II. MACROECONOMIC PERFORMANCE, ISSUES AND POLICIES

REGIONAL OVERVIEW

Rapid economic growth and macroeconomic stability are widely recognized as central objectives of development policy. All developing countries need rapid output growth to fulfil the rising aspirations of their citizens for a better standard of living. Poorer developing countries need more rapid growth to generate the resources needed to develop the social and physical infrastructure to make progress towards achieving the Millennium Development Goals. Macroeconomic stability is a prerequisite for rapid socio-economic growth since high inflation rates, high interest rates and fluctuating exchange rates can be devastating for both economic growth and sustained social progress, as shown by the economic and financial crises that have affected different parts of the world over the years. According to this measure, the developing economies of the Asian and Pacific region have been quite successful in achieving both social and economic objectives, enjoying average GDP growth of 6.6 per cent and an average inflation rate of just below 5 per cent between 2003 and 2005 (see table II.1).

Following a strong performance in 2004, the economic growth rate of developing countries in the Asian and Pacific region slowed moderately to 6.6 per cent in 2005, a deceleration of 0.8 percentage point. This was the result largely of high oil and commodity prices and a global slowdown in trade. From the perspective of countries in the region, much of 2004 and 2005 was characterized by a cyclical downturn in the world's information and communication technology industry in which many of the region's economies enjoys considerable competitive strength. The slowdown in 2005 was fairly uniform, with all subregions and country groups experiencing some loss of momentum in economic activity.

China, India and Pakistan saw high economic growth in 2005 despite high oil prices

However, a number of individual economies, principally the energy producers, registered higher economic growth in 2005 than in 2004. By far the most striking performers were China, India and Pakistan, countries that are net oil-importers, where growth accelerated in 2005. In those countries, growth is increasingly being driven by buoyant domestic investment and consumption and, significantly, neither the higher energy prices nor the global trade slowdown affected their dynamism. In China, however, exports remain a major component of growth. From a more global point of view, despite the modest slowdown, the Asian and Pacific region had the highest rate of economic growth of all regions of the world. For the third year in succession, no country in the region experienced a negative rate of economic growth.

Inflation remained low in 2005

The rise in oil and other commodity prices did, however, nudge inflation up in 2005 over that in 2004, although price increases throughout the region remained mild by historical standards at less than 5 per cent, the average level in recent years. North and Central Asia, despite being a net oil-exporting area, saw inflation rise to 12 per cent, fuelled mainly by high inflation in the Russian Federation. The North and Central Asian subregion continues to remain susceptible to price pressures, primarily because of chronic supply-demand mismatches and high rates of growth in money supply in the transition to a market-based system among countries of the former Union of Soviet Socialist Republics. Inflation declined in East and North-East Asia as food prices fell following good harvests in China and the price of manufactured goods in that subregion trended lower; in addition, there was subdued aggregate demand growth in the Republic of Korea. Similarly, average inflation was close to zero in the developed countries of the region because of continuing deflation in Japan. All other subregions experienced only a moderate increase in price pressures as economies adjusted well to the higher oil and commodity prices. Some countries attenuated the effects of

Table II.1. Rates of economic growth and inflation in selected Asian and Pacific economies, 2003-2006

(Percentage)

