with increases in government spending and private consumption, should offset most of the impact of weak exports. GDP is forecast to increase by 6.3% in 2012 and by 6.6% in 2013, both projections trimmed slightly from the *ADO 2012* (Figure 3.5.9).

In light of the weakness in exports and the rise in imports, the current account deficit this year will be deeper than anticipated and is now forecast at 2.1% of GDP. While exports are seen stabilizing in the second half of 2012, imports are expected to remain relatively strong. The anticipated recovery in external demand in 2013 should rein back the current account deficit to about 1.4% of GDP.

FDI and portfolio investment are projected to remain positive and so improve the overall balance of payments.

Inflation this year is lower than anticipated because of the continued postponement of fuel price increases. For 2012 as a whole, inflation is now forecast to end the year at 4.9%, for an average rate of 4.4%—which, if realized, will be the lowest average inflation rate in 12 years.

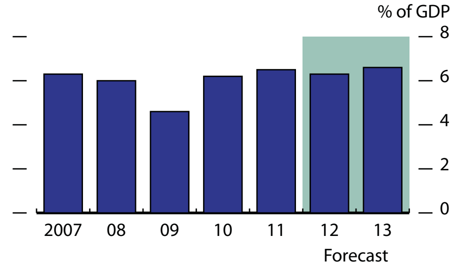
Next year, inflation is seen edging higher, partly as a consequence of planned increases in electricity tariffs (Figure 3.5.10). The 2013 budget does not propose increases in administered fuel prices. To manage potential supply-side pressures on inflation, such as food shortages, the government has strengthened its inflation task force, which can recommend temporarily suspending duties on imported commodities including food and take other steps to improve the availability and affordability of items in short supply.

Key downside risks to this outlook are further deterioration of export performance and capital outflows. Lower-than-projected economic growth in Indonesia's major export markets would widen the current account deficit further and dampen growth. The economy is susceptible to financial market volatility, as two-thirds of equities and one-third of sovereign bonds are foreign held. Deficits in the budget and current account reinforce the importance of maintaining capital inflows.

To mitigate these risks, the authorities have increased capital spending, augmented flexibility to raise spending and switch budget priorities in case of an economic emergency, and put together a $5 billion standby loan from development partners. Contingency plans cover a bond stabilization program under which the government can draw on accumulated budget surpluses and funds from state-owned enterprises to steady the market. For its part, the central bank has taken steps over the past year to reduce short-term and speculative capital inflows and to mitigate the risk of sudden outflows.

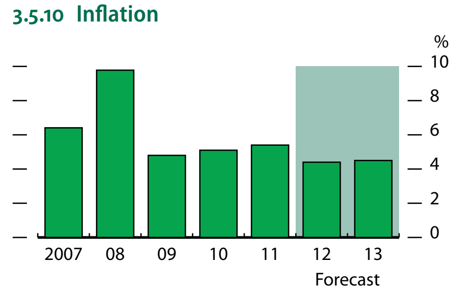
National government debt is projected to decline this year as a percentage of GDP, maintaining the downward trend of the past 11 years and helping to bolster the economy's resilience against shocks (Figure 3.5.11).

**3.5.9 GDP growth**




*Source: Asian Development Outlook* database.

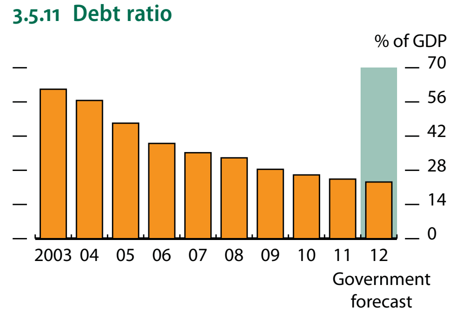
**3.5.10 Inflation**




*Note:* 2007 base year = 2002; 2008 onwards base year = 2007

*Source: Asian Development Outlook* database.

**3.5.11 Debt ratio**




*Sources: Asian Development Outlook* database; Bank Indonesia. *Recent Economic Developments, August 2012*. http:www.bi.go.id (accessed 14 September 2012).

# Malaysia

Driven by strong consumption and investment that benefited from fiscal stimulus, economic growth was higher than projected in the first half of 2012. This robust domestic demand overrode weakness in exports. In light of the first-half outcome, GDP growth will outperform the previous forecast. Growth is seen edging higher in 2013, but the forecast is trimmed from April owing to downgrades in global prospects. Inflation forecasts are lowered, as are those for external current account surpluses.

## Updated assessment

A surge in fixed investment and buoyant consumption spending drove unexpectedly strong economic growth in the first half of 2012. GDP rose by 4.9% year on year in the first quarter, picking up to 5.4% in the second quarter to put growth at 5.1% for January–June (Figure 3.6.1).

Fixed capital investment accelerated at 21.3%, growing at more than three times the pace seen in the first half of 2011 (Figure 3.6.2). It contributed more to GDP growth in the first half than did private consumption, reversing the usual positions.

Both private and public sector investment surged. Private investment flowed mainly into domestic-oriented services and manufacturing, as well as into oil and gas processing. Government investment was channeled by state-controlled enterprises into transportation, utilities, and oil and gas, as well as through the federal government's development spending.

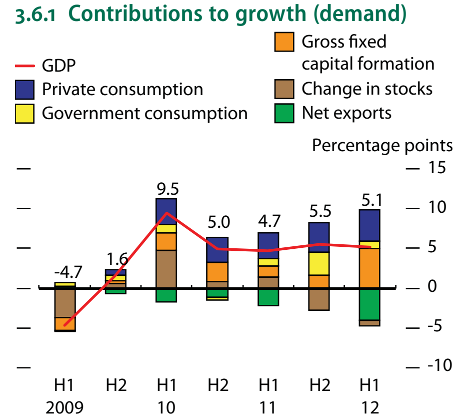
Consumption, too, gathered momentum in both the private and the public sector. Private consumption growth of 8.1% was underpinned by a robust labor market, income growth, and improved consumer sentiment. Employment increased by 3.4% in the 12 months to June 2012 while the seasonally adjusted unemployment rate fell to 2.8%. Wages in manufacturing rose by nearly 6% in the first half.

The government raised public sector wages by 13.0% in March. It also increased public sector pensions and made cash transfers to low- and middle-income households. A $3.2 billion initial public offering of shares in state-controlled Felda, a palm oil plantation company, in June paved the way for the government to make substantial cash payments and issue shares at a discount to 112,000 families of farm workers resettled under its Federal Land Development Authority program.

Higher public sector wages and pensions, together with large outlays on subsidies, contributed to an 8.4% rise in government consumption spending in the first half.

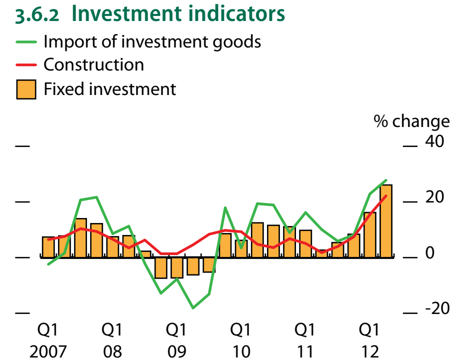
The external sector was, by contrast, a drag on GDP growth. Lackluster demand from major trading partners curtailed exports of goods and services, while buoyant consumption and investment powered imports.

**3.6.1 Contributions to growth (demand)**




*Sources:* Bank Negara Malaysia. 2012. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (accessed 6 September 2012).

**3.6.2 Investment indicators**




*Sources:* Bank Negara Malaysia. 2012. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (accessed 18 September 2012).

This chapter was written by Gary Krishnan of the Southeast Asia Department, ADB, Manila.

From the supply perspective, services continued to provide most of the increase in GDP (Figure 3.6.3). Industry also made a substantial contribution, but agricultural production fell, mainly because the production of natural rubber and palm oil declined.

Solid domestic demand supported 5.8% growth in services. Increased consumer spending benefited the retail trade, hotels, and restaurants, while robust investment lifted demand for communications, real estate, and business services.

Manufacturing output increased by 5.0%, with stronger growth in production oriented to domestic markets than for export. Double-digit growth was recorded in fabricated metal products, largely for construction, and consumer goods. The electronics and electrical products subsector, which contracted in the first half of 2011, grew by a slight 1.5% in the latest half. This turnaround stemmed in part from a recovery in the global electronics supply chain, which was disrupted in 2011 by the March earthquake and tsunami in Japan. Global demand for mobile phones and tablets supported the turnaround.

Construction was particularly strong in the first 6 months, expanding by 18.9%. This reflected a pickup in infrastructure, utility, and oil and gas projects under the government's Economic Transformation Programme, launched in 2010. This program aims to propel Malaysia into the ranks of high-income nations by 2020 by developing industries with higher value addition. Also spurring construction was demand for new housing as house sales rose by 13.2% in the half year.

Mining grew by 1.3% owing to higher production of crude oil following efforts to enhance recovery from existing oil fields. This represented a recovery from 2011, when oil production fell.

Federal government spending accelerated to grow by 19.9% in the first half of 2012. Revenue increased by 10.3%, dampened by lower prices for commodities, which widened the fiscal deficit in January–June. Federal government debt, standing at 40% of GDP as recently as 4 years ago, equaled 51.9% of GDP at mid-2012.

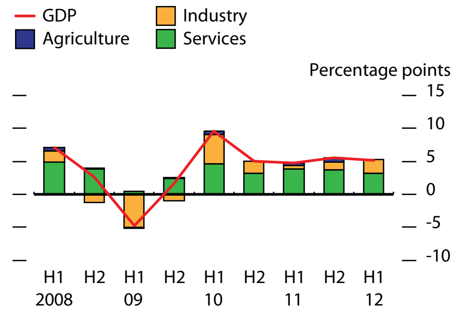
Despite strong domestic demand, inflation receded to 1.4% year on year in August from 3.0% at the end of 2011 (Figure 3.6.4), driven down by a deceleration in food and fuel prices. Price increases were further contained by subsidies and price controls, including on fuel.

Bank Negara (the central bank) kept its policy interest rate steady at 3.0%, as it balanced buoyant domestic demand and fiscal stimulus on the one hand against low inflation and subdued global prospects on the other. Loans outstanding to businesses expanded by 14.3% in June, the pace quickening from a year earlier. Loans to households decelerated slightly to 11.8% in the 12 months to June, likely reflecting moves by the central bank in 2011 to curb risky personal lending and speculation in housing.

In external accounts, the surplus in goods trade fell by 13% to \$21.1 billion in the first 6 months, eroded by sluggish exports (Figure 3.6.5). Merchandise exports edged up in US dollar terms by just 2.0%. Exports of manufactured goods rose marginally in value, but higher prices received for natural gas sharply raised exports of minerals. Shipments of agricultural commodities, including palm oil, fell.

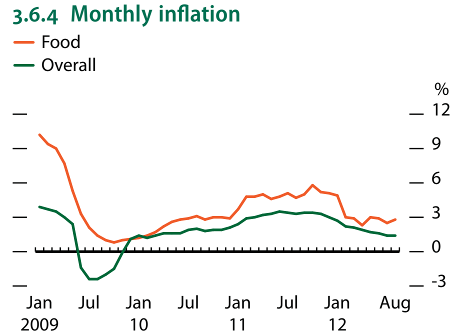
Imports, by contrast, rose by 6.0%. Strong investment drove a 22% climb in imports of capital goods (on a customs basis), and buoyant

**3.6.3 Contributions to growth (supply)**



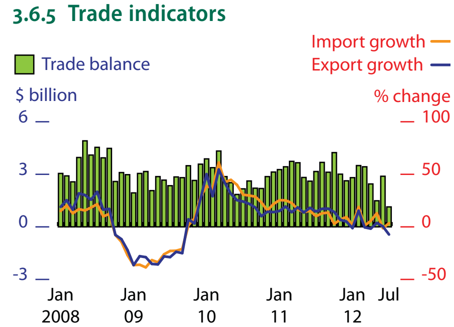

*Sources:* Bank Negara Malaysia. 2012. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (accessed 6 September 2012).

**3.6.4 Monthly inflation**




*Sources:* Bank Negara Malaysia. 2012. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (accessed 11 Septmber 2012).

**3.6.5 Trade indicators**

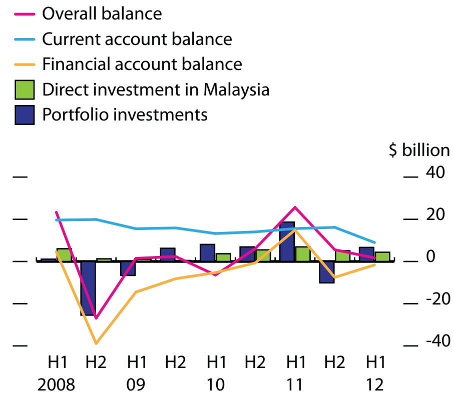



*Source:* CEIC Data Company (accessed 18 September 2012).

consumer demand was met through a 13% increase in imports of consumer goods. After accounting for wider deficits in services and income, the current account surplus fell by 42.4% to $9.0 billion in the first half (Figure 3.6.6).

The financial account recorded a small net outflow in the first 6 months, compared with a large net inflow a year earlier. Portfolio investment inflows were greatly reduced from a year earlier, and direct investment subsided. The overall balance of payments recorded a surplus of $1.7 billion. International reserves remained substantial at the end of August at $134.9 billion, which is cover for 9.5 months of imports and 3.9 times the short-term external debt. By late September, the ringgit had appreciated by 3.9% against the US dollar since the end of 2011.

**3.6.6 Balance-of-payment indicators**




*Sources:* Bank Negara Malaysia. 2012. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (accessed 12 September 2012).

## Prospects

While weak external demand will continue to weigh on economic growth, domestic demand is stronger than anticipated in the *ADO 2012* and expected to remain buoyant through the forecast period. The forecasts assume that national elections scheduled to be held by April 2013 will go smoothly and that the government will maintain policies that provide significant support for growth.

GDP growth is projected to decelerate in the second half of 2012 from the 5.1% pace of the first half as external drag intensifies. For 2012 as a whole, GDP is seen growing by 4.6% (Figure 3.6.7). This forecast is revised up from April because of stronger-than-anticipated domestic demand in the first half. Next year, GDP growth is projected at 4.8%, on the assumption that world trade and growth will improve somewhat. The 2013 forecast is trimmed from April in view of the more subdued outlook in this *Update* for the global recovery.

