ASIAN DEVELOPMENT

Outlook 2003

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The world economy and developing Asia began 2002 quite strongly, but as the year advanced the pace of growth in industrial countries slowed and became more uneven. The United States (US) economy showed strong growth in the first and third quarters of 2002, but weaker performance toward the end of the year kept overall recovery below expectations. Economies in the euro area performed poorly in comparison with projections. In Japan, despite stronger than expected gross domestic product (GDP) growth in the second half, the economy expanded only slightly over the course of the year.

In contrast, growth in developing Asia (the developing member countries [DMCs] of the Asian Development Bank) strengthened; it accelerated further in the second half of the year as export demand began to pick up. Expansionary fiscal policies and accommodative monetary policies strengthened aggregate demand—particularly consumption—while somewhat firmer external markets boosted industrial production.

Prospects for 2003 are clouded by economic weaknesses in the industrial countries and uncertainties relating to the conflict in Iraq and the recent outbreak of severe acute respiratory syndrome (SARS) in Asia (Table 1). As a result, forecasts have all been adjusted downward in early 2003.

In most DMCs, domestic demand will remain robust and exports will continue to expand. Macroeconomic policies will generally remain supportive, although both fiscal and monetary policy will need to be tightened in many countries.
At the start of the second quarter of 2003, the economic outlook for Asia is highly vulnerable to the risks of a further weakening in the outlook for industrial countries, volatility in oil prices, disruptions in tourism, the negative impacts on regional and international markets resulting from the conflict in Iraq and its aftermath, and the yet uncertain consequences of SARS.

OVERVIEW OF ECONOMIC TRENDS IN DEVELOPING ASIA IN 2002

Growth in developing Asia strengthened in 2002 compared with the previous year. In most countries, export growth accelerated and domestic demand remained strong while, except in the Pacific, inflation subsided. Consumption expenditures grew strongly in the People’s Republic of China (PRC), Republic of Korea (Korea), India, Indonesia, Malaysia, Philippines, Thailand, and Vietnam. In contrast, business investment continued to decline in most East and Southeast Asian economies, due to a combination of uncertainty and

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— Not forecast.
Sources: Asian Development Outlook database; staff estimates.
overcapacity. In South Asia, investment showed positive growth except in the Maldives and Pakistan. Export growth, which increased more rapidly in the second half of the year, was also notable in Cambodia; PRC; India; Korea; Malaya; Philippines; Taipei, China; Thailand; Viet Nam; and several Central Asian Republics (CARs). The US dollar value of exports increased by 9.4%, a substantial reversal from the almost 7% decline in 2001. In terms of overall growth performance, the PRC and Korea had the best record in East Asia; Lao People’s Democratic Republic (PDR), Thailand, and Viet Nam in Southeast Asia; Bhutan in South Asia; and Azerbaijan, Kazakhstan, Tajikistan, and Turkmenistan in Central Asia. In the Pacific, the performance of the Fiji Islands and the Marshall Islands stood out. In 19 DMCs, output grew at 4% or more. Still, in spite of this performance, growth in most DMCs remained below its long-term potential, and in many of the smaller and poorer DMCs, growth was insufficient to substantially raise income and reduce poverty.

Inflation in developing Asia remained low despite the growth acceleration, averaging 1.4% compared with 2.4% in 2001. There was high inflation in a few countries such as Indonesia, Lao PDR, Papua New Guinea, Sri Lanka, Tajikistan, Tonga, and Uzbekistan.

Fiscal deficits remained common throughout Asia. The economies most affected by the 1997–98 financial crisis continued fiscal expansion to strengthen their recovery, while structural deficits persisted in some countries. Throughout the region, budgetary stances are coming under increasing scrutiny and efforts are under way toward fiscal consolidation.

With the exception of the Pacific DMCs, external balances improved in 2002 as surpluses on both the trade and current accounts increased, and the deficits in Central Asia narrowed. Exports grew faster than imports, and the region’s aggregate current account surplus increased from 2.9% of GDP in 2001 to 3.6% in 2002. The region thus continued to accumulate international reserves in 2002. One of the important reasons for the buoyancy of exports in several countries appears to be rapidly increasing exports to the PRC, partly resulting from the PRC’s reforms associated with its entry into the World Trade Organization (WTO).

EXTERNAL MACROECONOMIC CONDITIONS IN 2002

Industrial countries remain by far the largest market for DMC exports. In the US, the destination for about one fifth of developing Asia’s exports, consumer spending was buoyant in 2002. Along with a modest revival in equipment and software investment, and restocking, this served to sustain the growth momentum. However, by the end of the third quarter some of the steam had gone out of consumer spending. In the last months of the year, consumer confidence indicators dipped and investment spending slowed. Concern over the conflict with Iraq, weak stock and job markets, and uncertainty over the form of fiscal stimulus all served to shake consumer confidence.
Both the euro area and Japan depended to a significant extent upon external markets to drive economic growth in 2002. In the euro area, weak domestic demand combined with slowing external demand toward the end of the year to produce very modest economic growth of less than 1% for the year. In Japan, consumer spending and exports strengthened in the second and third quarters of the year. However, later in the year the yen strengthened, export performance deteriorated, unemployment increased, and consumer confidence fell. Growth for the year was minimal.

Consumer price inflation remained very low in 2002. Inflation in the US and the euro area averaged around 2%. Prices continued to fall in Japan for the third year in a row. Several factors contributed to a low level of inflation, including stiff price competition among exporters, generally strong supplies of primary products (aside from oil toward the end of the year), and innovations that continue to lower the costs of technologically based goods and transportation.

Fiscal policy in most industrial countries became more accommodating and then expansive as the year unfolded and the recovery turned more tentative. Government deficits in the Organisation for Economic Co-operation and Development (OECD) countries generally increased as a percentage of GDP—from 1.4% in 2001 to 2.9% in 2002—most strongly in the US, where it increased from 0.7% of GDP in 2001 to over 3% in 2002. While the European Union (EU) stability and growth pact limits the deficit to 3% of GDP in the euro area, Germany and France were approaching that limit. In Japan, the deficit, which was already high at 7.2% of GDP at the end of 2001 widened further.

Monetary policy likewise remained accommodative throughout the year. In the US, the Federal Funds rate remained at 1.75% for nearly a year and was reduced further to 1.25% in November 2002. Policy interest rates in other OECD countries also remained largely unchanged through the year (nearly zero in Japan, 3.25% for the euro area until early December when it was reduced by 0.5%, and 4% in the UK.) Long-term interest rates have fallen, particularly after the first quarter, as the weakness of the overall recovery became more apparent and inflationary expectations abated.

Developments in external markets are critical for DMCs since their exports respond very quickly to changes in the pattern of world import demand. Growth in the world economy and in import demand improved in 2002, albeit at a modest pace. Import demand of industrial countries grew at 3% and economic growth accelerated to 1.4% from 0.8% in 2001. As the world economy recovered, some commodity prices firmed somewhat. Despite the uncertainties associated with the conflict in Iraq, average oil prices increased by only 2.25% in 2002 compared with the 2001 level. Other commodity prices sensitive to increasing uncertainty, such as rare metals, also increased. Overall, prices for manufactured goods remained weak in 2002 but prices for many food and agricultural products, grains in particular, increased significantly for
various reasons, including adverse weather conditions (e.g., drought in major wheat-producing countries) and civil disturbances in some commodity-producing countries (e.g., Cote d’Ivoire).

Worldwide equity markets continued to trend downward in 2002. A combination of lower corporate earnings, fallout from accounting irregularities, and concern about geopolitical instability and its impact on petroleum prices were responsible for the continued weakness. By the end of the year the Nikkei 225 index, the Dow Jones Industrial Average, and the FTSE All-Share index were down, respectively, by 19%, 17%, and 32%. In credit markets, short-term interest rates remained at historically low levels for the year. The yield curve flattened out, reflecting a continued low inflation environment and weaker equity markets.

Emerging market sovereign risk spreads widened slightly in the middle of 2002, and then narrowed in the second half of the year. By the end of the year they were very close to their levels at the end of 2001. Spreads were highest for Latin American countries at over 900 basis points while spreads for African, European, and Asian sovereign risk were 400–500 basis points lower.