	Real GDP				Inflation[a]			
	2003	2004	2005[c]	2006[d]	2003	2004	2005[c]	2006[d]
Developing economies[b]	6.5	7.4	6.6	6.5	4.8	4.7	4.8	4.4
East and North-East Asia	6.5	7.7	6.9	6.5	1.4	3.2	2.2	2.2
China	10.0	10.1	9.6	8.4	1.2	3.9	1.9	2.0
Hong Kong, China	3.2	8.1	7.5	5.4	–2.5	–0.4	1.1	1.6
Mongolia	5.6	10.6	6.0	6.0	4.6	11.0	10.0	6.0
Republic of Korea	3.1	4.6	3.8	4.9	3.6	3.6	2.8	2.9
Taiwan Province of China	3.3	5.7	3.8	4.1	–0.3	1.6	2.3	1.6
North and Central Asia	7.5	7.4	6.9	6.1	12.9	10.2	12.0	9.9
Armenia	13.9	10.1	13.9	7.0	4.8	6.9	0.6	3.0
Azerbaijan	11.2	10.2	26.4	24.8	2.2	6.7	9.6	7.4
Georgia	11.1	6.2	7.7	9.0	4.8	5.7	8.2	3.0
Kazakhstan	9.3	9.6	9.2	8.6	6.4	6.9	7.6	6.7
Kyrgyzstan	6.7	7.1	–0.6	3.0	3.1	4.1	4.3	4.7
Russian Federation	7.3	7.2	6.4	5.7	13.7	10.9	12.7	10.3
Tajikistan	11.0	10.6	6.7	6.8	17.1	6.8	7.8	7.3
Turkmenistan	13.0	9.0	11.0	9.0	6.5	10.0	10.5	11.0
Uzbekistan	4.2	7.7	7.2	7.0	13.1	1.7	7.1	7.4
Pacific island economies	3.0	3.3	2.7	3.0	10.7	3.0	2.2	3.4
Cook Islands	3.1	3.4	3.2	3.0	2.0	0.9	2.9	2.0
Fiji	3.0	4.1	1.7	2.0	4.2	3.3	3.0	3.0
Papua New Guinea	2.9	2.9	3.0	3.5	14.7	2.1	1.0	3.4
Samoa	3.3	3.7	5.6	3.0	0.1	11.7	7.8	3.0
Solomon Islands	5.3	5.0	2.9	2.6	10.0	7.1	6.2	5.0
Tonga	3.1	1.6	2.8	2.8	11.6	11.0	9.6	9.0
Vanuatu	2.4	3.2	2.9	2.2	3.0	1.4	2.5	2.5
South and South-West Asia[e]	7.3	7.4	7.0	7.0	10.4	6.5	7.0	5.7
India	8.5	7.5	8.1	7.9	3.9	3.8	4.5	4.0
Iran (Islamic Republic of)	6.7	4.8	5.0	7.4	15.6	15.2	14.5	11.5
Pakistan	5.1	6.4	8.4	7.0	3.1	4.6	9.3	8.0
Sri Lanka	6.0	5.4	5.5	6.0	6.3	7.6	11.6	6.4
Turkey	5.8	8.9	5.0	5.0	25.3	8.6	7.7	5.8
South-East Asia	5.0	6.4	5.4	5.9	3.1	3.9	5.8	6.0
Indonesia	4.9	5.1	5.6	6.2	6.6	6.1	10.5	11.4
Malaysia	5.4	7.1	5.2	5.9	1.2	1.4	2.9	2.8
Philippines	4.5	6.0	4.8	5.2	3.5	6.0	7.6	7.0
Singapore	1.4	8.4	6.4	6.0	0.5	1.7	0.4	1.2
Thailand	6.9	6.1	4.5	5.7	1.8	2.8	4.5	4.0
Viet Nam	7.3	7.7	8.4	8.0	3.1	7.8	8.4	7.4
Least developed countries	5.6	6.1	5.2	5.8	4.7	5.8	6.3	6.6
Bangladesh	5.3	6.3	5.4	6.0	4.4	5.8	6.5	7.0
Bhutan	6.8	8.7	8.8	8.0	2.1	4.6	5.5	5.0
Cambodia	7.1	7.7	6.3	6.1	0.5	5.6	5.5	3.5
Lao People’s Democratic Republic	5.8	6.5	7.2	7.5	15.5	10.5	8.0	7.0
Myanmar	13.8	5.0	4.5	3.5	8.0	..	..	..
Nepal	3.1	3.7	2.6	4.5	4.8	4.0	4.5	5.0

(Continued on next page)

Table II.1 *(continued)*

(Percentage)

	Real GDP				Inflation[a]			
	2003	2004	2005[c]	2006[d]	2003	2004	2005[c]	2006[d]
Developed economies	1.9	2.4	2.5	2.1	–0.1	0.2	0.0	0.5
Australia	3.3	3.3	2.5	3.2	2.8	2.3	2.8	2.9
Japan	1.8	2.3	2.5	2.0	–0.3	0.0	–0.3	0.3
New Zealand	3.8	4.4	2.2	2.0	1.8	2.3	2.8	3.0

Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, EIU, 2005 and 2006), various issues; Commonwealth of Independent States Inter-State Statistical Committee, <www.cisstat.com>, accessed on 9 January 2006 and 10 February 2006.