Private consumption will be supported through the forecast period by a robust labor market, low inflation, and transfer payments. Incomes will get a boost from a scheduled increase in the minimum wage next year. The government passed legislation in July to introduce a minimum wage of RM900 ($300) per month for Peninsular Malaysia and RM800 for East Malaysia, effective from January 2013. Up to a quarter of the labor force could benefit if this wage rise is implemented as planned.

Declines in prices for agricultural export commodities will hurt rural incomes, but some of this impact will be offset by cash transfers.

An index of consumer sentiment compiled by the Malaysian Institute of Economic Research rose in both the first and second quarters of 2012, though the pace of improvement slowed in the latest reading (Figure 3.6.8).

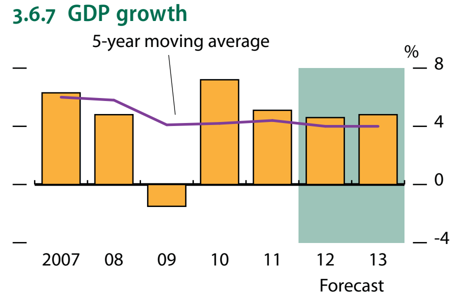
Investments under the Economic Transformation Programme are gathering momentum, including an $11.5 billion mass rapid transit rail system in Kuala Lumpur, the country's biggest-ever infrastructure project, and significant urban redevelopment in the capital. Other projects under way are a second bridge to Penang costing over $1 billion and a $550 million oil and gas terminal for Sabah. The federal government has boosted development spending on a range of industries and services, while state-controlled enterprises plan further substantial investments.

**3.6.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.0 | 4.6 | 5.0 | 4.8 |
| Inflation | 2.4 | 1.9 | 2.8 | 2.5 |
| Current acct. bal. (share of GDP) | 12.1 | 9.3 | 11.9 | 9.8 |

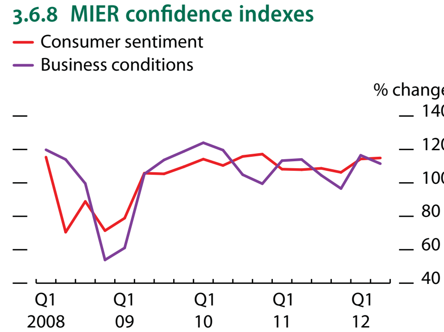
*Source:* ADB estimates.

**3.6.7 GDP growth**




*Source: Asian Development Outlook* database.

**3.6.8 MIER confidence indexes**




MIER = Malaysian Institute of Economic Research.

*Source:* CEIC Data Company (accessed 18 September 2012).

Housing approvals doubled in the first half of 2012 from a year earlier, indicating that this area of investment, too, will be buoyant. Credit to the private sector accelerated from January to the end of July (Figure 3.6.9).

The Business Conditions Index, compiled from a survey of manufacturers, remained positive in the second quarter but indicated slower growth in the months ahead. Manufacturers reported that inventories were starting to build and that the outlook for sales and production had softened, supporting the projection that the pace of economic growth would ease in the second half of 2012.

Services, which generate 60% of GDP, will gain from the solid growth projected in both consumption and investment. Communications, business services, financial and real estate services, retailing, and restaurants are expected to perform well during the forecast period.

Public spending will remain a significant force in sustaining growth. The government announced a supplementary budget in June that provides it with an additional RM13.8 billion ($4.5 billion) for this year. The federal budget deficit is expected to be about 5% of GDP, as in 2011. Fiscal policy looks set to stimulate growth next year, too, as the government pushes ahead with social programs and the Economic Transformation Programme. The 2013 budget targets a deficit of 4.0% of GDP.

Fiscal goals to eliminate the budget deficit and curtail subsidies, and to reduce the dependence of public finances on oil and gas revenue through a new goods and services tax, appear to be medium-term rather than near-term objectives. Subsidies absorbed just over 14% of total government spending in 2011. Receipts from oil and gas provide 30%–40% of government revenue.

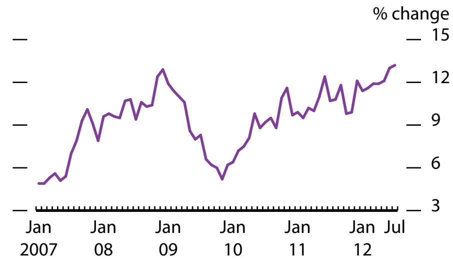
Monetary policy is projected to accommodate economic growth. The central bank stated in September that it expects domestic inflation to remain moderate for the rest of 2012 and into 2013. Inflation has receded more quickly than was anticipated in the *ADO 2012*, trimming the forecast for this year to 1.9%. Inflation is seen picking up to 2.5% in 2013 owing to further expansion of domestic demand and wage increases (Figure 3.6.10). Prices of subsidized goods and services could be adjusted upward during next year.

External demand is expected to sag through 2012. Merchandise exports fell in July by 7.3% (on a customs basis in US dollars). Exports to the European Union and the PRC were particularly subdued in that month. Imports rose by 9.5%. In 2013, exports are expected to recover in line with the projected pick up in world growth and trade, though imports will rise in tandem to provide the intermediate goods needed by the export industries and to meet expanding demand from consumption and investment.

The current account surplus forecast is therefore revised down from *ADO 2012*, now expected to decline to 9.3% of GDP in 2012 and edge back to 9.8% in 2013 (Figure 3.6.11).

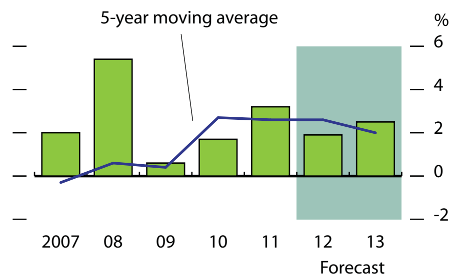
Economic growth has been resilient in the face of weaker-than-expected growth in major export markets, bolstered by supportive policies. Nevertheless, the economy is closely linked to global growth, particularly through trade, so its prospects next year would be undermined if the expected modest global recovery fails to materialize.

**3.6.9 Credit to the private sector**



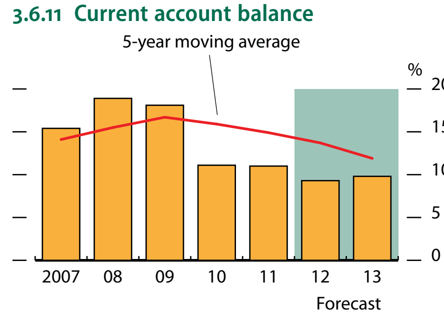

*Source:* CEIC Data Company (accessed 18 September 2012).

**3.6.10 Annual inflation**




*Source: Asian Development Outlook* database.

**3.6.11 Current account balance**




*Source: Asian Development Outlook* database.

# Pakistan

The economy continues to struggle with low growth and high inflation imposed by energy shortages, security issues, and macroeconomic imbalances. In FY2012, consumption continued to drive the economy as investment declined. Fiscal and external imbalances intensified, as the budget deficit reached 8.5% of GDP, principally to support the power sector, while official reserves sagged by $4.7 billion under the weight of larger debt repayments coupled with reduced capital inflows. *ADO 2012* forecasts of low growth and high inflation for the coming year are essentially maintained. The need for fundamental structural reforms is evident, but pending elections by early 2013 render major policy initiatives unlikely.

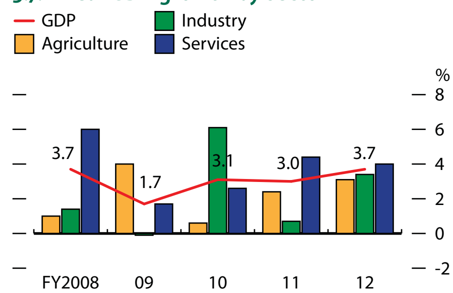
## Updated assessment

Over the past 5 years, economic growth has averaged 3.0%, well below the 6.8% average for the previous 5 years and the estimated 7% pace necessary to absorb new entrants into the labor market. The lower growth profile reflects a number of factors, including security issues, severe flooding in July–August 2010, volatile commodity prices, and steady deterioration in the performance of the energy sector that is estimated to knock at least 2 percentage points from GDP growth annually. Sluggish growth, an uncertain economic environment, and a decline in business confidence have steadily undermined investment and raised concern for the country's future growth prospects.

In FY2012 (ended 30 June 2012) the economy recovered modestly from the previous year's devastating floods to expand by 3.7%, marginally better than the *ADO 2012* projection of 3.6% (Figure 3.7.1). Agricultural growth picked up to 3.1%, markedly easing inflationary pressure. The recovery did not extend to large-scale manufacturing, which was hobbled by a significant increase in power load shedding during the second half of the year, holding growth in large-scale manufacturing to only 1.2%—even lower than the flood-induced slowdown to 1.8%. Pharmaceuticals strengthened, but the production of textiles stagnated and that of automobiles, chemicals, iron, and steel contracted. The industry sector nevertheless saw growth rebound to 3.4% on the strength of higher construction, mainly to rehabilitate flood-affected areas. While the expansion of the services slowed slightly to 4.0%, the sector is sufficiently large that it continued to account for most of the expansion in output.

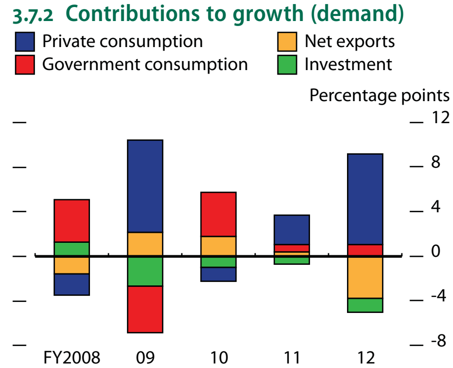
Private consumption, boosted by robust remittances from workers overseas and increases in public sector salaries, accounted for nearly all of GDP growth in terms of expenditures (Figure 3.7.2). The contribution from investment and net exports was negative, reflecting sluggish economic conditions and electric power disruption. Fixed investment has steadily declined from 20.9% of GDP in FY2007 to 10.9% in FY2012 as

**3.7.1 Real GDP growth by sector**




*Source:* Ministry of Finance. Pakistan Economic Survey 2010–11. http://www.finance.gov.pk

**3.7.2 Contributions to growth (demand)**




*Source:* Ministry of Finance. *Pakistan Economic Survey 2010–11*. http://www.finance.gov.pk

This chapter was written by Dawn Elizabeth Rehm and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

business conditions deteriorated, while the drop in net exports reflected a falloff in export volume coupled with increased imports.

Average consumer price inflation improved from 13.7% in FY2011 to 11.0% in FY2012 as food inflation fell back from the 17.1% pace (year-on-year) in July 2011 to 9.1% by July 2012 (Figure 3.7.3). Core inflation stayed in the low double digits, with three-fifths of the items in the consumer basket recording double digit price increases at the end of FY2012. Inflation declined to just below 10% in the first 2 months of FY2013, mainly reflecting a large reduction in administered prices for gasoline.

Inflation expectations are a factor in the persistence of inflation, as the public recognizes that the government's heavy borrowing from the State Bank of Pakistan, the central bank, stokes inflation. Such borrowing conflicts with legislation, including the State Bank of Pakistan Act, and the Fiscal Responsibility and Debt Limitation Law, which mandates that the government steadily lower its debt profile.

As inflation eased during the first half of FY2012, the central bank stepped down its main policy rate from 14% to 12% in July and October 2011 to provide an impetus for investment. Further cuts were suspended as inflation edged up in the second half of the fiscal year. Growth in reserve money and broad money during FY2012 came entirely from expansion in domestic assets, as foreign assets steadily declined. Total government borrowing from the banking system reached PRs1.2 trillion, more than double that of the previous year.

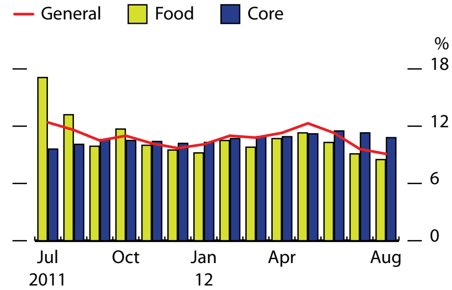
Private lending decelerated in the aftermath of Pakistan's economic crisis in FY2008, as banks looked to offset a surge in nonperforming loans with high-yield, low-risk government debt. In FY2012, heavy government borrowing and the weak business climate brought to a virtual halt private sector lending for working capital and squeezed to a minimum lending for fixed investment. Reflecting recent trends, credit to the private sector declined from about 65% of outstanding bank credit in FY2007 to 37% by June 2012, mirroring an increase in the share of credit to government from 26% to 55% (Figure 3.7.4).

Fiscal sustainability remains a concern, as the budget deficit in FY2012 increased to 8.5% of GDP from 6.6% a year earlier, well above the 4% target (Figure 3.7.5). Recurrent outlays accounted for the bulk of the overrun, reflecting mainly larger spending on power sector subsidies and funding to partly settle power sector arrears. Preliminary estimates indicate that subsidies to the power sector tripled from the budgeted 0.7% of GDP to 2.2%, boosting total subsidies to 2.5% of GDP. Domestic interest charges also exceeded budgeted amounts, reaching 4.0% of GDP as interest costs tracked higher domestic borrowing.

Development spending rebounded in FY2012, from the flood-induced compression a year earlier, at both the federal and the provincial level, increasing to an estimated 3.5% of GDP from 2.8%. Although both external and nonbank financing of the deficit were higher during the year, bank system lending surged to fill most of the gap in budget funding, nearly doubling from a year earlier to PRs1.1 trillion, or 5.3% of GDP.