During the first 2 months of 2002, the US dollar strengthened against a trade-weighted basket of currencies (the Federal Reserve’s “broad index”). Subsequently, the dollar weakened as capital inflows slowed. By the end of the year, the dollar had fallen by 2.6% against this broad index, by 17.6% against the euro, and by 10.2% against the yen. The weakness of the dollar reflected low nominal interest rates on treasury securities relative to those of other OECD countries. It also reflected a reappraisal of investment returns in the US equity market following weak earnings reports and a decline in corporate profits, lower returns on foreign direct investment (FDI), and continued concern following auditing irregularities as well as the need to finance a growing US current account deficit.

OUTLOOK FOR INDUSTRIAL COUNTRIES

The growth momentum of the world economy slowed in the closing months of 2002 and growth is likely to remain subdued during 2003. Nevertheless, barring major catastrophes affecting the world economy, a modest upturn is likely to start in the second half of the year in response to additional policy stimulus in industrial countries (Table 2). Consumption demand has, in the past few years, supported economic growth in industrial countries, particularly in the US. With the possible exception of the euro area, consumer demand is, however, likely to be weaker in 2003 than it was in 2002. The upturn projected in the latter part of 2003 in industrial countries critically relies on an improvement in business investment, which should start contributing positively to growth after 2 years of negative contribution. The upturn in industrial countries is projected to further strengthen in 2004 as uncertainties in the world economy abate. Hence, GDP growth for industrial countries is forecast at 1.5–1.7% in 2003 and 2.7–2.9% in 2004.
Many economic indicators in the US weakened in the fourth quarter of 2002 and GDP growth dipped to an annual rate of 1.4%. Slow growth is likely to continue in the first half of 2003. Prospects for the US economy continue to be affected by the hangover of the investment bubble of the past decade, the estimated $6 trillion decline in household net worth (since early 2000), and concerns about increasing unemployment rates. Other uncertainties relate to a possible retrenchment in the housing market and its related wealth effect, aftermath of the conflict in Iraq, and the prospects of a sharply deteriorating fiscal situation over the medium term.

In March 2003, the Conference Board’s Consumer Confidence Index reached its lowest level in nearly a decade. On the positive side, however, corporate profitability appears to be improving as a result of restructuring efforts, substantial improvements in productivity, and tax cuts, thus leading to an anticipated revival in corporate investment. The improvements in corporate balance sheets over the past year have resulted in a reduction in interest rate spreads and the cost of capital for corporate borrowing. Business investment picked up in the fourth quarter of 2002 for the first time in 2 years. Another positive factor is productivity growth, which should increase real wages and provide some support for growth in consumption spending in 2003. Hence, a progressive improvement in business investment offsetting a somewhat weaker consumption demand is a key element in the improving US outlook in the second half of 2003 and in 2004.

The November Federal Funds rate cut to 1.25% should add to the impact of the cumulative cuts of the past years, further supporting spending and investment. In the baseline scenario, the Federal Funds rate in 2003 is projected below the

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Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic model.
2002 average before rising in 2004 as inflation picks up and the fiscal deficit deteriorates further. Fiscal policy will be expansionary in 2003-2004 as tax cuts are implemented. Finally, a weaker exchange rate for the dollar might provide some stimulus for exports. US growth in 2003 should be more evenly balanced between consumption and investment growth as nonresidential investment begins to improve after 2 years of decline while private consumption and residential investment moderate somewhat. The baseline growth forecast for the US economy in 2003 is 2.2–2.4%, increasing to a range of 3.4–3.6% in 2004.

The economic performance of the euro area is likely to remain disappointing in 2003 after a particularly poor outcome in 2002. Stock market declines, high unemployment, weak consumer spending, and more fundamental structural weaknesses will continue to weigh on the euro area economies. In addition, the 2 largest economies, Germany and France, are running up against the EU stability and growth pact limit of 3% of GDP on budget deficits, and might have to cut back expenditures in 2003. At the beginning of 2003, many consumer and business indicators pointed toward slow growth in the euro area. The European Central Bank is likely to cut interest rates further, following a 0.5% cut in December 2002 and a 0.25% cut in February 2003. The growth momentum in 2003 will probably shift from reliance on exports toward final domestic demand. Combined with a more accommodating monetary policy, these developments should enable the euro area to post growth of 0.9–1.4% in 2003, and 2.4–2.7% in 2004.

Growth in the Japanese economy slowed substantially toward the end of 2002. With sluggish growth expected in the US and euro area in the first half of 2003, the Japanese economy will recover only slowly. Deflationary expectations, stagnant nominal wages, and growing unemployment will continue to depress private consumption. Nevertheless, continued expansion in liquidity, supplementary budgetary spending, and further progress in resolving the nonperforming loan issue should allow the economy to post modest GDP growth for 2003 as a whole. Baseline assumptions are for 0.5–0.7% growth in 2003, rising to 1.3–1.6% in 2004.

World trade as measured by export volume rose by 3% in 2002, sharply higher than in 2001. This trend is expected to continue in 2003, with growth strengthening by 5–6%.

Oil prices, which averaged $25 per barrel (/bbl) in 2002 (Brent crude spot price) increased sharply during the first quarter of 2003, averaging $31.40/bbl, due to uncertainties related to the Iraq conflict. As the conflict started, oil prices dropped. While uncertainties remain, it appears that major supply disruptions are unlikely. Seasonal demand for oil will also decrease in the second and third quarters of the year, at the same time that supplies from Venezuela are restored. However, commercial oil inventories at the end of the first quarter are at a 10-year low and restocking will be accelerated over the remainder of 2003. Taking all of these factors into account, oil prices are
not forecast to increase significantly in 2003. Although the oil market could remain volatile, prices are projected in the range of $25–27/bbl in 2003, and $21–23/bbl in 2004.

Prices of metals and minerals (aluminum, copper, gold) strengthened in the closing months of 2002 and in the early part of 2003. On average, the prices of nonprecious metals will likely be slightly higher in 2003 than in the previous year.

The outlook for agricultural commodity prices is positive. Vegetable oil prices have risen and should remain strong, supported by continued import demand from the PRC. Rice prices (Thai, 5% broken) that averaged $198.80/ metric ton in the first 2 months of 2003 are expected to increase by about 5% over the rest of 2003. Grain prices, which increased sharply in 2002, are projected to remain firm in 2003. Between January 2001 and February 2003, cocoa prices more than doubled due to continued supply disruptions in Cote d'Ivoire; prices will probably remain at current high levels in 2003. Stocks are high for coffee, cotton, and sugar, so further price increases are unlikely. Overall, food and agricultural prices are expected to continue growing at double-digit rates in 2003 with industrial raw material prices also rising faster in the range of 4–5%.

Consumer price inflation in OECD countries, estimated at 1.5% in 2002, was at a historically low level. With recovery in industrial countries projected to be relatively weak in 2003, inflation is forecast to pick up only slightly in the OECD (to around 2%), in spite of higher oil prices in the first half of 2003. In the US, consumer prices rose by 3% in February 2003 compared with February 2002, caused mainly by higher oil prices. Energy prices should, however, weaken in the second and third quarters, as a result of lower seasonal energy demand.

Monetary policies in industrial countries will remain accommodative for most of 2003, with benchmark policy interest rates declining further in the first part of the year, particularly in the euro area. The baseline assumption is for the Federal Funds rate (which averaged 1.7% in 2002), to average between 1.4–1.6% in 2003.

Developments in bond markets closely reflected expectations on monetary policies as well as overall sentiments of weaknesses in the global economy. In the US, the yield curve moved down during the second half of 2002. Comparing end-June 2002 yields with those at end-March 2003, the March curve, though still relatively steep, was flatter at the short end and the difference between the two curves was much larger at the long end. For maturities of less than 1 year, the curve dips slightly after June 2002, indicating that markets continue to expect lower rates. However, the upward slope, which is rather steep, indicates that markets expect a significant increase in rates over the medium and longer term.