[a] Changes in the consumer price index.
[b] Data are based on 38 developing economies representing more than 95 per cent of the population of the region (including the Central Asian countries); GDP figures at market prices (in United States dollars) in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates.
[c] Estimate.
[d] Forecast or target.
[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2004/05 = 2004 for India, the Islamic Republic of Iran and Myanmar; and fiscal year 2003/04 = 2004 for Bangladesh, Nepal and Pakistan.

those higher prices by continuing to subsidize oil products and others by pre-emptively tightening monetary policy, thereby dampening inflationary expectations.

The strong growth momentum in 2005, despite the rising energy prices, suggests the rise in overall prices that has manifested itself in an outward shift in the aggregate demand curve owing to the huge growth in the demand for goods and services from the region's fast-growing economies, especially China. This change has been accompanied by an equally large outward shift in the aggregate supply curve. As a result, the higher demand has been satisfied with an equally robust supply response rather than being dissipated in the form of higher prices, as had happened in previous oil shocks when "stagflation" resulted. Success in keeping inflation in check was also helped by the relatively low inflation rate prevailing in past few years, the lower intensity of energy needed per unit of higher output, especially in economies with a large preponderance of services, and more effective monetary policies that have been built on the experience gained in previous episodes of oil price increases.

Growth should continue in 2006, but there are some challenges ahead

The region as a whole is expected to grow at about the same pace in 2006 as in 2005, absent any new adverse developments such as a further large increase in oil prices, an influenza pandemic or a major realignment of exchange rates. Even as the Chinese economy is predicted to slow somewhat, the slack is likely to be taken up by India and the South-East Asian economies, by strong domestic consumption growth in India and by a cyclical upturn in the information and communication technology industry in South-East Asian economies. The countries of South and South-West Asia, recently affected by two major natural disasters within a 10-month period, have been fortunate in that the disaster zones were not major contributors to national output, except where tourism is a major activity.

Optimism for 2006 also stems from the hope for a sustained economic recovery in Japan, while continuing high commodity prices should help the region's commodity producers. On the other hand, a sharper than expected slowdown in the United States economy would adversely affect export momentum from the region, even though intraregional trade has become a strong driver of growth over the last two to three years. The following paragraphs examine the principal near- and medium-term policy issues and challenges likely to confront the region in the coming months. Policy issues with a global dimension, such as oil prices, regional imbalances, threat of avian influenza, the post-Hong Kong, China, WTO agenda and others, were discussed in chapter I.

Near-term policy issues

Tighter fiscal and monetary policies could produce adverse impacts

An important issue for economies in the region in 2006 is the potentially adverse impact on growth of tighter fiscal and monetary policies. For several years, many countries have been following a policy of fiscal consolidation with a view to reducing the growing burden of public debt and providing more space for private investment. Inflationary pressures induced by higher oil prices have resulted in a tightening of monetary policy and rising interest rates across the region, though with some notable exceptions. Reinforcing the effects of long-term fiscal consolidation, especially in countries that are cutting government spending rather than improving tax revenues, higher interest rates are bound to have some negative effect on the pace of economic activity. A particular danger is where low interest rates have fuelled strong growth in debt-financed private consumption and also created asset bubbles. Higher interest rates should prove less deleterious for economic growth than cuts in government spending, especially in poorer developing countries where government development expenditure is often the key to the pace of development. However, in the richer developed countries, where real interest rates are already high, a further increase could trigger a hard landing of the economy through a sharp fall in asset prices.

