EXECUTIVE SUMMARY

Healthy macroeconomic fundamentals to shield the region from global financial turbulence

After the fastest growth in a decade in 2007, the developing economies of the Asia-Pacific region are expected to grow at a slightly slower but still robust 7.7% in 2008. The region’s developed economies are expected to grow at 1.6% in 2008, slipping from 2% in 2007. China and India, the region’s economic locomotives, are expected to continue growing briskly in 2008, boosting the rest of the region. Commodity- and energy-exporting countries, particularly the Russian Federation, are expected to add to the momentum. The major drags on performance are the slowdown in the United States driven by the bursting housing bubble, the unfolding credit crunch in the United States and Europe, the appreciation of currencies in the region against the dollar and the high oil and food prices.

Although exports may suffer from the slower growth in industrial countries, strong domestic demand – driven by private consumption and investment in fast-growing countries and by fiscal accommodation – should cushion the blow. Export-dependent economies in East and South-East Asia will see exports contribute less to growth, but China’s on-going expansion will continue to offer opportunities.

North and Central Asia will continue to benefit from consumption and construction, thanks to income from high energy prices. With economies traditionally driven by domestic demand, South and South-West Asia will benefit from strong private consumption and investment – and from expansionary fiscal policy in some countries. In the Pacific, Fiji and Tonga are expected to recover from economic contractions, while Papua New Guinea will enjoy rising consumption as the benefits of high commodity prices spill over to the rest of the economy.

The region’s resilience lies mainly in its healthy macroeconomic fundamentals, enabling countries to adopt supportive fiscal and monetary policies. Government budget deficits have gradually declined and, in some countries, have turned to surpluses. There have been no signs of excessive current account deficits, as in the prelude to 1997. Countries have reduced their dependence on bank financing, addressed currency mismatches and improved the health of banking sectors. Large foreign reserves have added to the region’s resilience.

Food inflation – the next big challenge: Inflation in the developing economies of the region is projected at 4.6% in 2008, down from 5.1% the previous year, with currency appreciation cushioning the impact of high oil and food prices. This projection, however, is subject to some uncertainty. The key question is how much last year’s surge in prices will continue in 2008 and beyond. Oil prices are expected to decline from the record levels at the beginning of 2008 as the industrial economies slow, led by the United States. Food prices are likely to remain high, posing a greater inflationary risk because food accounts for a far higher proportion of consumer spending.

The rising food prices in 2007 were due in part to drought in Australia, flooding in China and dry weather in Europe. Added pressure came from the demand for biofuels. With the march towards biofuels apparently unstoppable, governments need to consider carefully the impact on the poor. ESCAP analysis shows that the poor have so far benefited little from the biofuel revolution despite its opportunities for lower income groups.

Currency appreciation to continue: Since 2006, major currencies in the region have risen against the dollar, a trend expected to continue in 2008, driven by the unwinding of large United States imbalances with the rest of the world and the turmoil in global financial markets. Currency appreciation sheltered the region’s economies from high oil and food prices, but it dealt a blow to the competitiveness of exports. Countries whose currencies appreciated the most faced intensive competition from lower cost producers, surrendering market share, especially in price-sensitive, low-technology manufacturing, along with some agricultural commodities.
Downside risks to the 2008 outlook – navigating the subprime crisis

The subprime crisis in the United States is still unravelling, and a significant slowdown in the United States and further turmoil in financial markets cannot be ruled out. Often-fickle investor sentiment makes it difficult to predict when and how that turmoil might affect regional markets. Even so, countries can ensure that they are strong and flexible enough to absorb the shocks and adapt to any disruption in financial flows. Because economic shocks exact a heavy toll on poor and vulnerable people, efforts to mitigate the impacts are urgent.

So far, Asia-Pacific economies have remained fairly immune to the tighter credit conditions in the United States and the European Union. The region’s corporate sector is generally cash-rich and not highly leveraged. The region is also reported to have little exposure to subprime or other vulnerable debt.

The main impact on the region will come through a downturn in exports. The United States has been cutting interest rates aggressively in response to slowing growth, fuelling further depreciation of the dollar. Countries in the region will face twin blows: reduced demand and less competitive exports to the United States. The possibility of substantial capital outflows from the region is another risk, whether triggered by external developments, concerns about the region’s growth or reversals in the foreign exchange “carry trade”.

In the worst case scenario of a recession in the United States and a deeper depreciation of the dollar, the impact in much of the region would be harsh. Most vulnerable will be the exporters of high-technology products, such as electronics, to the United States: Singapore, the Republic of Korea and Taiwan Province of China. The economy of China will remain reasonably resilient, as strong domestic demand should partly cushion the external shock. The impact is likely to be felt less in economies led largely by domestic demand, such as India.

To strengthen economies and to reduce the impact on the poor, countries must:

• **Solidify macroeconomic fundamentals – to maintain investor confidence and sustain economic growth.** Key policies are for moderate and stable inflation, low budget deficits and sustainable debt burdens – and more flexible exchange rates to absorb shocks.

• **Develop robust microeconomic foundations – to ensure efficient economic systems.** Clear property rights, overseen by a strong judiciary, allow companies and institutions to operate with confidence. Training programmes to improve labour mobility and measures to safeguard vulnerable segments of the working population are also important.

• **Ensure healthy financial sectors – to build confidence and benefit from capital inflows.** Financial markets need to be deepened by developing domestic and regional bond markets. Authorities must also keep pace with the greater diversity and complexity of new financial products.

• **Strengthen social safety nets – to support people facing hardship during economic downturns.** As such systems are difficult to set up during crises, the time to act is now. Safety nets should be large enough in scale and coverage to provide broad-based social protection.