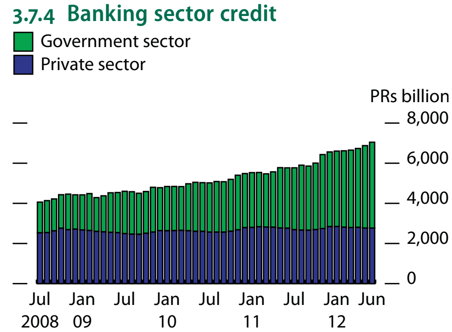
Federal and provincial government tax revenues were buoyant in FY2012, expanding more quickly than GDP for the first time in 4 years, to 9.9% of GDP. Income and sales tax receipts were particularly strong, supported by

**3.7.3 Inflation**



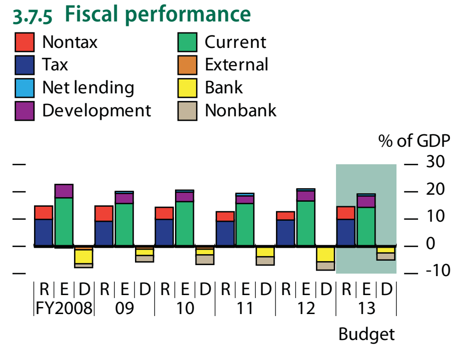

*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 18 September 2012).

**3.7.4 Banking sector credit**




*Source:* State Bank of Pakistan.

**3.7.5 Fiscal performance**




R = Revenue; E = Expenditure; D = Deficit financing.

*Notes:* Data refer to consolidated federal and provincial governments. Net lending includes statistical discrepancy. Non-bank includes privatization proceeds.

*Sources:* Ministry of Finance. *Pakistan Economic Survey 2011–12*; Pakistan Fiscal Operations July–June 2011–12; *Federal Budget 2012–2013, Budget in Brief*; ADB estimates.

improved administration and collection, while the one-off flood-related surcharges enacted in FY2011 and higher oil prices buoyed sales tax receipts. Nevertheless, tax revenue fell short of its budget target and continued to be much lower than the government's current operating cost.

Provisional data for the end of FY2012 indicate that domestic debt and liabilities increased by 26.5% to PRs7.9 trillion, or 38.2% of GDP, the marked addition to debt including the financing of some power sector and commodity debts. During the year, external debt and liabilities rose by 6.2% to PRs5.3 trillion, or 25.6% of GDP, to bring total government debt to 63.8% of GDP (Figure 3.7.6). While relatively high, the debt appears manageable, despite rollover and interest rate risks evident in the average maturity being less than 18 months, as most domestic debt is short term.

The current account returned to a deficit of 2.0% of GDP in FY2012, mainly owing to a 12% increase in imports as oil payments climbed 16.7% higher and fertilizer imports doubled to offset the impact of gas shortages on domestic production (Figure 3.7.7). A 2.8% fall in exports was an additional factor, mainly reflecting a marked decline in demand for food exports. Textile exports stagnated as volume fell in the second half of the year due to severe power outages, but favorable export prices for much of the year helped to maintain earnings. A strong expansion in worker remittances by 17.7% kept the current account deficit in check.

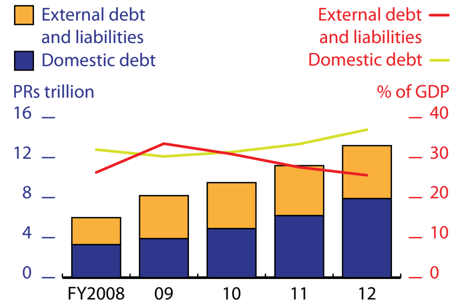
Inflows of foreign capital have slowed markedly in recent years, providing little cushion to offset the impact of current account deficits on reserves. Inflows of foreign direct investment plunged from $5.1 billion in FY2007 to $1.6 billion in FY2011 and a scant $813 million in FY2012 (Figure 3.7.8). Portfolio investment posted a $71.1 million outflow during the year. The current account deficit and higher foreign debt repayment obligations pushed the balance of payments into a deficit that drew $4.7 billion from gross official reserves, leaving $11.9 billion in June 2012. The Pakistan rupee depreciated by 9.0% against the US dollar in FY2012, while the real effective exchange rate appreciated by 4.6% because of inflation differentials between Pakistan and its trading partners.

## Prospects

Pakistan has potential for higher growth. Ample scope exists to improve agricultural productivity and expand manufacturing and services. The country has natural resources and a rapidly growing working-age population with a strategic location at the crossroads of Europe, Asia, and Africa. At present, security issues, energy shortages, financial imbalances, and governance concerns are holding the country back and undermining the business confidence needed to support a dynamic and growing private sector. While roadblocks appear daunting, sustained and deepened adjustment policies can allow Pakistan to realize its full potential, securing rapid and inclusive economic development.

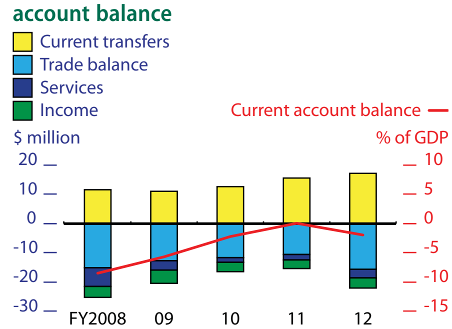
The current government is expected to complete its term and run for reelection in early 2013, making it Pakistan's first democratically elected administration to reach this milestone. Discussions are underway to put into place a caretaker government to serve during the 90-day pre-election period. This precludes any real prospect of difficult structural reforms being instituted during the forecast period of this *ADO Update*.

**3.7.6 Public foreign and domestic debt**



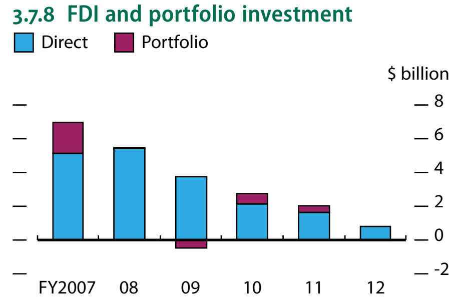

*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 17 September 2012).

**3.7.7 Components of the current account balance**




*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 7 August 2012).

**3.7.8 FDI and portfolio investment**




*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 17 September 2012).

Macroeconomic imbalances and structural issues are expected to hold growth to 3.7% in FY2013, in line with the FY2012 outcome, as the energy shortage is expected to continue as a binding constraint throughout the year. Moreover, slackening global demand is likely to further crimp growth in the country's key exports. In its monetary policy statement for FY2013, the central bank reduced policy rates by 150 basis points to motivate greater investment, but the impact of this is likely to be muted by the uncertain business climate.

The budget for FY2013 targets a 4.7% deficit, somewhat higher than the (widely overshot) 4% target for FY2012. Expenditures allow for a 20% increase in wages and salaries, with allocations for subsidies to be held to PRs208 billion, well below outlays of PRs512 billion in FY2012 (Figure 3.7.9). Meeting the announced target deficit will be challenging given the tendency for substantial current expenditure overruns, particularly for subsidies, and the prevalence of intra power sector debts.

Projected revenue growth of 24% from the estimated FY2012 outcome relies on administrative improvements and an increase in the number of taxpayers to offset adopted revenue-reducing measures: income tax slab consolidation to reduce the number of tax rates and the elimination of high sales taxes on imported inputs. Moreover, approved provincial budgets show a combined deficit equal to 0.2% of GDP, in contrast to the cash surplus of 0.4% of GDP that budget policy assumes. This alone endangers the 4.7% deficit target, even without likely current expenditure overruns or revenue shortfalls.

Inflation in FY2013 is projected to average 10.0%. While the federal government repaid in the first months of the fiscal year part of last year's borrowing from the central bank, the need for domestic budget financing is likely to exceed PRs971 billion in FY2013, as external financing is low and budget overruns are apparent, including those caused by elevated inflation expectations that drive up prices, costs, and credit demand.

Taking into account the revival of Coalition Support Fund inflows worth $1.2 billion, and the expected continued strong growth in remittances, the current account will likely post a deficit equal to 1.3% of GDP. Exports are projected to grow by 3.0% on weak demand and constrained gas and electricity supply. Imports are projected to rise by 8.0%, about in line with growth and the expected rise in global prices. Reserves remain adequate but may, along with the exchange rate, come under pressure from the projected current account deficit, lower capital inflows, and higher debt service obligations (Figure 3.7.10).

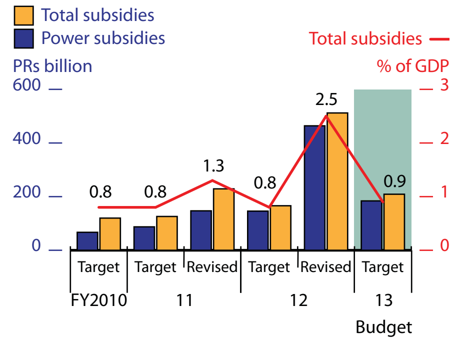
Improving the performance of Pakistan's economy depends on taking difficult steps to address structural problems. Increasing private investment sufficiently to satisfy growing demand for goods and services depends on the power sector becoming a reliable supplier of electricity and financially viable. Domestic capital markets also need to be developed before private investment can be substantially increased. Most important of all is to fundamentally improve the country's fiscal position by both eliminating subsidies and the drain on public finances caused by loss-making state-owned enterprises and broadening the tax base to raise one of the lowest tax participation rates in the region, promote equity, and provide the revenues needed to fund necessary government functions.

**3.7.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 3.6 | 3.7 | 4.0 | 3.7 |
| Inflation | 12.0 | 11.0 | 10.0 | 10.0 |
| Current acct. bal. (share of GDP) | -1.8 | -2.0 | -1.9 | -1.3 |

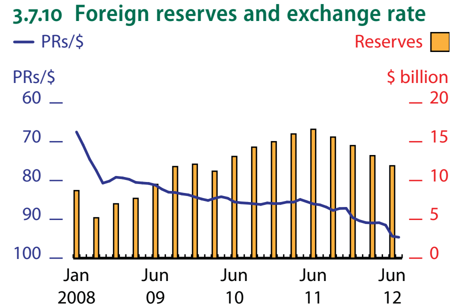
*Source:* ADB estimates.

**3.7.9 Subsidies**




*Source:* Ministry of Finance. Federal Budget Brief, Budget in Brief. Various issues. http://www.finance.gov.pk

**3.7.10 Foreign reserves and exchange rate**




*Sources:* State Bank of Pakistan; CEIC Data Company (both accessed 18 September 2012).

# Philippines

Robust private consumption and a rebound in government spending drove economic growth higher than expected in the first half of 2012, prompting an upward revision of the forecast for the full year. Growth is seen moderating in 2013 partly owing to global economic headwinds. Upgrades in indicators of competitiveness and sovereign ratings reflect an improved investment environment. Inflation is forecast to remain contained this year and next. Generating better jobs and reducing poverty remain the key challenges.

## Updated assessment

Economic growth in the first half of 2012 was broadly based and stronger than anticipated. Growth stemmed from buoyant private consumption, a rebound in government spending, higher fixed capital investment, and positive net exports of goods and services. GDP rose by 6.1% in January–June from the year-earlier period (Figure 3.8.1).

Private consumption, comprising about 70% of GDP, benefited from growth in employment, modest inflation, and remittances from overseas Filipino workers. Remittances rose by 5.3% to $11.3 billion, or by 3.8% in pesos. In the first 6 months private consumption rose by 5.4% compared with the first half of 2011.

Government spending, including public sector wages and cash transfers to poor families but excluding capital outlays, jumped by 12.3%, marking a turnaround from contraction in the first half of 2011.

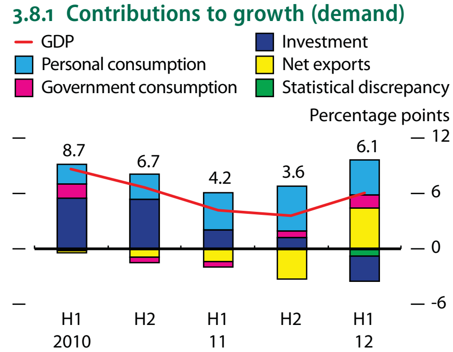
Fixed capital investment increased by 6.0%. Investment in public infrastructure surged by 51% as the government accelerated disbursements for projects (Figure 3.8.2). A base effect amplified the sharp rise because public agencies' disbursements in 2011 were delayed during governance reforms. Declining interest rates supported private investment. However, inventory drawdowns caused overall capital formation to contract.

The driving force from the production side was services, which contribute 57% of GDP. This sector expanded by 7.8%, generating nearly three-fourths of total GDP growth in the first half. Relatively high rates of growth were seen in real estate and business services, trade, transport, and communications. Tourist arrivals rose by 11.7% and export-focused business process outsourcing (BPO) continued to expand.

Manufacturing grew by 5.0%, with food processing an important contributor. However, the production of communications equipment including semiconductors fell by 6.9%, reflecting weakness in exports. Utilities and public construction put in solid performances. Industry as a whole accounted for about one-fourth of GDP growth.

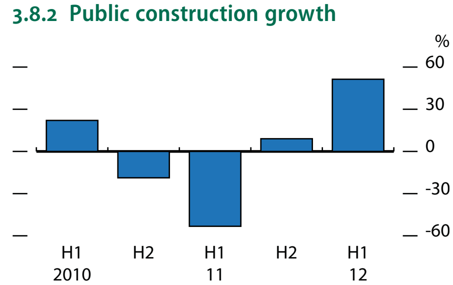
Agricultural production rose by just 0.8% in the first half. Rice output increased by 4.1%, partly offset by a decline in some other crops and fisheries.

**3.8.1 Contributions to growth (demand)**




*Sources: Asian Development Outlook* database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 31 August 2012).

**3.8.2 Public construction growth**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 12 September 2012).

---

This chapter was written by Norio Usui and Teresa Mendoza of the Philippines Country Office, ADB, Manila.

The number of people employed rose by 867,000 in the first 7 months of 2012 from the year-earlier period, slightly outpacing growth in the labor force. The increase was driven by part-time employment. The unemployment rate fell slightly to 7.0%, but the rate of underemployment rose to 22.7% in July, the worst since 2006. The unemployment rate for youths aged 15–24 was also high at 17%.