The euro benchmark yield curve shows an even stronger inverted shape, downward sloping at the short end and upward sloping for maturities beyond
one year. The market expectation is for further rate cuts by the European Central Bank. Higher yields are, however, contemplated for intermediate and longer maturities.

Over the medium term, the monetary easing might be reversed (hence the steepness of the curves) but the prospects for this appear to have receded, particularly in the US where the whole yield curve has dropped substantially since June 2002. Even with low interest rates, markets seem to expect a slow return to firmer economic growth rates.

In emerging markets, sovereign risk spreads converged in early 2003 as European and African sovereign risk fell toward Asian levels. However, the spreads for Asian markets remained somewhat below those of other emerging markets, particularly in Latin America, at the end of 2002. Hence the Asian market remains relatively attractive for investors. In the first months of 2003, substantial uncertainty and volatility continued to dominate financial markets but some improvement is likely as the year progresses.

While the PRC will continue to attract large capital flows, mainly in the form of FDI, capital flows to most other Asian countries should also improve from the 2002 rate. The Institute of International Finance estimates that net private financial flows to emerging markets in the Asia-Pacific region will increase from $61.8 billion in 2002 to $62.5 billion in 2003. Of that, flows to Indonesia, Korea, Malaysia, Philippines, and Thailand would total $5.7 billion, up from $2.9 billion in 2002, though this is still below the $17.2 billion recorded in 2000. Official flows are expected to remain negative as repayments exceed new inflows.

DEVELOPING ASIA: RISKS AND UNCERTAINTIES

Two broad kinds of risk underlie the forecasts for the next 2 years. The first set concerns threats to the macroeconomic assumptions underpinning the forecasts. The second set is related to geopolitical uncertainties associated with the possibility of terrorism and its impact on tourism, a major source of revenue for the region. Among these risks, the possible consequences of the conflict in Iraq on oil prices, trade, and remittances remain highly uncertain. In addition to these two risks, very recently the outbreak of SARS might have a substantial negative impact on several economies of the region.

Global Economic Uncertainties

Failure of Global Investment to Revive. Investment in the OECD could remain weak given the weight of low equity prices, geopolitical uncertainties, and volatility in oil prices. In previous recoveries in the US, equity prices rebounded strongly following the end of the recession. In the current recovery, however, this trend has been strongly reversed as equity prices fell by 19.4% (to 31 March 2003) from the end of the recession (i.e., 31 January 2002).
uncertainty has also increased because of the series of accounting and other corporate malfeasance, as well as concerns about oil prices and the growth potential of industrial countries. Should these developments, plus low capacity utilization and weakening consumption demand, lead the industrial countries to put off capital spending, it would have a depressing effect on economic growth in these countries with knock-on effects for developing Asia.

*Deflation.* There has been growing concern in several countries about the problem of deflation—a general fall in the price level for some sustained period of time. Among industrial countries, Japan has been in such a situation on and off for the past few years and both the PRC and Hong Kong, China have experienced deflationary pressures. There are several possible negative effects of deflation. Some of them are psychological while others have real effects on the economy. From the psychological point of view, if lower prices are anticipated in the future, consumers may hold off purchases until a later date. That will have a depressing effect on aggregate demand and contribute to a possible acceleration in a downward spiral of decreasing prices. In a country with a large debt overhang, deflation increases the cost of servicing as well as the real value of debt. It makes fiscal consolidation difficult and jeopardizes the loan portfolios of the financial system as corporations experience difficulty in servicing debt. The burden of addressing the problem of deflation is complicated when normal policy options such as devaluing the currency, increasing the money supply, lowering interest rates, and undertaking fiscal stimulus are limited. This could occur in circumstances where the banking system is already burdened with a large volume of nonperforming loans, where government deficits and existing debt are already high or legally constrained, and where the exchange rate is fixed.

*Rapid Adjustment in the US Current Account Balance and Dollar Exchange Rate.* The problem of the so-called “twin deficits” of the US fiscal and current account balances has been cited as a risk in previous ADO forecasts as well as those of other forecasts by the World Bank and International Monetary Fund. These risks have not materialized. In 2002, the value of the dollar fell by 2.6% against a trade-weighted basket of currencies which should, other things equal, result in a tendency for the US current account deficit to narrow. After posting a surplus in the last years of the Clinton administration, the fiscal position of the US has recently deteriorated substantially following the onset of the recession at the end of 2000 and in the early months of 2001, as a result of higher spending following the events of September 11 2001, and more recently the conflict in Iraq.

Has the twin deficit challenge reemerged as a significant risk? First, the chances of a downward spiraling of the dollar following capital flight are low. This scenario is unlikely because it would create a situation from which none of the major regions of the world economy would benefit, in particular Europe.
and Japan. Flight from the dollar would require a major reassessment of the risk-return trade-off in holding US assets. This appears unlikely, as US assets seem a safer haven amid increasing global uncertainty, despite the threat of international terrorism. A flight from the dollar would help make US manufacturing more competitive in international markets and that would promote US exports. However, it would have strong negative domestic effects, putting upward pressure on prices and interest rates and possibly discouraging investment. It would also hurt the exports of Japan and the EU and their stock markets, and thus their growth prospects. Developing countries would also be adversely affected. In particular in Asia, the exchange rates of several currencies could come under severe pressure. For these reasons it is unlikely that the required adjustments in external and domestic imbalances in the US will take place sharply. A more likely outcome is that the recent downward adjustment in equity prices will have a dampening effect on consumption, leading to a greater balance between the forces of investment and consumption sustaining growth. However, if very large unexpected fiscal deficits, partly resulting from tax cuts, add to the already high US federal debt held by the public ($3,711 billion as of March 2003), upward pressure on interest rates will intensify, possibly affecting a revival in investment and pulling down growth.

Geopolitical Uncertainties

*Terrorism and Shortfall in Tourism.* The terrorist attack on the Indonesian island of Bali showed that terrorism can have a significant impact on tourism in Asia. For many DMCs, tourism is a major source of external revenue and economic growth. Tourism accounts for about 9% of developing Asia's GDP and 7% of employment (see Box 1.1 “Tourism Trends in Developing Asia”, ADO 2002).

Terrorist activities could significantly impact many economies in the Asia-Pacific region, with GDP, employment, and the balance of payments directly affected. In the case of Indonesia, estimates of the impact of the Bali bombing on the economy range from 0.5% of GDP in 2002 to 0.5–2% of GDP in 2003, depending on the effectiveness of the government response to the security threat and the repercussions on consumer and investment confidence.

*Impact of Conflict in Iraq.* The conflict could affect DMCs in a number of ways. Certainly, one is the risk of terrorism and its impact as mentioned above. The economic impact of the conflict and its aftermath could be felt through three other channels: (i) a significant oil price increase; (ii) a fall in overseas worker remittances; and (iii) a sharp fall in export demand from industrial and Middle Eastern countries.

While the Asian and Pacific region includes several oil exporters, most of the DMCs are oil importers. Hence, a significantly higher oil price lasting several quarters would have a substantial direct impact on DMCs oil importers,
in terms of higher imports and inflation. For instance, a $2.50/bbl average increase in oil prices would cost Korea—the world's fourth largest importer of oil—over $2 billion a year in higher imports. However, while somewhat higher oil prices are already factored into the baseline forecast, it appears that with the conflict unwinding, the oil market situation is such that neither significant supply disturbances nor high oil prices are expected. But high volatility might remain in the oil market.

The conflict might significantly affect the remittances of DMC workers in the Middle East. About half of Pakistan's overseas worker remittances originate in the Middle East, and so does a significant proportion of remittances to Bangladesh and Sri Lanka. Remittances from the Middle East to the Philippines are also substantial (about 10% of total remittances, or about $700 million).

The conflict and its aftermath might seriously impact many of the DMCs' economies—the greatest risk appears to be that beyond a certain length of time, it will adversely impact consumer (and mainly investor) confidence in industrial economies, further retarding a recovery which is already anticipated to be weak. Also, the conflict will have a direct impact on the exports of DMCs to the Middle East. Some DMCs depend on the Middle Eastern markets, and on Iraq in particular, for a significant share of their exports. For instance, Iraq alone absorbs about one third of Viet Nam's exports of rice and tea (which are among Viet Nam's leading primary exports).