China faces excess capacity

Several economies in the region have become closely tied to the Chinese economy through trade and investment links, as in much of the East and North-East Asian subregion. After years of furious growth, the Chinese economy is now faced with excess capacity in a number of sectors, such as steel, cement, consumer electronics and construction. Among the various adjustment measures that are being taken by the Chinese authorities to cool the economy, a reduction in imports related to these sectors is probable. That would adversely affect other economies, the exports of which have been driven by the strong pace of Chinese demand in the last two to three years. China is the largest destination for exports from the Republic of Korea and Taiwan Province of China; China ranks second to the United States among Japan's main export destinations. Commodity exporters such as Australia have also benefited hugely from Chinese demand. All the above-mentioned countries, including China's smaller neighbours, would have to make suitable adjustments in their external sectors, especially as slower growth in Chinese demand could weaken overall commodity prices in the region.

A potentially positive development in the Asian and Pacific region is the Japanese economy's recovery from a decade of stagnation. The prospects of more sustained growth in that country over the next few years have led to remarkable buoyancy in Japan's stock markets, isolated but significant increases in property prices and the likelihood that the country will overcome deflation in 2006. In addition, corporate investment activity has increased and unemployment has begun to decline. Together, these developments should strengthen consumer confidence and provide a more durable basis for sustained output growth over the medium term. As one of the main sources of foreign direct investment and an important destination of exports for many countries, the recovery of the world's second largest economy has great significance for the region as a whole. However, Japan's recovery is at a nascent stage, and its real impact on the region will depend on the revival of domestic consumption and on how it deals with its massive public debt.

Medium-term policy issues

Poverty reduction remains the most significant challenge for the region

Despite growing faster than most regions of the world for more than two decades, poverty reduction remains the most important challenge for the Asian and Pacific region. It is a chastening reality that the region contains two thirds of the world's poor, with 40 per cent of the extremely poor who earn less than $1 a day living in South Asia and in the least developed countries. Pockets of extreme poverty also exist in parts of South-East Asia and in some Pacific island States.

It should be emphasized that elimination of poverty has no general solution that would be applicable equally in all countries and at different levels of development. The handful of economies in the region, such as Hong Kong, China; the Republic of Korea; Singapore; and Taiwan Province of China, that have effectively overcome poverty during the past quarter century have done so by applying individual approaches and policies. The one common feature in their diverse experience is that a fast pace of economic growth is vitally important. Rapid growth not only provides ever-increasing opportunities for employment in both the formal and informal sectors but also generates resources for the public sector to use in addressing issues of non-income poverty, such as insufficient or poor quality public goods: education, health, transport and housing.

Rapid growth alone is not enough

However, rapid growth alone may not be enough. The impressive growth of China and, of late, India is widely believed to have pulled millions of people out of extreme poverty. These successes, welcome as they are, have nevertheless been skewed in their impact. For instance, in China growth has been most visible in the coastal areas, with income levels growing more slowly in the interior and in the western part of the country. In India, the information and communication technology boom has reduced the incidence of poverty in urban areas, but large parts of the rural economy have been left behind. It thus appears that in countries where poverty is widespread, jobs and income growth alone will not eliminate non-income poverty. Governments need to expand the provision of public goods and ensure better access for the poor. Without such intervention, even rapid economic growth will deliver inequitable outcomes and will be unsustainable over the long term.

While the private sector, including civil society, can provide critical support in widening access to public services, through public-private partnerships and other means, government intervention remains essential for scaling up individual successes and creating a favourable environment, through regulation, for promoting and sustaining universal access to public services. A good example is Viet Nam, where the Government has not only created a favourable business environment for domestic and foreign investors but also has extended the benefits of economic growth to the wider society by investing in education, medical facilities, roads, drinking water and electricity in rural areas. Governments would do well to re-examine dispassionately their successes and failures in tackling the challenge of poverty and address decisively the constraints that could prevent them from attaining the Millennium Development Goals.