Exports held up relatively well in the first 6 months, and the trade deficit narrowed. Merchandise exports rose by 8.2% year on year in US dollar terms. Increases were seen in exports of machinery and transport equipment, chemicals, furniture and fixtures, and processed food and beverages. By contrast electronics (mainly semiconductors), comprising half of all exports, fell by 4% as global demand sagged (Figure 3.8.3). Imports increased at the subdued pace of 3.7% as capital equipment, consumer goods, and oil rose but imported materials used by electronics manufacturers fell in line with weak exports of electronics.

Receipts from BPO, together with remittances, contributed to a current account surplus of $3.7 billion (3.1% of GDP) in the first half (Figure 3.8.4). The capital and financial account posted net outflows of $1.2 billion. Foreign direct investment inflows remained relatively low at $917 million. Net portfolio investment inflows totaled $1.9 billion, much reduced from year-earlier inflows. The overall balance of payments recorded a surplus of $1.3 billion. Gross international reserves rose to $80.8 billion as of August, sufficient for 11.9 months of import cover.

Bangko Sentral ng Pilipinas (the central bank) fine-tuned its macroprudential measures, in part to contain risks associated with capital inflows. To enhance oversight of lending for real estate the central bank directed banks to provide more information on their exposure to property, including their investments in debt and equity securities as well as loans that fund real estate activity.

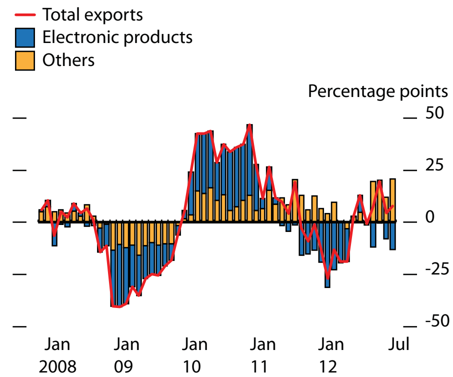
Inflation eased from 4.2% year on year at the end of 2011 to 3.2% in July, then edged up in August, when floods disrupted food supplies in some areas (Figure 3.8.5). Against the backdrop of a weakening global economic outlook and moderate domestic inflation, the central bank cut its overnight borrowing rate by 75 basis points between January and July 2012 to 3.75%.

Bank lending to the private sector grew briskly, by 18.4% year on year in July (Figure 3.8.6). The central bank used its special deposit accounts (deposits from banks and certain other institutions) to manage liquidity. It lowered interest rates on the accounts and prohibited deposits in them from nonresident sources to curb speculative inflows and resist upward pressure on the peso. Nevertheless, the peso appreciated by about 5% against the US dollar from December 2011 to late September 2012.

## Prospects

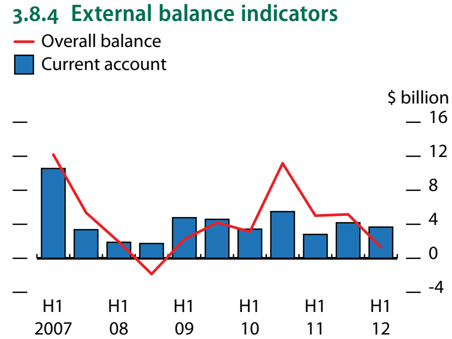
The forecast for GDP growth this year is raised to 5.5%, taking into account the higher-than-expected outcome in the first half and more moderate growth projected for the second half. Next year, the economy is seen growing by 5.0% (Figure 3.8.7). The impact of the 2012 rebound in government spending will fade in 2013 (though capital spending will

**3.8.3 Contribution to export growth**



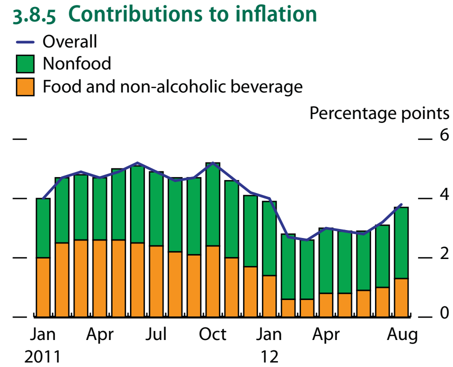

*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 14 September 2012).

**3.8.4 External balance indicators**



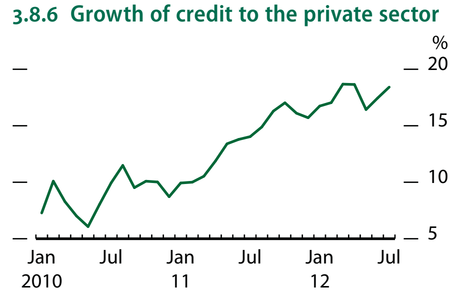

*Source:* CEIC Data Company (accessed 22 September 2012).

**3.8.5 Contributions to inflation**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 12 September 2012).

**3.8.6 Growth of credit to the private sector**




*Sources: Asian Development Outlook* database; CEIC Data Company (accessed 14 September 2012).

increase) and net exports will likely weigh on GDP growth, as growth in imports is projected to outpace that for exports.

Private consumption will continue to grow, though at a slightly slower rate in the second half of 2012 because remittance inflows have moderated (Figure 3.8.8). Remittances should pick up in 2013, in line with the anticipated improvement in the global outlook. Moderate inflation projected through the forecast period will support growth in consumption.

A survey of consumers conducted in July showed consumer sentiment positive for 2013, based on expectations of moderate inflation and better prospects for employment and incomes (Figure 3.8.9).

A separate survey shows business sentiment for the fourth quarter of this year at an all-time high (Figure 3.8.9). Among other factors, respondents were optimistic about new orders and increased spending in the run-up to local and national legislative elections scheduled for May 2013.

Investment is expected to remain robust, as suggested by higher imports of capital goods and bank lending and by commitments to public infrastructure. By July, the government had released to its agencies about 80% of the 2012 budget, and it deployed teams in key agencies to address bottlenecks to spending. Rising public investment will likely continue, though the pace of increase is seen decelerating from the fourth quarter of this year because it was in late 2011 that the government started to pump up public investment.

The budget for 2013 proposed by the government includes a 16.4% increase in the allocation for economic services, which include infrastructure, from the amount budgeted this year. Overall spending is to rise by 12.8%, excluding debt-service payments. The government is preparing detailed plans aimed at ensuring the timely disbursement of budget funds and procurement of goods and services.

Infrastructure investment projects under the public–private partnerships program launched in 2010 should finally gather momentum in 2013, after a slow start.

Upgrades of sovereign credit ratings and global competitiveness indicators reflect improvements in the investment environment. Standard & Poor's raised the country's long-term foreign currency credit rating in July 2012 to one notch below investment grade, noting progress on fiscal consolidation, a strong external position, and macroeconomic stability. Moody's rates the Philippines two notches below investment grade, but upgraded its outlook to positive in May.

The Philippines' ranking in the World Economic Forum's 2012–2013 Global Competitiveness Report rose by 10 places to 65 out of 144 economies, marking the second year in a row that the country moved up 10 places. Significant gains were posted in the category of institutions, which measures governance (Table 3.8.2), and in the macroeconomic environment, technological readiness, and financial market development. The country continues to rank poorly in terms of infrastructure, labor market efficiency, health, and primary education.

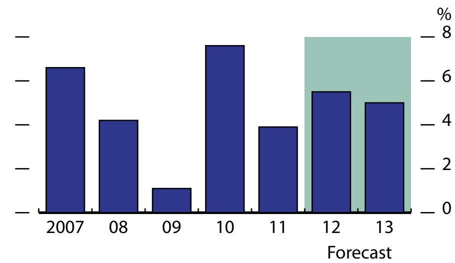
Growth in private consumption and investment will fuel the expansion of services through 2013. BPO is expected to maintain solid growth; export revenue from this industry climbed from $4.8 billion in 2007 to

**3.8.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 4.8 | 5.5 | 5.0 | 5.0 |
| Inflation | 3.7 | 3.5 | 4.1 | 4.1 |
| Current acct. bal. (share of GDP) | 2.1 | 2.6 | 2.3 | 2.8 |

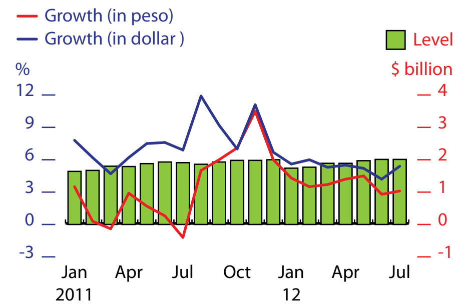
*Source:* ADB estimates.

**3.8.7 GDP growth**




*Source: Asian Development Outlook* database.

**3.8.8 Personal remittances**




*Sources: Asian Development Outlook* database; Bangko Sentral ng Pilipinas; CEIC Data Company (both accessed 20 September 2012).

**3.8.9 Confidence indexes**


*Source:* CEIC Data Company (accessed 12 September 2012).

$11.0 billion in 2011 and is projected to grow by 20% annually through 2016. Tourism will gain from investments in provincial airports and other infrastructure. Manufacturing, while drawing support from robust domestic consumption, is being buffeted by the external headwinds. A modest recovery in major export markets will provide a lift to manufacturing next year. Construction will benefit from spending on public infrastructure.

There is room for further policy support for economic growth if required. Modest inflation (well within the central bank's 3.0%–5.0% target range), a strong external position, and an appreciating currency suggest that monetary policy can stay accommodative, at least in the near term. Fiscal outlays fell $2 billion short of the budgeted amount in the first half of this year, despite the boost in government spending.

Next year, the government aims to narrow its budget deficit to 2.0% of GDP, from 2.6% in 2012. It targets an increase in tax revenue to 13.8% of GDP. A proposal to raise taxes on tobacco and alcoholic drinks has been approved by the lower chamber of Congress but still must be passed by the Senate.

Pending increases in electricity tariffs and higher prices for imported grain will put some additional pressure on inflation in the second half of 2012. Still, in light of lower-than-anticipated inflation so far this year, the forecast for 2012 is trimmed to 3.5% (Figure 3.8.10). For 2013 the forecast is kept at 4.1% on the expectation of higher prices for imported food, as well as sustained growth in domestic demand.

Current account surpluses are projected for this year and next, generated largely by remittances and receipts from BPO. Merchandise exports should benefit from a modest recovery projected for most major trading partners in 2013, notably the US, which buys 15% of total exports, and the European Union and PRC (each 12%). Imports will rise to accommodate higher spending on consumer and capital goods.

Risks to the economic forecasts come mainly from global economic uncertainty. Weaker-than-expected growth in industrial countries and the PRC would hurt prospects for exports, investment, and remittances. Further delays affecting public–private partnership projects would dent investor sentiment.

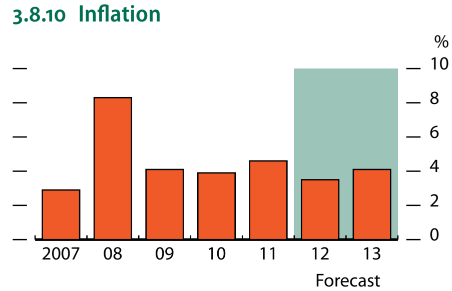
The key challenge is to link economic growth to poverty reduction. GDP growth has accelerated to average 4.7% since 2000, but job generation remains inadequate, reflected in fairly rigid rates of unemployment, growing underemployment, and the continuous deployment of workers overseas. The incidence of poverty remains high: the latest available data put it at 26.5% in 2009, up from 24.9% in 2003.

**3.8.2 Rank in Global Competitiveness Index**

| | 2011–2012 (out of 142) | 2012–2013 (out of 144) |
|---|---|---|
| **Overall ranking** | | |
| Malaysia | 21 | 25 |
| Thailand | 39 | 38 |
| Indonesia | 46 | 50 |
| Philippines | 75 | 65 |
| Viet Nam | 65 | 75 |
| **Institutions** | | |
| Malaysia | 30 | 29 |
| Indonesia | 71 | 72 |
| Thailand | 67 | 77 |
| Viet Nam | 87 | 89 |
| Philippines | 117 | 94 |
| **Infrastructure** | | |
| Malaysia | 26 | 32 |
| Thailand | 42 | 46 |
| Indonesia | 76 | 78 |
| Viet Nam | 90 | 95 |
| Philippines | 105 | 98 |

*Source:* World Economic Forum. 2012. *The Global Competitiveness Report 2012–2013*. http://www.weforum.org/reports/global-competitiveness-report-2012-2013 (accessed 17 September 2012).

**3.8.10 Inflation**




*Source: Asian Development Outlook* database.

# Thailand

Recovery from severe flooding in 2011 and policy stimulus sparked, as expected, a rebound in GDP growth in the first half of 2012. Domestic demand strengthened, but weak external demand dampened exports. Economic growth forecasts for 2012 and 2013 are trimmed from those in April's *ADO 2012*, mainly owing to the weaker global environment. Inflation is lower than expected this year, brought down by decelerating food prices. Forecasts for inflation in 2012 and 2013 are revised down.

## Updated assessment

After contracting late in 2011 because of severe flooding, the economy rebounded in the first half of 2012. Floods during August–November 2011 submerged factories and disrupted a range of industries. During the first 6 months of this year, investment and private consumption recovered strongly. However, export-oriented manufacturers were still restoring facilities damaged during the floods, as well as facing sluggish export demand. In the first half, GDP rose by 2.3% from the year-earlier period (Figure 3.9.1).

Recovery in manufacturing picked up in the second quarter as more factories came back into production (Figure 3.9.2). This upturn was from a suppressed base, as the March 2011 earthquake and tsunami in Japan had caused supply shortages for Thai manufacturers of automobiles and computer hard drives that curtailed manufacturing output in the second quarter of last year.

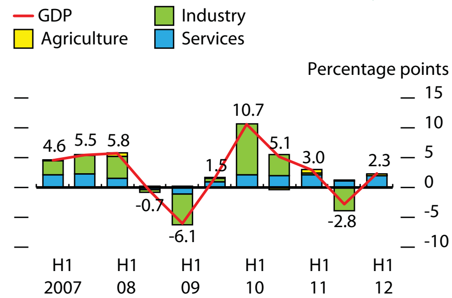
Automobile production surged by 37% in the first half, with sales spurred by a government program to provide cash incentives for first-time buyers of domestically produced cars.