Uncertainties Related to SARS

Increasingly, a major risk to economic growth in developing Asia, particularly East and Southeast Asia, relates to the spread of SARS. Already, the epidemic is significantly affecting travel and tourism in several countries of the region, as well as several other services subsectors, such as hotels and restaurants, retail trade, and transport—particularly air transport within the region. While it is too early to evaluate the impact of the epidemic on economic activity, as much will depend on how long it lasts, economies such as PRC; Hong Kong, China; Indonesia; Malaysia; and Singapore will be affected, even if the impact is of short duration (2–3 months). Hence GDP growth forecasts for these economies for 2003 have already been lowered.

However, if the epidemic is not brought under control by mid-May, the economic impact on developing Asia will be much broader and deeper, for two main reasons. First, the major tourism season associated with summer holidays in Europe and elsewhere in the northern hemisphere will be lost. Second, the reduction in business travel and other transport-related cutbacks could start to affect manufacturing export orders, such that the impact of the epidemic would be felt across a broader swath of the economy. In response to these uncertainties, several governments in Southeast Asia, e.g., those of Singapore and Thailand, are considering support packages for those sectors of their economies most affected by the epidemic.
Part II
DEVELOPING ASIA
SUBREGIONAL TRENDS
AND PROSPECTS

INTRODUCTION

Following an outcome for 2002 which was significantly stronger than expected, growth projections for 2003–2004 show the Asia-Pacific region to continue to expand at a robust rate. Despite the softness in the world economy expected for the first part of 2003 and uncertainties linked to the conflict in Iraq and the outbreak of the SARS epidemic, aggregate GDP growth of 5.3% for 2003 is only slightly below the projections made in the September 2002 ADO Update. The Asia-Pacific region will thus remain a bright spot on the world economic map. There will be diversity, but continued strong domestic demand, improving export performance partly linked to greater diversification and to dynamism of intraregional trade, as well as a continuing supportive policy environment, in particular fiscal and monetary policies, will be the main driving forces of Asian economic dynamism over the next 2 years. This partly results from the strong fundamentals of the region as shown by the high level of reserves and generally low inflation rates. While international reserves are estimated at about $1 trillion at the end of 2002, the aggregate current account surplus for developing Asia is projected at $99 billion for 2003, further adding to the region’s remaining reserves. Average inflation for the region is estimated at 2.5% in 2003, about a percentage point higher than in 2002, but still a fairly low average rate. The positive outlook is also predicated on the continuation and often acceleration of major economic reforms in finance, trade, industry, small and medium enterprises, and economic governance in most countries of the region. Governments are also making determined policy efforts to raise productivity and competitiveness of Asian firms.
EAST ASIA

The East Asian subregion posted a solid performance in 2002, with GDP growth averaging 6.5%, though performance varied considerably among countries (Table 3). The PRC continued its rapid expansion bolstered by strong exports, surging FDI, buoyant domestic demand, and expansionary macroeconomic policies. Korea's brisk recovery was underpinned by both strong external and domestic demand. While exports in the second half of 2002 moderately lifted economic growth in Hong Kong, China and Taipei, China, both economies continued to face weak domestic demand. After 2 years of stagnation, expansion in industry and services and a mild winter saw growth return to Mongolia's economy.

Despite strong overall growth in the subregion, some economies still had to grapple with deflation and high unemployment. Deflation in the PRC occurred because of cheaper imports following WTO accession, productivity growth, and excess capacity. Rising unemployment, intensified competition, and increased economic integration with the PRC caused deflationary pressure in Hong Kong, China and Taipei, China. Falling prices in Hong Kong, China also reflected the post-financial crisis decline in property prices. Weak domestic demand dampened labor market performance in Hong Kong, China while economic restructuring pushed unemployment higher in the PRC. Strong economic growth has helped Korea's unemployment rate decline each year since 1998. While Mongolia's official unemployment rate dropped from 4.6% in 2001 to 3.6% in 2002, incomplete registration may mask the actual figure.

Robust economic growth is likely in 2003-2004 if the global economic environment strengthens, geopolitical stability prevails, and the recent outbreak of SARS is brought under control quickly. Growth is expected to be lower than in 2002, however, averaging 5.6% in 2003 and 6.2% in 2004. In the PRC, rising unemployment, an expanding fiscal deficit, and lagging development in poor interior provinces are likely to constrain expansion. The 2003 outlook for Korea

Table 3. Growth Rate of GDP, East Asia, 2000–2004, %

<table>
<thead>
<tr>
<th>Country</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
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<td>China, People's Rep. of</td>
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<td>8.0</td>
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<td>7.6</td>
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<td>4.0</td>
</tr>
<tr>
<td>Korea, Rep. of</td>
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<td>1.1</td>
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<td>Taipei, China</td>
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<td>-2.2</td>
<td>3.5</td>
<td>3.7</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Sources: Asian Development Outlook database; staff estimates.
reflects significantly more moderate growth than in 2002, due primarily to the slowdown in consumer credit expansion and a deterioration in investor sentiment stemming from geopolitical uncertainties, including those on the Korean peninsula. While economic performance will improve in Hong Kong, China and Taipei, China in the second half of 2003 and in 2004, domestic recovery will lag behind due to ongoing structural adjustments. In Mongolia, growth is expected to strengthen as mining and labor-intensive industries expand. In contrast, the agriculture sector is likely to struggle.

Consumption growth will vary among economies in East Asia. Consumption in the PRC will expand on the back of continued enthusiasm in the emerging markets for housing and cars. High unemployment will partly offset this expansion, however. Korea’s consumption growth is likely to remain firm because of strong real wage growth and low unemployment, although tighter consumer credit and mortgage terms will restrain growth somewhat. High unemployment in Hong Kong, China and Taipei, China will constrain consumer spending there. Additionally in Hong Kong, China, falling property prices and deteriorating household balance sheets will dampen consumption growth. The recent outbreak of SARS will further delay the pace of economic recovery in the first half of 2003. The impact of a short epidemic of SARS on Hong Kong, China’s economy is estimated at about 0.6% of GDP in 2003.

Private investment will however firm up over the next 2 years. In the PRC it is likely to gather momentum as economic reforms continue, rural incomes grow moderately, and substantial FDI inflows continue. Korea’s 200 largest corporations plan to increase investment in 2003 as corporate indebtedness declines, and the successful promotion of broadband Internet usage boosts high value-added technology sectors. Investment spending in Hong Kong, China and Taipei, China is expected to rebound moderately, with renewed acquisition of machinery and equipment to boost productive capacity. However, building and construction may decline again in Hong Kong, China, with few new projects planned and a public housing construction cutback.

Trade has increased within East Asia. In particular, the PRC is emerging as one of the largest export markets for the other economies in the subregion. Strong growth in the PRC should, therefore, help regional exporters to weather slowdowns in other markets, though East Asian export growth will still be affected by economic performance beyond the region. Strong price competitiveness will support PRC export growth, but growth may not match the 2002 level as only modest demand is expected in its biggest markets, the US and Japan. Hong Kong, China and Taipei, China for their part should experience an export-led recovery, fueled by strong growth in the PRC. This will eventually feed into the domestic economies, although ongoing structural adjustments will continue to curb domestic demand. Growth in tourism (and in the services sector in Hong Kong, China) is likely to slow in the subregion as a result of mounting concerns over the emergence of SARS.

Fiscal expansion has played an important role in stimulating East Asian
growth, though concerns about rising deficits and debt are likely to constrain expansion in 2003-2004. In the PRC, there is a growing need to reduce the fiscal deficit and debt as the Government contemplates another huge bank bailout as well as ways to fund its fledgling pension system. Reining in the deficit is the top priority for the authorities in Hong Kong, China. Although legislation in Taipei, China has cleared the way for fiscal expansion if necessary, the authorities remain cautious about implementing such policies. Concerns are also mounting over Mongolia's short- to medium-term debt sustainability. Although structured as long-term debt, repayments are due to start soon. Korea's healthy fiscal position has given the Government leeway to carry out desired spending.