Inequitable growth is an important issue

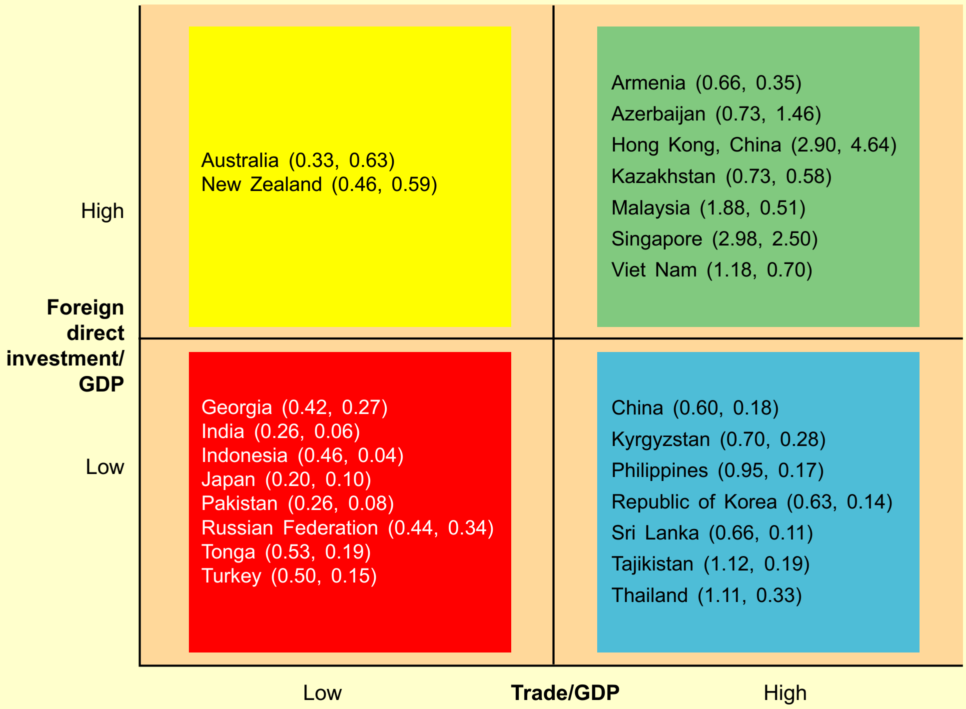
The problem of inequitable growth is not confined to specific geographic areas and it is not specific to certain levels of development (discussed at length in chapter I). Inequitable growth is an important issue in many of the smaller economies, including the least developed countries and the Pacific island States. In such countries, national efforts can be severely undermined by the paucity of financial and non-financial resources; these efforts are also made more difficult owing to the physical remoteness of the countries. Their prospects for sustained long-term growth and, hence, for reducing poverty are very limited without regional and indeed, international aid and support, such as the global compact envisioned as one of the Millennium Development Goals. In that context, the temporary movement of workers on contract employment abroad is an option with enormous potential for reducing poverty. This option is not capital-intensive and, with its relatively short lead time, it could deliver visible results quickly.

Remittances help to raise living standards

Remittances sent to their families by temporary migrants and workers on contracts abroad have helped enormously to raise the standard of living in some of the poorest sections of society in Bangladesh and Nepal in South Asia; Cambodia, the Lao People's Democratic Republic and Myanmar in South-East Asia; and Samoa and Tonga in the Pacific. Governments in these and other economies with high levels of underemployment and with limited opportunities in formal sector employment could follow the example set by the Philippines and systematically promote the temporary export of workers as part of a national development and poverty-reducing strategy. However, countries facing labour shortages or shortages of people with specific skills would also have to allow migrant workers to enter and work in their economies legally, without fear of harassment, and to treat them with dignity.