Manufacturers of computers, hard drives, and semiconductors were generally slower to return to full production, in part because it took longer to replace their specialized equipment. Also, export demand for electronics products softened. Consequently, hard drive production fell by nearly 21% in the first half from a year earlier.

Construction expanded by 3.9% in January–June, reflecting a return to work on construction projects suspended during the floods and repair work on flood-damaged houses.

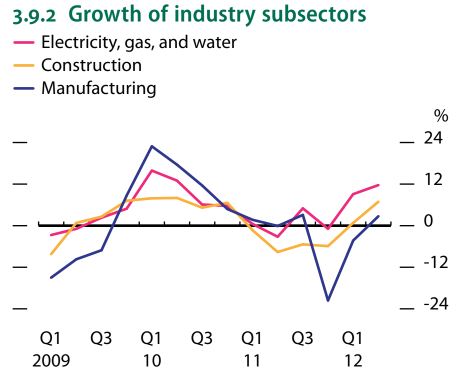
Services expanded by 4.4%, contributing most of the GDP growth compared with the first half of 2011. The ramping up of manufacturing and other industrial operations after the floods generated strong demand for electricity and business services. Tourist arrivals, which had declined during the floods, picked up in the first half. Financial services grew by 5.9% as credit expanded.

**3.9.1 Contributions to growth (supply)**




*Source:* National Economic and Social Development Board. http://www.nesdb.go.th (accessed 20 August 2012).

**3.9.2 Growth of industry subsectors**




*Source:* National Economic and Social Development Board. http://www.nesdb.go.th (accessed 20 August 2012).

This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

Agricultural output rose by 2.5% to make a small contribution to GDP growth, with gains in the production of cassava, natural rubber, oil palm, poultry, and rice.

Regarding demand, private consumption increased by 4.1% in January–June, supported by government decisions to raise the minimum wage and incomes in the public service. The minimum wage boost of about 40% came into effect in seven provinces (including Bangkok) from April. Public service incomes were increased from January. The average monthly wage across the economy jumped by 15% in the first half.

During the floods, many employers reduced working hours instead of laying off staff, thereby keeping the unemployment rate low (Figure 3.9.3). Employment grew by a further 1.4% in the first half of 2012, bolstering growth in consumption. Government incentives for car buyers and first-time buyers of houses contributed, too. Households affected by the floods bought new furniture and appliances. Additional support to spending came from credit growth, as personal loans rose by 16.3%.

Private investment increased by 10.5% in the first half as firms replaced plant and equipment and invested in flood-control infrastructure. The government stepped up its work on public infrastructure in the second quarter. Total fixed capital investment rose by 7.7%.

Merchandise exports, which plunged in late 2011 when factories were submerged, started to recover as plants reopened (Figure 3.9.4), particularly for autos, computer parts, and electrical appliances. External demand for Thailand's rice and textiles remained weak, however. Compared with the first half of 2011, total exports rose by 0.2% in US dollar terms in the first half of 2012. By contrast, merchandise imports rose by 10.0%, reflecting buoyant private consumption and the replacement of capital equipment damaged by the floods.

These developments cut the surplus in goods trade to $2.7 billion on a balance-of-payments basis and contributed to a current account deficit equivalent to 1% of GDP in the first half. Capital and financial accounts recorded a net outflow of $1.3 billion. Gross international reserves of $179.3 billion in August were little changed from the end of 2011.

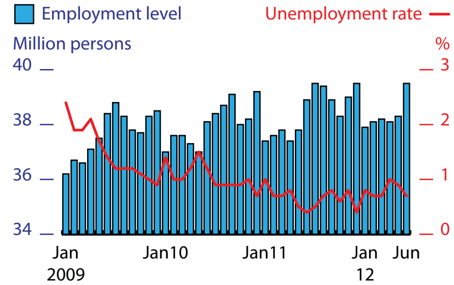
The baht initially appreciated against the US dollar before softening when international economic concerns intensified. By the end of August the currency had appreciated against the US dollar by 1.0% since the end of 2011.

Food price inflation eased after picking up when the floods disrupted agriculture and distribution networks last year. This favorable influence on overall inflation has been offset in part by price pressures generated by growth in wages and domestic demand. Year-on-year inflation slowed from 3.5% at the end of 2011 to 2.7% in August 2012 (Figure 3.9.5), averaging 2.9% in the first 8 months.

Moving to support the economy when the floods hit, the Bank of Thailand lowered its policy interest rate in November 2011 and again in January 2012, to 3.0%. It maintained this rate through the third quarter.

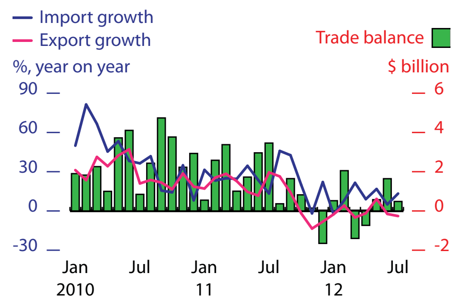
Fiscal policy, too, was set to stimulate growth as the government rolled out a variety of flood-relief measures, including assistance to farmers and low-income households and tax breaks and low-interest loans for businesses. The government budgeted for a deficit of B400 billion, or 3.4%

**3.9.3 Labor indicators**




*Source:* National Economic and Social Development Board. http://www.nesdb.go.th (accessed 12 September 2012).

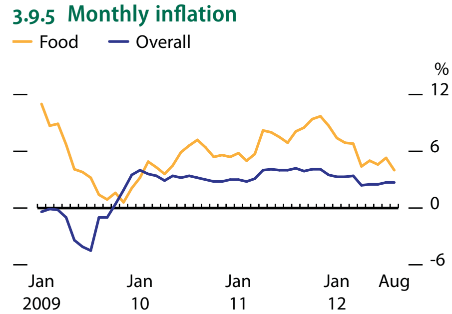
**3.9.4 Trade indicators**




*Note:* Trade data based on balance of payments. Exports and imports are valued as free-on-board.

*Source:* Bank of Thailand. http://www.bot.or.th (accessed 12 September 2012).

**3.9.5 Monthly inflation**




*Sources:* CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 15 September 2012).

of GDP, for FY2012 (ended 31 September 2012). Of $3.9 billion budgeted for flood-relief measures, about 70% was disbursed by the end of June 2012.

The authorities also planned large off-budget outlays on water management and flood control. Parliament endorsed an emergency decree allowing the government to borrow the equivalent of $11.6 billion by June 2013, to be spent over several years on flood-control projects. About 3% of this total was borrowed by September 2012, and an even smaller amount disbursed, reflecting a slower start to these projects than anticipated. Consequently, public debt showed a smaller increase than expected, rising to 43.3% of GDP at mid-2012.

A program to support farmers from October 2011 by purchasing their unmilled rice at prices above the market cost the government an estimated $9 billion in FY2012 and pushed rice stockpiles up to 12 million tons. The Thai Rice Exporters Association reported that rice exports at mid-2012 were down 43% from a year earlier, partly because of competition from lower-priced Indian and Vietnamese rice. Sales from the stockpile at current market prices will likely incur losses for the government.

## Prospects

Domestic demand is projected to remain robust through the forecast period. However, external demand is weaker than was anticipated in April's *ADO 2012,* and the outlook for growth in major economies and in world trade is downgraded in this *Update*. Thailand's economy is still expected to record a solid rebound from last year's weak performance caused by the floods, though GDP growth forecasts are trimmed from April, to 5.2% for 2012 and 5.0% for 2013 (Figure 3.9.6).

Growth in private consumption is expected to be underpinned through the forecast period by scheduled expansion of the higher minimum wage throughout the country from January 2013; incentives for buying cars, extended to the end of 2012; the rice support program to lift farm incomes; and relatively low interest rates.

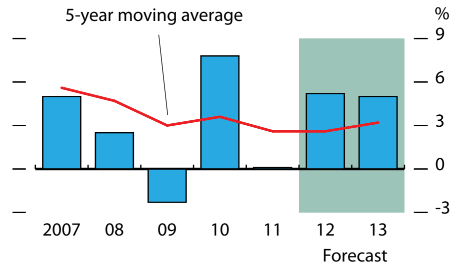
Private investment is forecast to remain positive. Small and medium-sized enterprises hurt by the floods have tapped into a low-interest loan program. Flood-control works are planned by both the private and the public sector. Capacity utilization has recovered to high rates in some industries (Figure 3.9.7), suggesting that expansion in these fields is likely.

Consumer confidence and business sentiment rebounded this year, though the gloomy international outlook has recently dampened sentiment (Figure 3.9.8). The index of private consumption rose by 7.0% in July from the year-earlier month, and the index of private investment jumped by 19.5%.

Reflecting tepid export demand, the production of export-oriented manufactures such as hard drives and integrated circuits declined in July. Industries oriented to domestic sales continued to grow but not enough to keep the index of manufacturing production from sagging in July. Because of the low base for manufacturing set by the slump in production during the floods, output will show a sharp increase in the final months of 2012 from a year earlier.

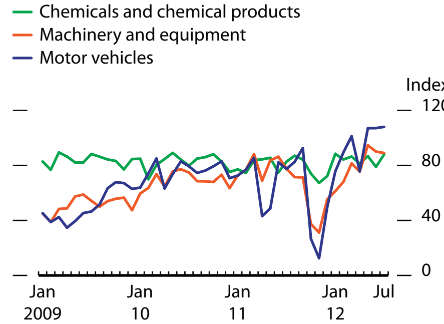
Looking to 2013, the expected pickup in major export markets should lift manufacturing production, but companies have cautioned that the

**3.9.6 GDP growth**



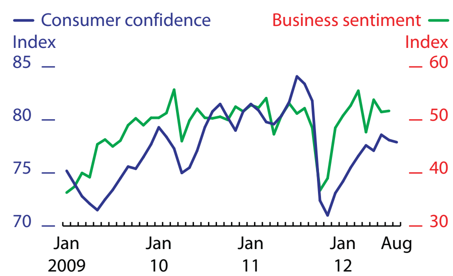

*Source: Asian Development Outlook* database.

**3.9.7 Selected capacity utilization rates**




*Source:* Bank of Thailand. http://www.bot.or.th (accessed 12 September 2012).

**3.9.8 Consumer confidence and business sentiment**




*Sources:* Center for Economic and Business Forecasting; Bank of Thailand. http://www.bot.or.th (both accessed 12 September 2012).

**3.9.1 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.5 | 5.2 | 5.5 | 5.0 |
| Inflation | 3.4 | 3.0 | 3.3 | 3.2 |
| Current acct. bal. (share of GDP) | 0.5 | 0.1 | -0.5 | -0.1 |

*Source:* ADB estimates.

higher minimum wage and shortages of some types of skilled labor will constrain growth.

Thai agriculture has benefited from generally better weather so far this year, and the rice support program is expected to be maintained in 2013. The government is also discussing measures to support rubber producers faced with weaker export prices.

However, the outlook for exports for the rest of 2012 has deteriorated. The latest available customs data on trade show the value of merchandise exports falling by 3.9% year on year in July, with declines recorded in electronic products, electrical appliances, rice, rubber, and textiles.

Fiscal policy is expected to be supportive of economic growth through next year. The FY2013 budget targets a deficit of B300 billion, or about 2.7% of projected GDP. In addition, public investment on flood-prevention and water-management projects, funded by off-budget borrowing rising as high as $9.7 billion, is scheduled to accelerate, probably toward the end of 2013. The fiscal deficit, including budget and off-budget spending, could widen to 4.8% of GDP.

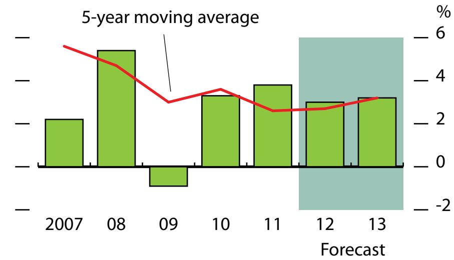
Finally, the government has outlined ambitious plans to invest up to $65 billion on infrastructure such as roads and railways over 7 years. That program looks unlikely to get underway until after 2013. Taking into account all planned borrowing, the Public Debt Management Office expects the ratio of public debt to GDP will not exceed 50% in the medium term.

Monetary policy is projected to remain accommodative in response to sluggish global growth and modest domestic inflation. In that regard, lower-than-expected inflation so far this year, brought about largely by lower food price inflation and also by subsidies, has prompted a downward revision in inflation forecasts to 3.0% in 2012 and 3.2% next year (Figure 3.9.9).

Forecasts for the external current account are revised down slightly owing to weakness in exports and downgraded assumptions for growth in world trade in 2012 and 2013 from those in *ADO 2012* (Figure 3.9.10). Exports of rice are likely to remain difficult if the price stays above that of competitors. Solid domestic demand will underpin imports of consumer and capital goods, the latter likely to get a lift from 2013 by the planned investment in flood control and water management.

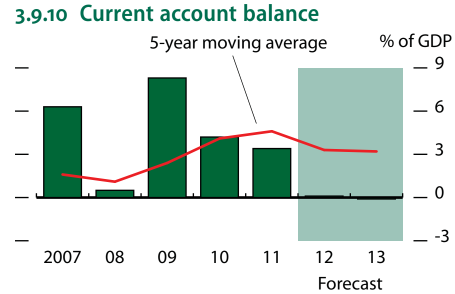
Risks to the outlook center on the global economy. Weaker-than-assumed growth in 2013 in the euro area (which takes 9% of Thailand's merchandise exports) and the PRC (12% of exports) would hurt growth. Any sharp rise in global oil prices would have a significant impact on this economy, which is particularly sensitive to oil price movements. While projected fiscal and debt trends look manageable, it would be prudent for the authorities to consider expanding the revenue base to fund higher levels of debt (Figure 3.9.11).

**3.9.9 Inflation**



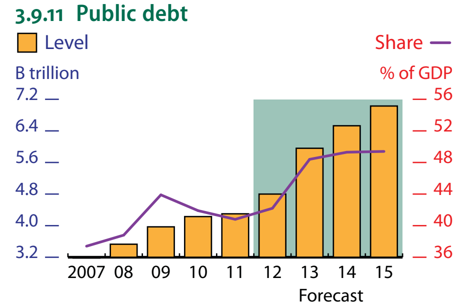

*Source: Asian Development Outlook* database.