With the exception of Korea and Mongolia, price pressures are likely to remain subdued in East Asia. Monetary policy in most subregional economies is thus expected to remain expansionary, while interest rates in the US, and so in Hong Kong, China, are likely to remain low for most of 2003. Tackling unemployment has become a major issue for PRC; Hong Kong, China; and Taipei, China. Unemployment is a particularly pressing problem in the PRC. More workers from state-owned enterprises will be laid off as reforms continue, swelling the ranks of the 8 million new labor-market entrants and rural migrants seeking work each year. These challenges add urgency to the task of fostering the conditions that promote private sector development. Developing an urban social safety net and social security reforms are also needed to ameliorate the social costs of economic reform.

East Asia's growth hinges on global economic recovery and continued robust growth in the PRC economy. Considerable downside risks are evident in this regard since the global economic recovery remains uncertain. The aftermath of the conflict in Iraq and the potential instability stemming from developments in the Korean peninsula could lead to a significant economic deterioration. All East Asian economies are net oil importers, which makes any significant rise in oil prices harmful to them.

The recent outbreak of SARS has already affected the economy of Hong Kong, China, and, to a lesser extent, those of the PRC and Taipei, China. Any further spread of SARS would pose a serious threat to the subregion's economic outlook. The forecasts are based on the assumption that SARS will be brought under control quickly.

SOUTHEAST ASIA

The recovery in the economies of Southeast Asia was generally much stronger in 2002 than anticipated earlier in the year. Indeed, GDP growth at 4.1% in 2002 was about 1% above that forecast in ADO 2002 (Table 4). Malaysia, Thailand and, to some extent, the Philippines showed a strong recovery in growth in 2002 while Singapore moved out of recession. The economies of Indonesia, Laos PR, and Vietnam improved only marginally from the 2001
levels. In contrast, GDP growth fell from 6.3% in 2001 to 4.5% in Cambodia, one of the poorest countries in Southeast Asia.

The recovery in Southeast Asia was the outcome of a combination of factors. Although business investment remained generally depressed due to overcapacity, domestic demand through the subregion, mainly consumption (both private and public), gained strength during the year. At the same time, the subregion experienced a significant improvement in exports, particularly in the second half of the year. For many countries, high export growth to the PRC appears to have played an important role in this favorable outturn. With inflation generally low—except in Indonesia and the Lao PDR—monetary policies remained accommodative while fiscal policies maintained a generally strong expansionary stance.

Given the momentum of strong domestic demand and solid export performance, GDP growth in Southeast Asia is projected at 4.0% in 2003. As the world economy recovers from the uncertainties and weaknesses experienced in 2001–2002, prospects are somewhat better for 2004, with a forecast of 4.8% GDP growth. Still, many countries are expected to grow at a rate well below their potential. This is particularly the case for Indonesia.

In most Southeast Asian countries, domestic demand is expected to remain strong in 2003–2004, particularly private and public consumption. In early 2003, consumer expenditure strengthened in several countries, including Singapore, Thailand, and Viet Nam. In Indonesia, Malaysia, and Philippines, consumption growth is, however, expected to decelerate somewhat in 2003 as fiscal policies become less expansionary. With few exceptions, fiscal policy stances will be less expansionary in 2003 because of governments’ concerns—to varying degrees—over increasing fiscal deficits in the past few years and rising public debt burdens. In Cambodia, Lao PDR, Malaysia, Philippines, and

<p>| Table 4. Growth Rate of GDP, Southeast Asia, 2000–2004, % |</p>
<table>
<thead>
<tr>
<th>2000</th>
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<th>2002</th>
<th>2003</th>
<th>2004</th>
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<td>3.3</td>
<td>3.7</td>
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</table>

Sources: Asian Development Outlook database; staff estimates.
Viet Nam, fiscal deficits are a particular concern that will be addressed.

In the outlook for 2003-2004, a progressive strengthening of private investment is indicated as capacity utilization rates improve and financial sector reforms are accelerated. The vigorous pursuit of financial sector reforms will be particularly critical in Indonesia, the Philippines, and to some extent Thailand. In the subregional economies in transition of Cambodia, Lao PDR, and Viet Nam, the momentum of market-oriented reforms accelerated in 2002 and is expected to continue in 2003-2004, thereby stimulating private sector investment.

Accommodative monetary policies will continue to support resilience of domestic demand. With the exception of Indonesia and the Philippines, nominal interest rates are projected to remain low and in some cases to be reduced further in 2003, before increasing in 2004. In the Philippines, real interest rates will remain high in 2003, further dampening investment prospects. Inflation is projected to remain relatively low in most countries of Southeast Asia, with the exception of Indonesia and the Lao PDR.

A critical factor in the outlook is the continued strength of exports. Despite a softening of growth in industrial economies expected during the first half of 2003, exports are forecast to keep their momentum in 2003-2004, and data in the first months of 2003 appear to confirm this trend. Greater diversification in export production, restructuring of regional manufacturing production, and increases in trade among subregions linked to continued strong domestic demand in the East and Southeast Asian economies are supporting the forecast for sustained export growth. A driving force for the subregion's exports will be the PRC market, which will absorb a rapidly rising share of the subregion's exports. The governments in virtually all countries in the subregion have been concerned over the past 2 years about a possible loss of competitiveness of their economies (Part III) and are implementing measures to address this issue. For instance, Singapore strongly supports the development of biotechnology; Malaysia and Thailand have both initiated national competitiveness programs over the past year; and the Philippines is pursuing a Medium-Term National Action Agenda for Productivity. For the oil exporters of the subregion (Indonesia, Malaysia, and Viet Nam), higher oil prices were a windfall, although countries like Viet Nam, which is a large exporter of rice and tea to Iraq, and countries receiving substantial overseas remittances from workers in the Middle East (the Philippines and Viet Nam) will be adversely affected by the conflict in Iraq.

Imports in Southeast Asia are projected to grow more rapidly in 2003 and 2004 (by 7.8% and 9.6%, respectively), partly due to higher average oil prices in 2003. Overall, as current account surpluses shrink or deficits increase, trade will likely contribute less to real GDP in 2003-2004 than in 2002.

In the first few months of 2003, downside risks have significantly increased for many Southeast Asian economies as prospects for industrial countries have weakened for the first half of 2003, thus possibly dampening stronger export
prospects. Several of the Southeast Asian economies are vulnerable to volatile oil prices, the loss of export markets in the Middle East, and reduced remittances from overseas workers. Finally, and more importantly, the outbreak of the SARS epidemic might substantially affect tourism and the other services sectors of the subregion if prolonged. Already, it is estimated that SARS will lower GDP growth in Indonesia and Singapore by about half a percent and that of Malaysia by somewhat less.

SOUTH ASIA

In recent years, South Asia has experienced relatively low growth in per capita income. Relative to its population, the subregion accounts for a very low share of global GDP (less than 3%) and an even lower share of global exports (about 1%). The economies in the subregion are relatively closed on average, with the subregion’s ratios of merchandise exports and imports to GDP lower than any other major subregion in the world. Government revenues tend to be low in relation to GDP while expenditures continue to be higher than revenues, resulting in persistent fiscal deficits.

Savings and investment rates vary widely across countries, with gross domestic savings reaching over 46% of GDP in the Maldives and only about 15% in Pakistan. Similarly, gross domestic investment as a share of GDP ranges from under 14% in Pakistan to 48% in Bangladesh. In India, 2002 savings and investment rates were about 24% of GDP—substantial, but less than would contribute to more rapid poverty reduction.

In 2002, South Asia was affected somewhat less than other subregions by global developments due to its relatively low levels of trade and financial integration with the rest of the world. The subregion’s export growth rate continued to exceed the import growth rate, further reducing the trade deficit. Domestic factors played a more important role, such as the security situation in

<table>
<thead>
<tr>
<th>Table 5. Growth Rate of GDP, South Asia, 2000–2004, %</th>
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<td>Sri Lanka</td>
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<td>3.0</td>
<td>5.0</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Sources: *Asian Development Outlook* database; staff estimates.
Nepal, tensions between India and Pakistan, and progress on peace talks in Sri Lanka. With the relatively high importance of agriculture to GDP and to food security, floods and droughts in different parts of the subregion impacted significantly on economic growth and development.