• **Improve regional cooperation – to prevent crises and react to them.** More needs to be done across the region to share information about portfolio flows and to collaborate in regulatory activities. Also needed is action to provide an early warning system for potentially disruptive financial flows.

On the upside, the subprime crisis can bring new opportunities. Interest in Asia-Pacific assets may increase because of the strong growth projections for the region. Asia-Pacific investors have been instrumental in supporting developed countries through the recent turmoil, as sovereign wealth funds and State investment institutions from the region bolster weakened banking sectors in the United States and Europe. That shifting balance of financial power is also evident in the dramatic rise in the overseas investment of Asia-Pacific corporations.
Medium-term challenges to sharing prosperity across the region

The region is likely to weather the relatively short-term global uncertainty in 2008. Asia-Pacific countries, however, will continue to face critical medium-term social, economic and environmental challenges in ensuring inclusive and sustainable growth that reaches the poor. Climate change and international migration are two key issues.

Managing climate change: In Asia and the Pacific, all people face severe consequences from climate change – but especially the poor, both rural and urban, who typically lack the resources to insulate themselves against natural disasters. Globally, Asia-Pacific countries can actively contribute to climate change negotiations. Closer to home, they can take the lead in implementing mitigation and adaptation measures. A new regional framework for managing climate change should include measures to promote eco-efficiency, expand carbon trading, support technology transfers and manage waste efficiently.

Addressing the social dimensions of international migration: International migration, which continues unabated, affects both those involved and broader communities – impacting marriage, families and governance structures. These dimensions seldom receive enough attention. Alongside the economic aspects of migration, Governments need to assess fully the social implications of family separation and marriage migration, as well as the public health effects. Protecting migrant rights by ensuring equal treatment under the law in receiving countries should be high on the policy agenda.

Added to these regionwide issues are specific challenges confronting each subregion:

• Addressing rising inequality: East and North-East Asia has witnessed widening income disparities across most countries. To address differences in economic and human development among provinces and between rural and urban areas, China has enacted a host of regional development programmes. As a result of the “Go West” policy, there are preliminary signs of faster economic development in some western provinces than in coastal provinces, with benefits for China and its neighbours.

• Navigating economic transition: Social reforms in North and Central Asian economies are lagging behind economic reforms. Strategic investments are needed to reverse rising inequality and deteriorating educational and health-care systems. The challenge for the subregion is to finance and deliver services efficiently and equitably. Effective use of the subregion’s large intellectual potential should be integral to economic and social cooperation, especially on education. By pooling resources, North and Central Asian countries can set up new organizational structures and procedures for joint activities. The private sector has a role in mobilizing finance.

• Improving employment opportunities: The Pacific island developing countries must provide employment for their citizens. The challenges: widespread underemployment in most countries, too many engaged in subsistence and small-scale cash-cropping, women left disadvantaged and underrepresented in formal employment, and high youth unemployment. Developing skills and updating labour legislation to respond to changing macroeconomic and business conditions are crucial.

• Ensuring public debt sustainability: Public debts in South Asia are generally high and must be lowered to enhance the flexibility in the use of macroeconomic policies and to make resources available to create jobs and reduce poverty. Making South Asia’s public debt more sustainable requires controlling fiscal deficits, expanding government revenues and containing wasteful expenditures. Public expenditure should be directed more towards priority areas such as providing education, health, sanitation, housing and other basic services to promote pro-poor growth.

• Gaining from greater integration: Regional integration in South-East Asia has intensified through regional trade agreements, but the potential gains remain largely untapped. Greater regional integration could substantially reduce the number of people living on less than a dollar a day and improve overall welfare. Nonetheless, the gains from multilateral trade liberalization are substantially higher than those from regional trade agreements.
A long-term challenge to the region – addressing the neglect of agriculture

Over the long term, sharing prosperity means including the more than 600 million of the world’s poor who live in Asia, nearly two-thirds of the global total. Living largely in rural areas, many of them depend on agriculture. Addressing the neglect of agriculture is crucial to reduce poverty and inequality.

Agriculture employs 60% of the working population in Asia and the Pacific and shelters a majority of the poor. Decades of neglect, however, have weakened the sector’s capacity to cut poverty and inequality. Growth and productivity in agriculture have stalled, and the green revolution that boosted agricultural yields in the 1970s has bypassed millions. Farmers are now facing mounting pressure, evident in declining subsidies, rising input prices, intensifying protests over landlessness and an alarming number of suicides among the indebted.

Improving agricultural productivity could have a profound impact on poverty. Raising average agricultural labour productivity to the level in Thailand, for example, would take 218 million people – a third of the region’s poor – out of poverty. Large gains in reducing poverty are also possible through comprehensive liberalization of global agricultural trade, which could lift another 48 million people out of poverty. Diversification into high-value crops, so far limited to a few countries, should be the policy focus over the coming decades. But agriculture alone will not raise the region’s 641 million poor people out of poverty. Developing the non-farm sector is just as important.

A two-pronged strategy is required to make agriculture economically and socially viable, returning it to its place in reducing poverty and inequality:

• First, agriculture needs another revolution. A market orientation with a focus on quality and standards would be part of this strategy. Investments in research and development and human capital will increase agricultural productivity significantly. Also necessary is to revamp land policies, connect the rural poor to cities and markets and make credit instruments and crop insurance farmer-friendly.

• Second, facilitating migration out of agriculture should complement agricultural development – by empowering the poor, particularly women, with the skills to tap labour market opportunities and by promoting rural non-farm activities and regional growth centres.