**3.9.10 Current account balance**




*Source: Asian Development Outlook* database.

**3.9.11 Public debt**




*Source:* Thailand Ministry of Finance.

# Viet Nam

Policy tightening last year to suppress inflation and stabilize the exchange rate took a toll on economic growth. When GDP growth continued to slow in the first half of 2012, the government started to relax the tight monetary and fiscal policies. Nevertheless, forecasts for growth in 2012 and 2013 are lowered from those published in April in the *ADO 2012*. Inflation, too, will be lower than anticipated. The authorities are starting to address risks in the finance sector that, if allowed to intensify, could cloud the outlook.

## Updated assessment

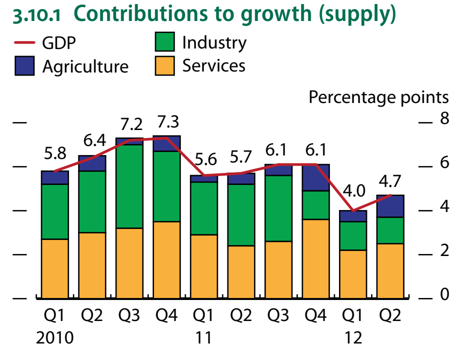
After acting to rein in inflation and stabilize the economy in 2011, the government has eased monetary and fiscal policies this year to support growth. It also outlined plans to address concerns over the finance sector that have curbed credit and hurt investor sentiment. The stabilization measures taken in 2011 dampened domestic demand, slowing the trajectory of economic growth. That continued into 2012, and GDP growth was a modest 4.0% year on year in the first quarter and 4.7% in the second (Figure 3.10.1), putting growth at 4.4% for the half.

Manufacturing slowed in the first 6 months of this year, reflecting weak domestic demand and tight credit. The purchasing managers' index, a forward-looking indicator of manufacturing activity, contracted for 4 consecutive months through July before picking up slightly in August (Figure 3.10.2). Industrial production grew by a moderate 4.8% in the first 9 months. However, construction fell by 5.4% in the first half owing to curbs on lending for real estate. Toward mid-year, the decline in construction appeared to bottom out thanks to a pickup in public investment.

Services expanded by 5.7% in January–June. Retail sales benefitted from lower inflation and further increases in visitor arrivals, which rose by 13% in January–September. Agricultural output rose by 2.8%, recovering from drought and floods in 2011.

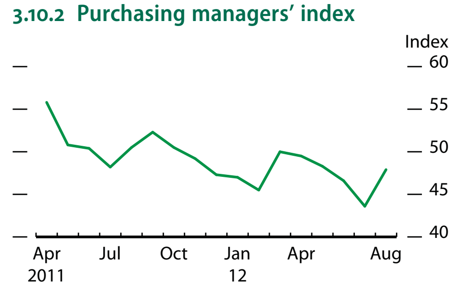
Inflation receded more rapidly than anticipated, from 17.3% year on year in January 2012 to 6.5% in September (Figure 3.10.3). It was driven down by declines in food prices between March and August and by the impact of policy tightening in 2011. Better weather for agriculture also helped to subdue inflation, as did relatively steady global food prices and a stable exchange rate for the dong. Lower food prices partly offset increases in administered prices of electricity and fuel and rises in fees for education and health care. Core inflation, excluding food, slowed from 12.8% in January 2012 to 6.8% in July, before quickening to 10.1% in September.

**3.10.1 Contributions to growth (supply)**




*Source:* General Statistics Office of Viet Nam.

**3.10.2 Purchasing managers' index**




*Note:* <50 means a contraction in manufacturing activity; > 50 means expansion.

*Sources:* Markit Economics; HSBC.

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

After depreciating over the previous 4 years, the dong stabilized within its official exchange rate band (Figure 3.10.4). Interest rates were lowered more gradually than inflation, ensuring that real interest rates on dong deposits were positive. Lower prices of gold in the domestic market increased the relative attractiveness of dong-denominated assets.

The State Bank of Viet Nam (the central bank) targeted a 15%–17% expansion of credit and 14%–16% increase in M2 money supply for 2012. By the end of September, however, credit had increased only by an estimated 1.9% year to date (7.2% year on year). In August, the central bank increased the limit it had set on credit growth to 25%–30% for some commercial banks. Growth in M2 money supply by the end of September was estimated at 11.1% year to date (15.0% year on year), which suggests there is sufficient liquidity but little appetite for credit (Figure 3.10.5).

Further, central bank restrictions on banks' consumer credit and lending for real estate and marketable securities, introduced in 2011, curtailed lending to these activities.

The steep decline in inflation paved the way for the central bank to cut its refinancing and discount rates by 500 basis points, to 10.0% and 8.0% respectively, between March and July 2012 and its repo rate by 600 basis points to 8.0% over the first 8 months (Figure 3.10.6). Interest rates on central bank bills dropped by about 600 basis points between March and June. Bank reserve requirements were unchanged.

The central bank reintroduced ceilings on bank lending rates in an effort to assist certain priority borrowers, including exporters, rural enterprises, and small and medium-sized enterprises. The average rate for borrowing in dong fell to an estimated 13%–15% in August, still high in real terms for many borrowers. Real interest rates on dong deposits rose to about 6% owing to the pullback in inflation.

However, the effectiveness of monetary policy is constrained by caps imposed by the central bank on interest rates and uncertainty over the financial health of banks, making them cautious in lending to one another.

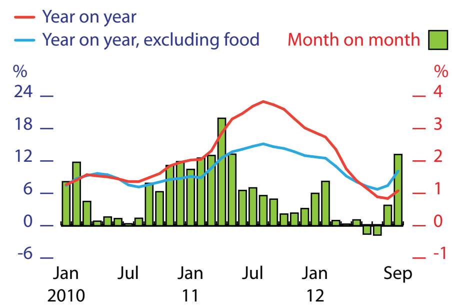
Fiscal support to the economy was augmented moderately in May, when the Ministry of Finance unveiled a package of measures, equivalent to about 1% of GDP, that includes deferments on tax payments by firms, exemptions from excise tax, and reductions in land lease fees. The government also brought forward capital expenditure from 2013–2015 to the 2012 budget year, equivalent to 0.8% of GDP.

Government spending from the budget increased by 4.8% in real terms in the first half, while total revenue excluding grants fell by 5.5%. Revenue fell short of the target because of lower corporate income and trade tax collections. Oil revenue rose, though, owing to prices higher than projected for domestic crude oil. Capital spending from the budget is estimated at 20% of total outlays, slightly below the budgeted amount and down from 30% of total outlays during 2007–2011.

The government kept its fiscal deficit target for 2012 at 4.8% of GDP, despite the reduction in revenue from the May fiscal package.

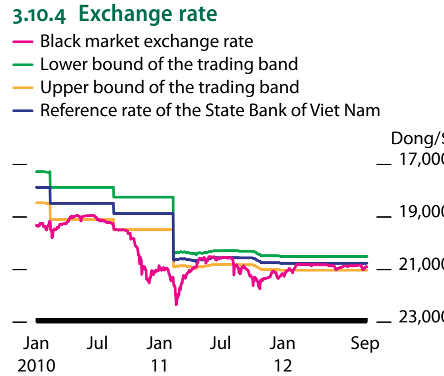
Viet Nam's external position strengthened in the first half. Merchandise exports rose by an estimated 24% on a balance-of-payments basis. Solid gains were recorded in exports of agricultural commodities,

**3.10.3 Inflation**



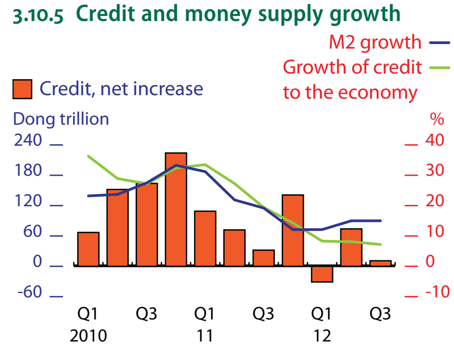

*Sources:* General Statistics Office of Viet Nam.

**3.10.4 Exchange rate**



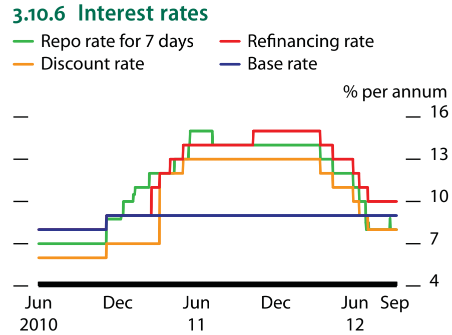

*Sources:* State Bank of Viet Nam; ADB observations.

**3.10.5 Credit and money supply growth**




*Sources:* State Bank of Viet Nam; ADB estimates.

**3.10.6 Interest rates**




*Sources:* State Bank of Viet Nam; ADB observations.

clothing and footwear, and electronics. Merchandise imports rose by an estimated 9%, suppressed by lackluster domestic demand. The trade balance swung into surplus estimated at $4 billion, from a deficit of $2 billion in the first half of 2011. Receipts from tourism rose, but remittances fell. A current account surplus estimated at $4.8 billion reversed a deficit of $1.1 billion a year earlier (Figure 3.10.7).

Preliminary estimates indicate that foreign direct investment held firm at $3.8 billion in the first half, while portfolio investment increased by 31% to $1.2 billion. The VN Index of stock prices rose by 11.7% in the first 9 months of 2012.

Capital inflows and the stable exchange rate enabled the central bank to increase foreign reserves to a level sufficient to cover an estimated 2.4 months of imports (Figure 3.10.8).

Cycles of rapid credit growth (as high as 63% in early 2008) followed by policy tightening and downturns in economic growth, together with a weakening in the property market in the past 2 years, have put the banking sector under increasing stress. Nonperforming loans (NPLs) have increased, and several small banks facing liquidity problems were merged under the supervision of the central bank.

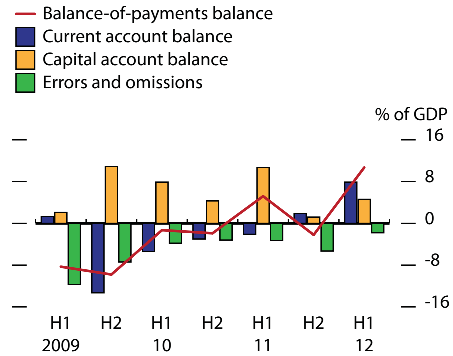
In June, Standard & Poor's revised its outlook on Viet Nam's credit rating to stable from negative and it later revised its banking industry country risk assessment to "high risk" from "very high risk", citing improved macroeconomic stability. However, Moody's downgraded its credit rating for Viet Nam to B2 from B1 in September, citing banking system weaknesses and expectations of weaker economic growth.

The government approved reform plans for the finance sector in March and for state-owned enterprises (SOEs) in July. The finance sector plan calls for merging more weak banks, recapitalizing banks, and partly privatizing some state banks. It also proposes adopting international prudential standards and improving bank supervision and regulation. In June, the central bank started to disclose selected aggregate banking sector data, including on NPLs and capital adequacy.

Under the plan for SOEs, the government will partly privatize more of these corporations, excluding those deemed to have a high strategic importance. The government instructed state firms to divest themselves of noncore activities within 3 years (because many have accrued debts by expanding into areas unrelated to their core business), and it committed itself to disclosing more financial information about SOEs.

However, it is not clear how and when further proposed actions under these two plans will be implemented.

**3.10.7 Balance-of-payments indicators**




*Sources:* State Bank of Viet Nam; ADB estimates.

**3.10.8 Gross international reserves**


*Note:* Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Import are on free-on-board basis.

*Sources:* International Monetary Fund; ADB estimates.

## Prospects

The government responded to previous economic downturns with countercyclical policies that pushed hard to revive growth to meet targets but usually reignited inflation and delayed financial and corporate reform. This time, while the official growth target has been kept at 6.0%–6.5% for 2012, the government is likely to settle for lower growth, suggesting a greater degree of restraint and a stronger emphasis on macroeconomic stability. The discussion on the outlook below assumes policy easing during the forecast period will be moderate.

In light of the economy's performance in the first 6 months, the forecast for GDP growth in 2012 is reduced to 5.1% (Figure 3.10.9). Private investment is expected to remain subdued, given domestic and external uncertainties and concerns about the government's ability to deal swiftly with bank NPLs. Also, the outlook for major export markets has deteriorated since the *ADO 2012*.

On the positive side, economic activity in the second half of 2012 is expected to get a lift from the policy steps taken earlier in the year and the usual trend for budget execution to accelerate toward the end of each year. Off-budget government expenditure financed through domestic bond issues is also expected to pick up in the second half. Private consumption will be bolstered by lower inflation.

Preliminary data indicate that GDP grew by 5.4% year on year in the third quarter. The pickup was driven by improved performances in manufacturing, construction, and transport.

GDP growth in 2013 is expected to increase to 5.7%. Fiscal policy is likely to be relaxed next year and export industries will get a lift from the expected modest recovery in world trade. This forecast is trimmed from the ADO 2012 mainly owing to the downward revision in the global outlook.

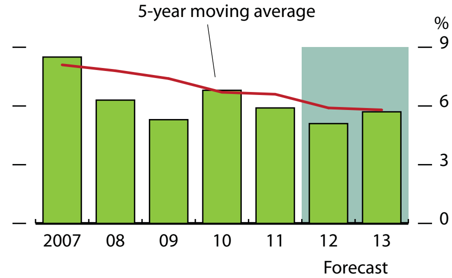
The pace of economic growth will likely be influenced by progress in addressing finance sector vulnerabilities. The International Monetary Fund–World Bank finance sector assessment program that the government agreed to undertake is scheduled to be completed by the first quarter of 2013. The disclosure of its main findings and a government commitment to a credible reform roadmap with time-bound actions should revive lending and improve investor sentiment.

Inflation is projected at about 7% by the end of 2012. That would put the year-average rate at 9.1% (Figure 3.10.10), lower than the projection in the *ADO 2012* because of the sharp decline in food prices and weaker-than-anticipated domestic demand. By the end of 2013, inflation is forecast to quicken to 9.4%. Global food prices are projected to increase next year and domestic demand to trend higher, while fiscal policy will likely be relaxed. The favorable base effect on food prices seen this year will fade. Year-average inflation in 2013 will be lower than previously anticipated because of the successful suppression of inflation this year, the downward revision in GDP growth for next year, and the assumption that policy easing will remain moderate.