Growth in GDP for the subregion declined to 4.2% from 5.0% in 2001, instead of increasing as forecast in ADO 2002, primarily as a result of adverse weather conditions in Bangladesh, India, and Nepal (Table 5). In addition, the economies of Bangladesh and Nepal suffered from extremely weak external demand. In contrast, Bhutan, Maldives, Pakistan, and Sri Lanka experienced stronger growth in 2002 compared with the previous year. Strong construction growth in Bhutan, tourism recovery in the Maldives, robust consumption in Pakistan, and services recovery in Sri Lanka contributed to dampen the negative effects of insufficient rainfall in other parts of the subregion.

Inflation remained generally mild at 3.0%, as most economies in the subregion adopted macroeconomic policies that kept prices stable. While Sri Lanka still had double-digit inflation in 2002, it was an improvement from the previous year’s 12.1%. Export growth in the subregion picked up to 7.0% in 2002 as India’s exports recovered, in spite of weak external demand in some major markets. Import growth also recovered to 2.5% on account of India’s strong demand.

The medium-term outlook for South Asia is based on an assumed acceleration in global economic growth, improved political stability and security in the countries of the subregion, and normal weather conditions. In this context, growth is expected to increase to 5.7% in 2003 and to 6.1% in 2004, led by strong expansion in India which accounts for roughly three fourths of the subregion’s economy. Growth in Pakistan and Sri Lanka is expected to accelerate substantially, benefiting from continued macroeconomic stability and favorable developments on both supply and demand sides. In addition, domestic demand recovery in Bangladesh, plus continued construction expansion in Bhutan, should contribute to the subregion’s growth. Per capita income growth of 4.1% and 4.4% in 2003 and 2004, respectively, will contribute to poverty reduction.

With continued economic liberalization and private sector-led growth, gross domestic investment as a share of GDP is expected to increase in most countries, contributing to rising labor productivity and future growth. With the stronger growth and accommodative monetary policy, prices are expected to rise in South Asia, to 4.9% in 2003 and to 5.0% in 2004, though these rises are still moderate.

Agricultural production, a key for poverty reduction in the subregion, is expected to increase moderately over the medium term on the assumption of less inclement weather. Industrial output and services, which already account for the bulk of value added in South Asian economies, are expected to continue expanding more robustly.

With strengthening recovery in major markets outside the subregion,
merchandise export growth will accelerate to double-digit levels in 2003–2004 and exceed import growth, contributing to a narrowing of the subregional trade deficit. This is particularly true for Bangladesh and India, where export growth is projected to surpass import growth by over 3 percentage points in 2003. While there are significant variations across countries, the balance of payments surplus on the current account is expected to significantly decline for the subregion as a whole and drop to about $600 million in 2003 and about $130 million in 2004, assuming oil prices remain fairly stable. However, as a percentage of GDP, the aggregate current account is projected to remain near zero in the medium term, as the deficits in Bangladesh, Nepal, and Sri Lanka are offset by surpluses in India and Pakistan.

Fiscal consolidation may again make slow progress because of political uncertainties. The revenue to GDP ratio in most countries is expected to moderately rise, but restraint of expenditure is expected to continue to be difficult. Consequently, government share in the economy will increase and fiscal deficits are projected to persist. The external debt service ratio is already high in several South Asian countries, and may increase to the extent that the persistent fiscal deficits are financed from external sources.

The medium term outlook is subject to several risks. Political uncertainty could affect the scope and pace of economic reforms, and volatile oil prices would adversely affect growth. Remittances from overseas workers could decline substantially as a result of the conflict in Iraq. In addition, growth will remain fragile unless governments pursue fiscal consolidation with determination. Prudent exchange rate management will be necessary to take advantage of the revival in global growth, and enhanced foreign reserve management is becoming increasingly important as the subregion’s reserves rise.

CENTRAL ASIA

Economic growth for 2002 in the six Central Asian republics (CARs) as a group is estimated to be 7.7%, somewhat better than the 5.7% rate forecast in ADO 2002 (Table 6). While growth had been expected to moderate from the strong 10.9% expansion in 2001, GDP growth weakened by more than predicted in two countries due to unexpected events—in the Kyrgyz Republic an accident that closed the important Kumtor gold mine, and in Turkmenistan an extremely poor cotton harvest. On the other hand, this was more than offset by faster than expected growth in Azerbaijan, Kazakhstan, and Tajikistan at rates of 9–11%. Growth in Azerbaijan and Kazakhstan continued to be driven by large-scale investments in the oil sector, largely funded by FDI, while in Tajikistan it reflected continued strong post-civil war recovery in aluminum, agriculture, and electricity. Export gains, at rates of 9–13% in dollar terms, boosted growth in Azerbaijan, Kazakhstan, and Turkmenistan (the large oil/gas producers), and in Tajikistan where the gain in part reflected a bounceback from a sharp drop.
in 2001. Unemployment and underemployment were little improved in 2002, even in the fast-growing oil/gas-producing economies, due to the capital-intensive nature of oil and gas development.

As countries in transition to market economies, the CARs have faced—and to varying degrees effectively dealt with—a legacy of issues including large structural and pricing distortions, off-budget spending, and incomplete statistics that make macroeconomic assessment and comparison between countries difficult. However, some broad developments in 2002 can be highlighted.

Progress continued on the inflation front. Monetary policy in Azerbaijan, Kazakhstan, and Kyrgyz Republic maintained relative price stability in 2002, while strong adjustment efforts reduced average inflation in Tajikistan to 14.5% from the very high levels associated with the civil war and its aftermath. In Uzbekistan, monetary policy remains largely oriented to meeting the credit needs of state-owned enterprises and inflation has remained high at about 28%. Policy is similar in Turkmenistan where inflation increased to 8.8%. In both Uzbekistan and Turkmenistan, price structures are heavily affected by state provision of commodities and services, and distorted by the multiple exchange rate regime with highly overvalued fixed official rates. Uzbekistan, however, adjusted the official rate over 2002 to reduce the spread between the official and market rates.

Financial policies kept floating exchange rates in Azerbaijan, Kazakhstan, Kyrgyz Republic, and Tajikistan roughly stable, or marginally depreciating, in real terms. In Azerbaijan and Kazakhstan, accumulation of part of the governments’ large oil/gas revenues in oil funds (to be used for economic diversification) led to overall government budget surpluses and aided sterilization efforts to prevent excessive appreciation of the exchange rate that would stunt development in the non-oil sector (“Dutch disease”).

Regarding structural reforms, significant actions were taken to improve budget management and transparency in Azerbaijan, Kazakhstan, and Kyrgyz

| Table 6. Growth Rate of GDP, Central Asia, 2000–2004, % |
|-------------|---------|---------|---------|---------|---------|
|            | 2000    | 2001    | 2002    | 2003    | 2004    |
| Central Asia | 8.5     | 10.9    | 7.7     | 5.8     | 5.8     |
| Azerbaijan   | 11.1    | 9.9     | 10.6    | 9.5     | 8.0     |
| Kazakhstan   | 9.8     | 13.5    | 9.5     | 6.0     | 6.2     |
| Kyrgyz Republic | 5.4 | 5.3     | -0.5    | 5.2     | 4.5     |
| Tajikistan   | 8.3     | 10.2    | 9.1     | 7.1     | 5.0     |
| Turkmenistan | 17.6    | 20.5    | 8.6     | 7.5     | 7.5     |
| Uzbekistan   | 4.0     | 4.5     | 4.2     | 3.5     | 4.0     |

Sources: Asian Development Outlook database; staff estimates.
Republic; reduce energy subsidies in Azerbaijan, Kyrgyz Republic, and Tajikistan; and improve the tax system while enhancing incentives in Kazakhstan and the Kyrgyz Republic. Action to strengthen bank supervision was taken in Kazakhstan and the Kyrgyz Republic. Deposit mobilization from the private sector improved in Kazakhstan and Tajikistan, but here as elsewhere in the CARs the bulk of deposits remained denominated in foreign exchange. The banking system needs to be strengthened and the public's confidence in it lifted if the low levels of savings and financial intermediation in the system are to be raised.