An issue with which many ESCAP developing countries will have to contend over the medium term is the emergence of China as a manufacturing powerhouse for the rest of the world. Several economies, mainly in East and South-East Asia, have prospered as relatively open economies, with international trade serving as the engine of growth. These economies, which have also benefited from the inflow of FDI and its various spillover effects, are listed in the two right-side quadrants of figure II.1. The figure depicts the relative openness of selected Asian

Figure II.1. Relative openness of selected Asian and Pacific economies



Sources: International Monetary Fund, *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., IMF, December 2005) and *World Economic Outlook, September 2005*, (Washington, D.C., IMF, 2005); United Nations Conference on Trade and Development, Foreign Direct Investment online database <http://stats.unctad.org>, accessed on 16 December 2005; and national sources.

Notes: Trade data refer to annual average exports and imports of merchandise goods for the period 2002-2004. Foreign direct investment refers to the annual average stock of FDI for the same period. The cut-off point between "High" and "Low" has been defined as 60 per cent in the case of total trade/GDP and 35 per cent in the case of FDI/GDP. Individual country ratios for trade/GDP and FDI/GDP respectively have been shown in parenthesis.

and Pacific economies. The position of China as the most attractive FDI destination in the region is changing, yet the country has a vast reservoir of workers and huge internal market. Thus, these phenomena will pose new and challenging issues with which economies in the region will have to deal if the overall regional growth momentum is to be maintained.

Although the sum of FDI is not fixed, that is, more FDI for China does not necessarily mean less for others, China enjoys a huge competitive advantage over other producers and exporters of labour-intensive manufactured goods in the region. As described in the section on the East and North-East Asian subregion, China dominates the world in textile and clothing exports and it is developing prowess in the export of information and communication technology equipment. In the near future it might emerge as an important base for automobile exports. Several established producers of information and communication technology goods have already felt China's impact. Other industries are likely to be affected by China's growing competitiveness in industries that are not labour-intensive. These developments suggest that South-East Asia could experience sharply reduced inflows of FDI and of access to the technology and markets that FDI brings.

The restructuring experience of Singapore (see discussion in the section on the South-East Asian subregion) suggests some of the alternatives available to South-East Asian economies. These include a radical restructuring of the manufacturing sector in order to benefit from China's economic development by moving from labour-intensive to more technology- and capital-intensive production niches. Expanding the service sectors with information and communication technology is another option, but this would require major investment in human resources and cannot be done in just a few years. Moreover, investment in education is only one element in improving human resources. Better standards of governance in both the public and private sectors of the region's economies are also required in order to maximize total factor productivity. The way in which individual economies cope with the challenges posed by China will depend on a variety of considerations, involving a strong interaction between all stakeholders in pursuing a common vision and agenda for the future.

North and Central Asia should expedite economic reforms

Finally, greater economic diversification is needed in the economies in transition in North and Central Asia. The subregion is going through a sustained period of growth, with the energy sector, helped by high oil and gas prices, providing the main source of growth in many economies, especially Azerbaijan, Kazakhstan, the Russian Federation and Tajikistan. In Azerbaijan, where foreign capital inflows into the energy sector constitute an unusually high proportion of GDP, the need for broad-based growth is particularly strong in order to prevent the Dutch disease phenomenon in which the exchange rate appreciates and the economy loses competitiveness in the non-energy sectors. The Central Asian economies also need to expedite their economic reforms, particularly in the macroeconomic arena, that have been going on since 1992. Only two countries, Kazakhstan and the Russian Federation, have achieved market-economy status thus far.

DEVELOPING COUNTRIES

East and North-East Asia

Overview

Robust growth continues in the subregion

The economies of the East and North-East Asian subregion differ greatly in size and level of development. China accounts for two thirds of subregional GDP. In purchasing power parity terms, however, that country's GDP per capita of $4,500 is exceeded by a wide margin by that of Hong Kong, China, at $27,000, and the Republic of Korea, at $17,000. Those two economies also have a much higher ranking than China in the human development index of the United Nations Development Programme. Nonetheless, the economy of the subregion is hugely influenced by the increasing weight and power of China as a trading nation and its remarkable impact on the prices of manufactured goods, raw materials, exchange rates, financial flows, services and tourism.