The current account deficit this year is projected to be narrower than anticipated in April because of an export performance stronger than expected. Next year, the current account deficit is seen widening, albeit less than projected in the *ADO 2012*. The exchange rate could come under downward pressure if real rates of return on dong deposits are not maintained. The improved (but still low) foreign reserves position provides the central bank with some scope to support the dong.

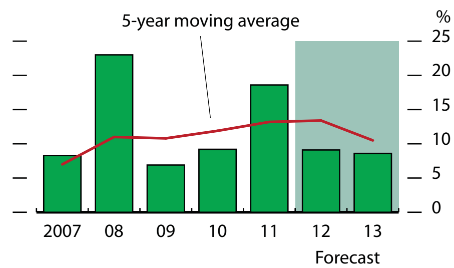
Domestic risks to the outlook center on the finance sector and could intensify until the NPL problem is addressed decisively. The central bank acknowledged in July that the ratio of NPLs to total loans outstanding was much higher than the officially published rate of 4.5% at the end

**3.10.9 GDP growth**




*Source: Asian Development Outlook* database.

**3.10.10 Annual inflation**




*Source: Asian Development Outlook* database.

**3.1.27 Selected economic indicators (%)**

| | 2012 | | 2013 | |
|---|---|---|---|---|
| | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| GDP growth | 5.7 | 5.1 | 6.2 | 5.7 |
| Inflation | 9.5 | 9.1 | 11.5 | 8.6 |
| Current acct. bal. (share of GDP) | -1.5 | -0.5 | -2.2 | -2.0 |

*Source:* ADB estimates.

of May (Figure 3.10.11), perhaps closer to 9%. This was a noteworthy development because the official statistics were widely thought to understate NPLs. A report by consultants published in September on the website of the economic committee of the National Assembly estimated the cost of putting the banking system on a stronger footing could be $12 billion-$14 billion (10%–12% of GDP).

Merging the weaker small banks was an important step. The authorities have considered establishing a state asset-management company to buy bad debts from banks or to facilitate the sale of bad debts to the private sector, but no progress on this proposal is evident.

The arrests and resignations of some executives of SOEs and senior bankers renewed concerns about corporate governance, the financial health of banks and SOEs, and the capacity of the government to cover significant contingent liabilities.

The capital adequacy ratio of the banking system increased slightly during the first 7 months of this year to 14.0% (Figure 3.10.12), well above the 9% floor set by the central bank. However, the uncertain level of NPLs and the risk profile of some bank balance sheets, particularly those with exposure to unprofitable and overstretched SOEs, raises questions about their capital adequacy. There are also concerns about links between banks, including equity cross-holdings and banks' loans to associated companies.

The decline in the property market over the past 2 years indicates that the value of property collateral for bank lending has diminished. Condominium prices in major urban centers fell by 5%–10% year on year in the first half of 2012, according to market data, and rents have been declining. Weak growth in credit and caps on interest rates are putting pressure on bank earnings.

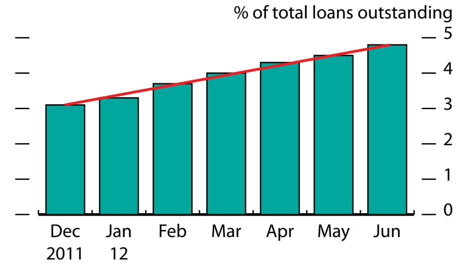
To attract foreign capital and expertise into banks, the government is considering an increase in the cap on foreign ownership in credit institutions. However, strains in the domestic banking system and reduced appetite for risk among international banks suggest that drawing substantial foreign investment may be a challenge at this time. It may also be difficult in the current environment to raise capital through the domestic securities market.

Another domestic risk is that the monetary and fiscal measures taken this year could have only a limited impact on economic growth unless they benefit the growing number of small- and medium-sized enterprises that could generate new jobs. Providing collateral for bank loans is often a hurdle for small businesses, muting the impact of lower interest rates. Firms earning low or no profit in the current subdued business climate will not gain much from the deferment of tax payments in the May fiscal package.

Finally, efforts to lift economic growth in the near term could distract the government from addressing structural impediments to growth in the longer term, such as weaknesses in the finance system, inefficient SOEs, power shortages, and other bottlenecks.

Confidence in the government's willingness to address structural reforms would be enhanced by greater disclosure about the progress reforms are achieving toward targets and by the publication of financial information on state-owned banks and enterprises.

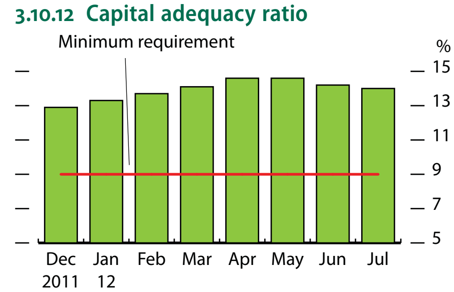
**3.10.11 Nonperforming loans**




*Note:* Data for June is an estimate.

*Sources:* State Bank of Viet Nam; ADB estimates.

**3.10.12 Capital adequacy ratio**




*Sources:* State Bank of Viet Nam; ADB estimates.

# Statistical appendix

# Statistical notes and tables

The statistical appendix presents selected economic indicators for 44 developing member economies of the Asian Development Bank (ADB) and for Brunei Darussalam, an unclassified regional member, in three tables: gross domestic product (GDP) growth, inflation, and current account balance as a percentage of GDP. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. The tables contain historical data for 2009–2011 and forecasts for 2012 and 2013.

The data were standardized to the degree possible to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the balance-of-payments data are based on International Monetary Fund accounting standards. Historical data were obtained from official sources, statistical publications, and databases, as well as documents of ADB, the International Monetary Fund, and the World Bank. Projections for 2012 and 2013 are generally staff estimates made on the basis of available quarterly or monthly data, though some projections are from governments.

Most countries report on a calendar-year basis, but South Asian countries (except for the Maldives and Sri Lanka) report all variables on a fiscal-year basis. Regional and subregional averages are provided for the three tables.

The averages are computed using weights derived from levels of gross national income (GNI) in current United States dollars following the World Bank Atlas method. The GNI data for 2009–2010 were obtained from the World Bank's World Development Indicators Online. Weights for 2010 were carried over through 2013. The GNI data for the Cook Islands and Tuvalu were estimated using the Atlas conversion factor. As Myanmar and Nauru have no GNI data, data for these two countries are excluded from the computation of all subregional averages and totals. The following paragraphs discuss the three tables in greater detail.

*Table A1: Growth rate of GDP (% per year)*. The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Constant factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most countries use constant market price valuation. Fiji, India, Pakistan, and Sri Lanka use constant factor costs, while the Maldives and Nepal use basic prices. The series for Timor-Leste is based on GDP excluding oil and the United Nations peacekeeping mission.

*Table A2: Inflation (% per year)*. Data on inflation rates represent period averages. Except for India, which reports the wholesale price index, the presented inflation rates are based on consumer price indexes. The consumer price indexes of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul, Cambodia is for Phnom Penh, the Marshall Islands is for Majuro, Solomon Islands is for Honiara, Timor-Leste is for the Dili region, and Nepal is for urban consumers. The series for India has been revised for a change in base year.

*Table A3: Current account balance (% of GDP).* The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. The values reported are divided by GDP at current prices in US dollars. In the case of Cambodia, the Lao People's Democratic Republic, and Viet Nam, official transfers are excluded from the current account balance.

**Table A1 Growth rate of GDP (% per year)**

| Subregion/Economy | 2009 | 2010 | 2011 | 2012 | | 2013 | |
|---|---|---|---|---|---|---|---|
| | | | | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| **Central Asia** | 3.2 | 6.8 | 6.6 | 6.1 | 5.7 | 6.2 | 6.0 |
| Armenia | -14.1 | 2.2 | 4.7 | 3.8 | 4.3 | 4.2 | 4.5 |
| Azerbaijan | 9.3 | 5.0 | 0.1 | 4.1 | 3.0 | 3.5 | 3.5 |
| Georgia | -3.8 | 6.3 | 7.0 | 6.0 | 6.0 | 6.3 | 6.3 |
| Kazakhstan | 1.2 | 7.3 | 7.5 | 6.0 | 5.8 | 6.5 | 6.3 |
| Kyrgyz Republic | 2.9 | -0.5 | 5.7 | 5.0 | 0.0 | 5.5 | 5.5 |
| Tajikistan | 3.9 | 6.5 | 7.4 | 5.5 | 6.5 | 6.0 | 6.0 |
| Turkmenistan | 6.1 | 9.2 | 14.7 | 10.0 | 9.0 | 9.0 | 8.0 |
| Uzbekistan | 8.1 | 8.5 | 8.3 | 8.0 | 8.0 | 7.9 | 7.9 |
| **East Asia** | 6.8 | 9.8 | 8.1 | 7.4 | 6.5 | 7.7 | 7.1 |
| China, People's Rep. of | 9.2 | 10.4 | 9.3 | 8.5 | 7.7 | 8.7 | 8.1 |
| Hong Kong, China | -2.5 | 6.4 | 4.9 | 3.0 | 1.6 | 4.5 | 3.9 |
| Korea, Rep. of | 0.3 | 6.3 | 3.6 | 3.4 | 2.7 | 4.0 | 3.4 |
| Mongolia | -1.3 | 6.4 | 17.3 | 15.0 | 11.0 | 17.5 | 12.0 |
| Taipei,China | -1.8 | 10.7 | 4.0 | 3.4 | 1.7 | 4.6 | 3.8 |
| **South Asia** | 7.5 | 7.7 | 6.2 | 6.6 | 5.5 | 7.1 | 6.4 |
| Afghanistan | 21.0 | 8.4 | 5.7 | 7.1 | 6.9 | 5.8 | 6.5 |
| Bangladesh | 5.7 | 6.1 | 6.7 | 6.2 | 6.3 | 6.0 | 6.0 |
| Bhutan | 5.7 | 9.3 | 8.3 | 8.0 | 7.9 | 8.5 | 8.4 |
| India | 8.4 | 8.4 | 6.5 | 7.0 | 5.6 | 7.5 | 6.7 |
| Maldives | -4.7 | 5.7 | 7.5 | 3.5 | 3.0 | 4.5 | 4.0 |
| Nepal | 3.8 | 4.0 | 3.8 | 4.5 | 4.6 | 4.0 | 3.8 |
| Pakistan | 1.7 | 3.1 | 3.0 | 3.6 | 3.7 | 4.0 | 3.7 |
| Sri Lanka | 3.5 | 8.0 | 8.3 | 7.0 | 6.5 | 8.0 | 7.0 |
| **Southeast Asia** | 1.4 | 7.9 | 4.6 | 5.2 | 5.2 | 5.7 | 5.5 |
| Brunei Darussalam | -1.8 | 2.6 | 2.2 | 2.6 | 1.5 | 3.2 | 2.1 |
| Cambodia | 0.1 | 6.1 | 7.1 | 6.5 | 6.4 | 7.0 | 6.8 |
| Indonesia | 4.6 | 6.2 | 6.5 | 6.4 | 6.3 | 6.7 | 6.6 |
| Lao People's Dem. Rep. | 7.7 | 8.1 | 8.0 | 7.9 | 7.9 | 7.7 | 7.7 |
| Malaysia | -1.5 | 7.2 | 5.1 | 4.0 | 4.6 | 5.0 | 4.8 |
| Myanmar | 5.1 | 5.3 | 5.5 | 6.0 | 6.3 | 6.3 | 6.5 |
| Philippines | 1.1 | 7.6 | 3.9 | 4.8 | 5.5 | 5.0 | 5.0 |
| Singapore | -1.0 | 14.8 | 4.9 | 2.8 | 2.2 | 4.5 | 3.8 |
| Thailand | -2.3 | 7.8 | 0.1 | 5.5 | 5.2 | 5.5 | 5.0 |
| Viet Nam | 5.3 | 6.8 | 5.9 | 5.7 | 5.1 | 6.2 | 5.7 |
| **The Pacific** | 4.3 | 5.5 | 7.0 | 6.0 | 6.0 | 4.1 | 4.2 |
| Cook Islands | -3.6 | 0.2 | 2.5 | 5.4 | 3.4 | 3.0 | 2.0 |
| Fiji | -1.3 | -0.2 | 2.0 | 1.0 | 1.3 | 1.2 | 1.7 |
| Kiribati | -0.6 | 1.8 | 3.0 | 3.5 | 3.5 | 3.0 | 3.0 |
| Marshall Islands | -1.3 | 5.2 | 5.0 | 5.4 | 5.4 | 2.6 | 2.6 |
| Micronesia, Fed. States of | 0.7 | 3.1 | 1.4 | 1.0 | 1.0 | 0.5 | 0.5 |
| Nauru | 0.0 | 0.0 | 4.0 | 4.8 | 4.8 | 4.2 | 4.2 |
| Palau | -4.6 | 0.3 | 5.8 | 3.0 | 4.0 | 2.0 | 3.0 |
| Papua New Guinea | 6.0 | 7.4 | 8.9 | 7.5 | 7.5 | 4.5 | 4.5 |
| Samoa | -5.4 | 0.2 | 2.1 | 2.5 | 1.4 | 2.4 | 2.5 |
| Solomon Islands | -1.0 | 7.1 | 10.7 | 6.0 | 6.0 | 5.0 | 5.0 |
| Timor-Leste | 12.8 | 9.5 | 10.0 | 10.0 | 10.0 | 8.0 | 8.0 |
| Tonga | 2.9 | 2.7 | 4.7 | 0.4 | 1.3 | 0.2 | 1.0 |
| Tuvalu | -1.7 | -2.9 | 1.1 | 1.4 | 1.2 | 1.3 | 1.3 |
| Vanuatu | 3.5 | 1.5 | 2.5 | 4.5 | 3.0 | 5.0 | 4.5 |
| **Average** | 6.0 | 9.1 | 7.2 | 6.9 | 6.1 | 7.3 | 6.7 |