In April 2002, four of the CARs—Azerbaijan, Kyrgyz Republic, Tajikistan, and Uzbekistan—together with three other low-income Commonwealth of Independent States (CIS) countries joined with bilateral donors, and four international financial institutions—ADB, European Bank for Reconstruction and Development (EBRD), International Bank for Reconstruction and Development (IBRD), and International Monetary Fund (IMF)—to create the CIS-7 Initiative. The Initiative seeks to create a collaborative effort to enhance economic growth and poverty reduction. Azerbaijan unveiled its Program on Poverty Reduction and Economic Development for 2003–2005 in October 2002. Moreover, the Kyrgyz Republic and Tajikistan have developed plans in the context of IMF’s Poverty Reduction and Growth Facility, implementing macroeconomic stabilization programs during 2002 and continuing in 2003–2004.

The outlook for the CARs is for a moderate slowing in growth for the subregion as whole to an annual 5.8% in 2003–2004 from 7.7% in 2002. This is because growth in the oil/gas producers is expected to be somewhat below recent rates, while present policies indicate that the economy of Uzbekistan can be expected to grow by only 3.5–4%, marginally lower than in recent years. The Kyrgyz economy should recover from its 2002 setback and grow at about 5%, while Tajikistan is likely to slow gradually since the recovery phase is now ending and new investment has been small.

THE PACIFIC

After 2 years of stagnation, the Pacific subregion witnessed a subdued recovery in economic growth in 2002 as GDP grew by about 1.0% (Table 7). The recovery reflected the strengthening of international commodity prices, a rise in tourist arrivals, and generally expansionary fiscal policies accompanied by accommodative monetary policies in most countries. As a result, domestic demand strengthened. The external environment also improved slightly with some strengthening of global trade in 2002 compared with the previous year. Tourists' perception of the Pacific as a safe destination due to global and regional security concerns seem to have benefited tourism in the subregion. However, the Pacific is still suffering from the after-effects of ethnic tension that erupted in mid-2000 in the Fiji Islands and Solomon Islands. Internal
problems accompanied by weak macroeconomic management in many countries prevented the Pacific from posting a stronger recovery. With annual population growth rate of 2.7%, per capita GDP continued to decline in 2002 for the third year in a row. Labor market conditions improved slightly in some countries but unemployment among educated young people remained a concern and continued causing social tensions in the subregion.

Fiscal outcomes in 2002 were disappointing, particularly among the larger countries. As a result, nearly all the countries are facing fiscal difficulties. In some of them, the situation is approaching crisis proportion. The average inflation rate increased from 6.9% in 2001 to 7.1% in 2002, reflecting a weakening of most Pacific currencies, and higher local food and transport prices in some countries. Despite some rise in most countries, merchandise exports declined by 9.7% for the subregion as a whole, largely reflecting a sharp fall in exports from Papua New Guinea due to declining oil production. Exports also declined in the Cook Islands and Samoa. Imports into the region fell by 5.8%, reflecting high costs as currencies depreciated in value. The overall current account for the subregion recorded a deficit for the first time since 1997, primarily reflecting deterioration in the current account in Papua New Guinea. The current account as a share of GDP also declined in Fiji Islands, Kiribati, and Timor-Leste. The flow of remittances, which is very important for some countries including Samoa and Tonga, remained strong in 2002. In several countries, trust funds suffered capital losses, reflecting weakness in global equity markets.

Medium-term prospects are for a modest rebound in economic performance in the Pacific. Factors contributing to the positive outlook include
rising tourist levels, favorable commodity prices, and prospects of a more stable macroeconomy. GDP is forecast to grow at a weighted average rate of 2.4% in 2003, with all countries projected to record positive growth, except for Timor-Leste where the international presence will continue to wind down. Papua New Guinea and Solomon Islands are expected to emerge from recession and the Fiji Islands is expected to experience much faster growth with a strong boost from tourism. In 2004, the subregion is projected to grow by 2.5%, with all Pacific countries experiencing positive growth. Inflation is forecast to decline to 6.3% in 2003, largely reflecting lower inflation in Papua New Guinea and modest or no increases in most other countries. Inflation is projected to decline further in 2004, mainly due to yet slower inflation in Papua New Guinea with expected currency stabilization.

The difficult fiscal situation in 2002 caused many countries to present more responsible budgets for 2003, which were mostly accompanied by frameworks for gradual adjustments toward fiscal consolidation. Accordingly, some progress is projected for an improvement in fiscal balances over the medium term.

Risks to these projections arise from the continuing possibility of sociopolitical instability, weakening of commitment to reforms, adverse commodity price movements, natural disasters, and external shocks. The credibility of fiscal measures and complementary policies announced in budgets for 2003 and their likely success also remain to be seen. Further, with the free-trade Pacific Island Countries Trade Agreement (PICTA) expected to come into force soon, PICTA will likely have an adverse impact on tax revenue of countries relying heavily on trade taxes; it will require them to make necessary adjustments, such as greater reliance on value-added-type taxes and excise taxes. Some countries face very demanding fiscal adjustments in both the medium and longer terms. In some cases, there are good signs that comprehensive economic and public sector reform programs will continue to be developed and implemented, but in other cases weak government commitment or slow progress is likely to continue to be a major constraint in achieving higher standards of living.
Part III
COMPETITIVENESS IN DEVELOPING ASIA: Taking Advantage of Globalization, Technology, and Competition

During the last decade, competitiveness has been brought into the discussion of the search for the panacea for growth almost as if it represented a pillar of economic development, similar to trade and openness or savings. Competitiveness is defined as the ability of firms to remain profitable by delivering to the market the products and services that consumers desire and demand. Firms become more competitive by competing with other firms and by slowly and patiently learning how to do business better. Consequently, it is inevitable that some firms will fail and go out of business, while others will emerge.

Governments and policy makers are particularly interested in the issue, which has given rise to the notion of “national competitiveness”. However, competitiveness is not the panacea for development for Asia's developing countries. Nevertheless, the firm-level framework developed in the Outlook provides a pragmatic route for discussions about competitiveness by focusing on firms. This discussion can, for example, help focus on ways to improve the climate for investment. It can also guide policy makers in linking the notion of competitiveness as a firm-level concept with growth at the national level. Hence, it is essential to provide a grounded explanation of the microeconomic foundations of competitiveness. Competitiveness is best understood as a course of action rather than a one-time event. It is a continuing process, a way of seeking a better future for individual firms, industries and, ultimately, national economies. The consideration of the East Asian experience, in particular,
provides useful insights for firms and policy makers in the less developed countries in the Asia-Pacific region as they devise new strategies and approaches to promote higher rates of sustainable growth.

The significance of competitiveness for firms and policy makers in Asia should be understood within the broader context of the constantly evolving environment created by the forces of globalization and technological progress, and where knowledge is the most important resource. These factors have raised a whole spectrum of new challenges but also of opportunities, which firms and policy makers in developing Asia must recognize. The key to success in the coming years is that governments and firms across Asia devise strategies to take full advantage of the potential benefits that globalization, technology, and competition offer. It will be necessary for them to understand what competitiveness means and how it fits in as a piece of the development process. In recent years, the emergence of the PRC as an economic powerhouse has generated some reservations and fears in the region. But contrary to some views, this environment offers substantial opportunities for the firms and countries in Asia to achieve sustained growth. While it may be true that firms in the PRC have gained comparative advantage in some sectors in the last decade vis-à-vis firms in some other countries in Asia, the PRC's growth and development, together with its recent accession to the World Trade Organization (WTO), imply that its huge market will be open to many firms in the region. The loss in comparative advantage should urge firms in other Asian countries to make efforts to move up the development ladder.

An important implication of the firm-level approach to competitiveness is that the term national competitiveness, especially if used in the context of nations competing for market shares in exports, as some scholars and governments have taken it, can be misleading. Moreover, the term competitiveness has been used with so many meanings at the national level, that it has become meaningless. While nations are certainly concerned about status and power, they do not compete for market shares in the same way that individual firms do. The construction of indices of national competitiveness by aggregating ad hoc a series of variables has little theoretical foundation and thus must be treated with caution. Misconceptions of the nature and role of competitiveness in national economic development can be counterproductive for they can lead to the implementation of the wrong economic policies.

Competition and the quest for profits are the driving forces of firms in a market economy. Competition among firms forces the adoption of the cheapest methods of production and the improvement in the quality of products. Technological upgrading, in the form of introduction of new machinery and improvement of technological capabilities, provides a firm with the means to be successful in competition. In the process of introducing better technologies, new lower-cost methods become available, which allow firms to
increase labor productivity, i.e., the efficiency with which the firm converts resources into value. Increasing productivity is critical for firms because this is how the profit motive that drives them is put into practice.

Labor productivity grows through the interplay of two complementary mechanisms. One is increases in efficiency while the other is the rate of technical progress. The latter is the result of both investment and the development of entrepreneurial and technological capabilities. These capabilities are defined as the ability to use, generate, change and add to the pool of the industrial arts. In other words: firms become more competitive not only by reducing costs but also by improving existing products and developing new technologically intensive products. This involves the firms moving into new areas, such as services, as well as taking higher risks and engaging in trial and error.

The only possible benefit of discussing national competitiveness is in the identification of the appropriate role for government policy in enhancing firms' competitiveness, and to show how government can remove barriers to firm-level competitiveness. The bottom line of what governments must try to do is to create a well-functioning market economy, which is, in the final analysis, what is meant by a competitive economy. This is the result of a partnership between the state and firms. Although national competitiveness may be an elusive concept, taken as shorthand for well-functioning market economy it has a place in the policy debate. The ultimate objective of the partnership between the state and the market is to increase living standards and, as a result, reduce the gap with the countries at the technological and income frontier. Likewise, at the aggregate level, increases in labor productivity are the key to achieving sustained long-run growth in living standards.

The other component of a well-market functioning economy is the development of effective and independent institutions that promote and favor a well-functioning market economy. These are determined by historical and cultural factors as well as by government actions that are necessary for growth. It is of utmost importance that governments do not delay the reforms needed to create market-friendly institutions. The key issue with institutions is that they are an internationally immobile factor of production and, consequently, each country has to experiment and set up the institutions that work in its particular context.

The process of moving toward the achievement of a well-functioning market economy—in the sense of firms making efforts to enhance their entrepreneurial and technological capabilities and the government providing the institutional infrastructure and promoting efficient and market-friendly institutions—must be undertaken as a synchronized progression.

An implication of the notion of a well-functioning market economy is that governments have a very important role to play in enhancing firms' competitiveness. They have to provide the institutional infrastructure and services that facilitate competition among firms by leveling the competitive
“playing field”. In terms of institutional infrastructure, governments should: (i) provide macroeconomic stability; (ii) set up the necessary legal system, including competition and entry and exit laws; and (iii) address market failures. Likewise, there are three major areas where there is room for state and markets to share responsibilities: (i) education, (ii) technology and innovation, and (iii) physical infrastructure. There is consensus among economists about the importance of these policies and agreement that, if governments of developing countries perform these tasks well, they will be laying the foundations for rapid development.

Some governments may believe that besides providing the necessary institutional infrastructure to achieve a well-functioning market economy they have an important role to play in identifying areas or sectors of growth, and thus become very active with a view to promoting competitiveness. The extreme of this position is the identification of specific sectors of growth, i.e., industrial policy and “picking the winners”. These aspects of government intervention with a view to enhancing competitiveness are, however, very controversial. These are (i) the provision of financial incentives to attract foreign direct investment (FDI), (ii) the creation of export processing zones, and (iii) the creation of clusters and industrial parks. The empirical evidence indicates that government intervention in these areas might not yield significant benefits and it is very difficult to show empirically that industrial policies were a major source of growth. For example, financial incentives to attract FDI work, at best, only at the margin. Moreover, technology transfer mandates, specific local content requirements, or mandatory joint ventures often do not bring the expected benefits. The problem with attempts to artificially create clusters and export processing zones is that often they are packaged as “new competitiveness policies” when, in many cases, they are no more than industrial policies that attempt to pick the winners. Once the costs of these measures for the host country, in terms of, for example, forgone taxes, are factored in, it is highly unlikely that these measures are significantly beneficial. These types of direct interventions often mask failures in achieving the essential functions of government required to sustain firm-level competitiveness.

Competitiveness is best achieved when firms are encouraged to continually enhance their entrepreneurial and technological capabilities. Global value chains (GVCs) are a key to this process, and as such they offer an immense window of opportunities to many Asian firms to take advantage of the potential benefits of globalization. There are many ways for a firm to enter a GVC and these largely depend on its level of development. The newly industrialized economies’ (NIEs’—comprising Republic of Korea; Hong Kong, China; Singapore and Taipei, China) firms successfully entered GVCs three decades ago and it was in this way that they climbed the development ladder. Their experience can be very useful to the firms in the less developed countries of the region. Ten practical strategies for entering GVCs and
technologically upgrading within them, are presented. These are: 1. Foreign
direct investment; 2. Joint ventures; 3. Foreign and local buyers; 4. Licensing;
5. Subcontracting; 6. Informal means (e.g., overseas training, hiring, returnees);
7. Original equipment manufacture (OEM); 8. Own-design and manufacture
(ODM); 9. Strategic partnerships for technology; and 10. Overseas acquisition
of equity.

A major prerequisite for competitiveness in all countries is the availability
of skilled labor through the provision of education. Education is an area of
shared responsibility between government and market, especially at the
tertiary level. The East and Southeast Asian countries now provide basic
education for all those eligible. However, in recent years they have realized that
their educational systems need important reforms, in particular regarding the
perceived mismatch between the type of education supplied by universities
and the skills demanded by the firms. There is no unique solution to this
problem and countries in the region will have to experiment.

Countries must make efforts to avoid getting caught in a cycle of low skills,
low wages, depressed productivity, and low levels of technology. Avoiding this
vicious cycle requires an upgrading of the educational base. For example,
countries that try to exploit their comparative advantages based on low labor
costs by restricting wages or through devaluations end up getting stuck into a
vicious cycle of low productivity, deficient training, and a lack of skilled jobs,
preventing the sector in question from competing effectively in the markets for
skill-intensive products. This situation is referred to as a “low-skill, bad-job
trap.” Bad jobs are associated with low wages and little opportunity to
accumulate human capital; good jobs, on the other hand, are the ones that
demand higher skills and command higher wages. A second trap derives from
the complementarities between capital and labor. The problem is referred to as
a “low-skill, low-tech trap.” If workers have insufficient skills to operate modern
machines, the latter will be underutilized. Consequently, firms will have little
incentive to invest in the latest technology. This reduces workers’ productivity
even more. A third problem emerges from the interaction between innovation
and skills. Innovating is crucial for developing technological capabilities.
However, innovation requires well-trained workers. Economies can get caught
in a vicious circle in which firms do not innovate because the labor force is
insufficiently skilled, and workers do not have incentives to invest in knowledge
(so that they do not train sufficiently) because there is no demand for these
skills.

One of the most important consequences of the deficiency in training is
the effect on the composition of goods produced in the country: a lack of
skilled workers adversely affects product quality. And skill deficiencies lead to
producing and exporting relatively poor-quality and low-value products.
Breaking out of such traps and vicious circles may require government
intervention by subsidizing the acquisition of knowledge.

Finally, it is argued that firms in the less developed countries in the region
can learn a great deal from the experience of the firms in the NIEs which successfully reduced substantially the technological gap with firms at the frontier during the last two decades and became strong international competitors. They did this not by undertaking R&D, but through behind-the-frontier innovation, which involved constant improvements to process and products. This has been referred to as "catch-up competitiveness", which depends on entrepreneurship, provision of education as well as market-friendly institutions, and sound macroeconomic management. However, it is argued that simply replicating the NIEs' experience or "model" is impossible given that the global economic environment has changed. Thus, although the successful experience of many NIEs' firms can provide valuable insights, catch up by the firms in today's developing countries in the region will be impossible without a substantial degree of indigenous innovativeness at the entrepreneurial and technological levels as well as at the policy and institutional levels.
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