**Table A2 Inflation (% per year)**

| Subregion/Economy | 2009 | 2010 | 2011 | 2012 | | 2013 | |
|---|---|---|---|---|---|---|---|
| | | | | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| **Central Asia** | 5.9 | 7.0 | 8.9 | 7.2 | 6.4 | 7.3 | 6.7 |
| Armenia | 3.4 | 8.2 | 7.7 | 4.1 | 4.1 | 4.5 | 4.5 |
| Azerbaijan | 1.5 | 5.7 | 7.9 | 9.0 | 6.5 | 8.5 | 6.0 |
| Georgia | 1.7 | 7.1 | 8.5 | 4.8 | 2.1 | 6.2 | 6.2 |
| Kazakhstan | 7.3 | 7.1 | 8.3 | 6.5 | 6.0 | 6.8 | 6.3 |
| Kyrgyz Republic | 6.8 | 7.8 | 16.6 | 5.0 | 4.1 | 5.5 | 8.1 |
| Tajikistan | 6.5 | 6.5 | 12.5 | 8.5 | 7.5 | 9.0 | 8.5 |
| Turkmenistan | -2.7 | 4.4 | 5.8 | 6.5 | 7.0 | 7.0 | 7.5 |
| Uzbekistan | 14.1 | 9.4 | 13.1 | 9.5 | 9.5 | 9.0 | 9.0 |
| **East Asia** | -0.1 | 3.1 | 5.0 | 3.7 | 3.1 | 3.7 | 3.3 |
| China, People's Rep. of | -0.7 | 3.3 | 5.4 | 4.0 | 3.2 | 4.0 | 3.5 |
| Hong Kong, China | 0.6 | 2.3 | 5.3 | 3.8 | 3.8 | 3.3 | 3.3 |
| Korea, Rep. of | 2.8 | 3.0 | 4.0 | 3.0 | 2.7 | 3.0 | 2.9 |
| Mongolia | 7.6 | 10.1 | 9.2 | 15.0 | 15.0 | 12.0 | 12.0 |
| Taipei,China | -0.9 | 1.0 | 1.4 | 1.5 | 1.9 | 1.6 | 1.8 |
| **South Asia** | 5.6 | 9.4 | 9.4 | 7.7 | 8.6 | 6.9 | 7.4 |
| Afghanistan | -12.2 | 7.7 | 11.8 | 4.6 | 9.1 | 5.0 | 6.7 |
| Bangladesh | 6.7 | 7.3 | 8.8 | 11.0 | 10.6 | 8.5 | 8.5 |
| Bhutan | 7.1 | 4.8 | 8.6 | 7.3 | 10.1 | 6.5 | 10.5 |
| India | 3.8 | 9.6 | 8.9 | 7.0 | 8.2 | 6.5 | 7.0 |
| Maldives | 4.0 | 4.7 | 9.7 | 4.5 | 10.3 | 7.5 | 7.0 |
| Nepal | 12.6 | 9.6 | 9.6 | 8.0 | 8.3 | 7.0 | 8.5 |
| Pakistan | 20.8 | 10.1 | 13.7 | 12.0 | 11.0 | 10.0 | 10.0 |
| Sri Lanka | 3.5 | 6.2 | 6.7 | 8.0 | 8.5 | 7.0 | 7.5 |
| **Southeast Asia** | 2.6 | 4.1 | 5.5 | 4.4 | 3.9 | 4.4 | 4.0 |
| Brunei Darussalam | 1.0 | 0.4 | 2.0 | 1.8 | 1.1 | 2.0 | 1.2 |
| Cambodia | -0.7 | 4.0 | 5.5 | 5.0 | 3.0 | 5.0 | 4.5 |
| Indonesia | 4.8 | 5.1 | 5.4 | 5.5 | 4.4 | 5.0 | 4.5 |
| Lao People's Dem. Rep. | 0.0 | 6.0 | 7.6 | 6.7 | 5.2 | 6.0 | 6.0 |
| Malaysia | 0.6 | 1.7 | 3.2 | 2.4 | 1.9 | 2.8 | 2.5 |
| Myanmar | 8.2 | 7.3 | 4.2 | 6.2 | 6.4 | 6.3 | 6.6 |
| Philippines | 4.1 | 3.9 | 4.6 | 3.7 | 3.5 | 4.1 | 4.1 |
| Singapore | 0.6 | 2.8 | 5.3 | 3.0 | 4.1 | 2.5 | 3.0 |
| Thailand | -0.9 | 3.3 | 3.8 | 3.4 | 3.0 | 3.3 | 3.2 |
| Viet Nam | 6.9 | 9.2 | 18.7 | 9.5 | 9.1 | 11.5 | 8.6 |
| **The Pacific** | 5.4 | 5.4 | 8.6 | 6.6 | 6.3 | 5.4 | 5.4 |
| Cook Islands | 10.2 | 1.8 | 0.6 | 3.0 | 3.0 | 4.2 | 4.2 |
| Fiji | 3.7 | 7.8 | 8.7 | 5.1 | 4.7 | 3.0 | 3.0 |
| Kiribati | 8.8 | -2.8 | 7.7 | 5.5 | 5.5 | 6.0 | 6.0 |
| Marshall Islands | 0.5 | 1.6 | 9.5 | 2.5 | 2.5 | 3.0 | 3.0 |
| Micronesia, Fed. States of | 8.2 | 4.3 | 7.9 | 3.5 | 3.5 | 4.0 | 4.0 |
| Nauru | 21.2 | -0.6 | -3.5 | 1.5 | 1.5 | 2.0 | 2.0 |
| Palau | 4.7 | 1.1 | 2.6 | 2.0 | 6.0 | 2.5 | 6.5 |
| Papua New Guinea | 6.9 | 6.0 | 8.7 | 7.0 | 6.5 | 6.0 | 6.0 |
| Samoa | 14.6 | -0.2 | 2.9 | 5.0 | 6.0 | 3.3 | 3.3 |
| Solomon Islands | 7.1 | 1.0 | 7.4 | 5.5 | 6.0 | 5.0 | 5.0 |
| Timor-Leste | 0.0 | 5.6 | 13.1 | 10.2 | 10.2 | 7.4 | 7.4 |
| Tonga | 5.5 | 1.7 | 6.1 | 6.0 | 4.6 | 7.5 | 4.5 |
| Tuvalu | -0.1 | -1.9 | 0.5 | 2.6 | 2.6 | 3.0 | 2.7 |
| Vanuatu | 4.3 | 2.8 | 0.8 | 3.0 | 3.0 | 4.0 | 4.0 |
| **Average** | 1.4 | 4.4 | 5.9 | 4.6 | 4.2 | 4.4 | 4.2 |

**Table A3 Current account balance (% of GDP)**

| Subregion/Economy | 2009 | 2010 | 2011 | 2012 | | 2013 | |
|---|---|---|---|---|---|---|---|
| | | | | *ADO 2012* | *Update* | *ADO 2012* | *Update* |
| **Central Asia** | 0.3 | 5.0 | 9.1 | 4.6 | 4.7 | 3.9 | 4.9 |
| Armenia | -15.8 | -14.8 | -10.9 | -11.2 | -10.2 | -10.0 | -9.8 |
| Azerbaijan | 23.0 | 28.4 | 28.7 | 22.0 | 18.0 | 19.0 | 17.0 |
| Georgia | -11.2 | -10.3 | -11.8 | -12.5 | -11.1 | -12.0 | -10.3 |
| Kazakhstan | -3.6 | 1.6 | 7.5 | 1.0 | 2.5 | 1.0 | 3.5 |
| Kyrgyz Republic | -2.2 | -6.9 | -3.1 | -6.6 | -8.3 | -6.8 | -6.8 |
| Tajikistan | -5.9 | 2.1 | -2.3 | -7.0 | -3.5 | -6.5 | -5.0 |
| Turkmenistan | -16.0 | -11.7 | 1.8 | 3.4 | 3.4 | 3.4 | 3.4 |
| Uzbekistan | 2.2 | 6.6 | 8.1 | 7.5 | 7.0 | 6.0 | 6.0 |
| **East Asia** | 5.3 | 4.2 | 3.1 | 2.5 | 2.4 | 2.2 | 2.1 |
| China, People's Rep. of | 4.9 | 4.0 | 2.8 | 2.1 | 2.0 | 1.7 | 1.6 |
| Hong Kong, China | 8.6 | 5.5 | 5.1 | 5.0 | 2.7 | 5.0 | 4.0 |
| Korea, Rep. of | 3.9 | 2.9 | 2.4 | 2.0 | 2.0 | 2.0 | 2.0 |
| Mongolia | -7.5 | -14.3 | -30.0 | -25.0 | -27.5 | -15.0 | -17.5 |
| Taipei,China | 11.4 | 9.3 | 8.9 | 8.1 | 8.2 | 7.9 | 7.7 |
| **South Asia** | -2.7 | -2.3 | -3.5 | -3.1 | -2.7 | -2.9 | -2.6 |
| Afghanistan | -2.8 | 3.9 | 3.3 | -1.1 | 1.7 | -2.5 | 0.5 |
| Bangladesh | 2.7 | 3.7 | 0.8 | -0.5 | 1.5 | -1.0 | -0.4 |
| Bhutan | -1.1 | -9.9 | -23.9 | -20.0 | -20.0 | -22.2 | -24.0 |
| India | -2.8 | -2.7 | -4.2 | -3.3 | -3.0 | -3.0 | -2.8 |
| Maldives | -21.6 | -22.3 | -31.9 | -38.0 | -38.0 | -38.0 | -35.0 |
| Nepal | 4.2 | -2.7 | -0.9 | 0.5 | 0.5 | 1.0 | 1.0 |
| Pakistan | -5.7 | -2.2 | 0.1 | -1.8 | -2.0 | -1.9 | -1.3 |
| Sri Lanka | -0.5 | -2.2 | -7.3 | -6.4 | -7.0 | -6.0 | -6.0 |
| **Southeast Asia** | 7.2 | 6.1 | 5.5 | 4.4 | 3.0 | 4.0 | 3.2 |
| Brunei Darussalam | 37.3 | 48.5 | 50.0 | 50.0 | 50.0 | 50.0 | 50.0 |
| Cambodia | -10.3 | -10.4 | -8.8 | -7.6 | -9.8 | -7.0 | -9.7 |
| Indonesia | 2.0 | 0.7 | 0.2 | -0.1 | -2.1 | 0.2 | -1.4 |
| Lao People's Dem. Rep. | -21.0 | -17.1 | -15.8 | -21.0 | -21.0 | -22.0 | -22.0 |
| Malaysia | 18.1 | 11.1 | 11.0 | 12.1 | 9.3 | 11.9 | 9.8 |
| Myanmar | -1.3 | -0.9 | -2.7 | -4.8 | -4.6 | -5.0 | -5.0 |
| Philippines | 5.6 | 4.5 | 3.1 | 2.1 | 2.6 | 2.3 | 2.8 |
| Singapore | 16.2 | 24.4 | 21.9 | 18.0 | 16.0 | 16.0 | 16.0 |
| Thailand | 8.3 | 4.2 | 3.4 | 0.5 | 0.1 | -0.5 | -0.1 |
| Viet Nam | -6.8 | -4.0 | 0.2 | -1.5 | -0.5 | -2.2 | -2.0 |
| **The Pacific** | 15.2 | 21.1 | 13.7 | 11.9 | 3.7 | 3.3 | -2.2 |
| Cook Islands | ... | ... | ... | ... | ... | ... | ... |
| Fiji | -7.6 | -11.0 | -11.2 | -9.6 | -9.6 | -11.6 | -11.6 |
| Kiribati | -29.8 | -23.1 | -28.9 | -29.2 | -29.2 | ... | ... |
| Marshall Islands | -17.0 | -24.6 | -12.6 | -30.3 | -30.3 | ... | ... |
| Micronesia, Fed. States of | -18.9 | -15.5 | -17.1 | -17.2 | -17.2 | -16.6 | -16.6 |
| Nauru | ... | ... | ... | ... | ... | ... | ... |
| Palau | -1.5 | 2.0 | 4.1 | 5.9 | 5.9 | ... | ... |
| Papua New Guinea | -7.1 | -6.5 | -36.8 | -33.2 | -33.2 | -29.7 | -29.7 |
| Samoa | -5.9 | -9.3 | -9.3 | -8.6 | -8.6 | -8.3 | -8.3 |
| Solomon Islands | -20.9 | -27.6 | -11.1 | -15.0 | -15.0 | -15.0 | -15.0 |
| Timor-Leste | 164.0 | 201.3 | 253.6 | 229.4 | 171.4 | 153.7 | 114.9 |
| Tonga | -8.9 | -6.7 | -1.5 | -11.7 | -6.1 | -10.7 | -2.3 |
| Tuvalu | ... | ... | ... | ... | ... | ... | ... |
| Vanuatu | -8.1 | -6.0 | -6.3 | -6.3 | -7.0 | -6.5 | -7.0 |
| **Average** | 4.0 | 3.4 | 2.5 | 1.9 | 1.7 | 1.7 | 1.5 |

... = data not available.

**Asian Development Outlook 2012 Update**
Services and Asia's Future Growth

Developing Asia is confronted with a protracted slowdown in the world's major advanced economies and decelerating growth in its own two giants: the People's Republic of China and India. The continuing sovereign debt crisis in Europe and tepid growth in the United States and Japan have undercut demand for the region's exports. Slowing investment and consumption in the People's Republic of China and India are further dragging down developing Asia's growth.

As turnout in the first half of 2012 tempered optimism by being generally lower than expected, this *Asian Development Outlook 2012 Update* trims most economic growth forecasts for the next 2 years. It presents an analysis of developing Asia's recent economic performance and explains the divergence between forecasts and the actual outturn.

Exploring Asia's future sources of growth, the *Update* analyzes the potential of the large and expanding service sector. It finds that a vibrant service sector could have positive spillovers into other sectors, promote greater inclusiveness, strengthen stability, and create new opportunities for foreign trade. Improving regulatory frameworks, infrastructure, and human capital are key to modernizing the service sector.

**About the 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 two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 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.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org

October 2012

Printed on recycled paper

ISBN 978-92-9092-862-1

9 789290 928621 >

Printed in the Philippines