EXECUTIVE SUMMARY

Impressive growth in 2006 amid rising risks

Developing economies in the Asia-Pacific region grew at 7.9% in 2006, up from 7.6% in 2005. The continuing buoyancy of external demand remained a source of growth for many countries. Exports of electronics continued to be a key source of growth, while oil and gas exports remained strong in the Islamic Republic of Iran and the oil and gas exporters of North and Central Asia, and South-East Asia. Domestic demand drove gross domestic product (GDP) growth in South and South-West Asia, particularly on the back of high investments.

The region's impressive economic performance was against the backdrop of a riskier global environment. Oil prices hit a record high in the middle of 2006, while stock markets plummeted across the Asia-Pacific region, raising fears of a downturn. Global imbalances steadily widened, with the current account balance of the United States of America deteriorating by a further $100 billion in 2006, increasing the possibility of an abrupt depreciation of the United States dollar. The sharp appreciation of major currencies in the region against the United States dollar made it difficult to keep exchange rates competitive while addressing inflationary pressure. The suspension of the Doha Development Round in July 2006 did not bode well for a region driven by trade and ready to gain from further liberalization.

Despite high and volatile oil prices in 2006, developing economies in the Asia-Pacific region kept inflation under control at 4.3%, similar to that of the previous year. Asian currencies were strong, reflecting larger-than-expected current account surpluses and capital flows, including those for speculative purposes. Developing countries in the region continued to add to their sizeable foreign exchange reserves, which had reached an unprecedented $2.5 trillion at the end of 2006. The large increase in reserves points to continuing efforts to push down the region's currencies by official intervention. Current account balances deteriorated across the region in 2006, mainly a result of rising oil imports. Strong exports in many countries offset some of the effects of rising oil prices. The region's exports grew at an impressive 18%, benefiting from healthy global demand.

Subregional performance – led by East and North-East Asia

Economic growth has been widely shared, with all subregions performing robustly. In keeping with the region's rapid integration into the global economy and the sectors in which it is most competitive internationally, the process of expansion has been concentrated in the industrial and services sectors.

East and North-East Asia had stronger than expected growth of 8.5%. Investment continues to accelerate in China, while investment and consumption posted healthy gains in Hong Kong, China and Macao, China. Except in China, some significant impediments still constrain domestic demand, leaving the subregion dependent on global growth to sustain its expansion. The challenges and opportunities emerging for Asia-Pacific economies from China's reshaping of global and regional trade patterns is examined in a policy research feature.

Averaging around 7.5%, economic growth was also strong in North and Central Asia in 2006, its seventh consecutive year of rapid growth. High oil prices continued to fuel inflation and the rapid growth of net oil exporters, such as Azerbaijan, Kazakhstan and the Russian Federation. The oil boom raises concerns about "Dutch disease", however, and this is examined in a policy research feature.

With few exceptions, Pacific island countries showed positive economic growth, ranging from slightly less than 2% in Tonga to more than 6% in Vanuatu. Growth was led by the primary sector in Papua New Guinea and the services sectors in the smaller countries. Pacific island developing countries are urbanizing at an alarmingly rapid pace, and the challenges associated with their urbanization are examined in a policy research feature.

Strong economic growth continued in South and South-West Asia, with industry and services the major contributors. India led the growth momentum by expanding 9.2%. Exports increased in all countries in the subregion, but imports grew even faster, partly due to higher oil prices. The Islamic Republic of Iran, the only net exporter of oil in the subregion, grew by 6.1%, the result of higher oil prices. The lack of physical infrastructure is constraining growth in the subregion, so investment in physical infrastructure is a priority, which is examined as a policy research feature.

Driven by strong external demand, economic growth in South-East Asia stood at a robust 5.9% in 2006. Strong external demand, especially for electronics, was the principal driver of growth. As a result, the current accounts of major economies in the subregion are estimated to have remained in surplus. Recognizing the importance of having well-functioning bond markets, a policy research feature focuses on corporate bonds, and re-examines the role of public policy.

All three developed countries in the region enjoyed modest growth. Capacity constraints tightened in Australia and New Zealand, creating inflationary pressure. Japan still looked for firm signs of graduating from deflation with limited growth in wages despite signs of labour shortages. The issue of poverty and inequality in Japan which came to prominence during the recession is highlighted in a policy research feature.

Outlook for 2007 – continuing dynamism

For developing economies in the Asia-Pacific region, economic growth is projected at 7.4% in 2007, slower than in 2006. The external environment is expected to be less favourable, mainly due to the slowing United States economy. A moderate decline in global electronics demand in 2007 may dampen the Asia-Pacific region's prospects. And the easing of commodity prices, including that of oil, comes as a mixed blessing.

As the international economic environment weakens, momentum in the region is expected to come from China, India and Japan. Together, these three economies contribute over 60% of the GDP of the Asia-Pacific region and close to 45% of imports, thereby creating considerable opportunities for the region.

Inflation will be less of a problem in 2007. For developing Asia-Pacific economies, it is projected at 3.8% for 2007, down from 2006. The fall in oil prices is expected to lessen inflationary pressures, while tight monetary policies across the region are also expected to help. Exchange rates, expected to appreciate further in 2007, would be an added brake on inflationary pressure. The current account surplus for emerging Asian economies is expected to fall slightly in 2007, though it will remain high. Further appreciation of exchange rates and reduced global demand in electronics and information technology components together with a rebound in domestic demand would contribute to the decline in current account surpluses.

Currency appreciation is expected to continue in 2007. It will be increasingly difficult for monetary authorities to pursue an independent monetary policy in response to shocks, as was the case in 2006, while targeting exchange rates against the backdrop of more open capital accounts. Monetary authorities can choose any two of three policy options: monetary autonomy, exchange rate targeting and capital convertibility – but not all three.

Greater exchange rate flexibility is one sustainable solution. It should take away the "one-way bet" that encourages even more capital inflows than otherwise because markets would quickly realize that the currency could move in either direction. In those economies where the central bank has not made a commitment to price stability, they could continue to manage their nominal exchange rates, but they would have to forego the practice of sterilized intervention and allow the real exchange rate to appreciate through increases in the price level.

Downside risks not to be ignored

The growth forecast of Asia-Pacific economies in 2007 is rather robust but the increased level of vulnerability observed in some of the major economies over the last 12 months suggests that the baseline forecast will be increasingly tilted towards the downside risks. Six downside risks merit attention:

- An oil price shock
- An abrupt cooling of housing markets in the United States
- A disorderly unwinding of global imbalances
- A reversal of the sustainability of the Japanese economic recovery

- Economic “overheating” in China
- An avian flu pandemic

Key economic issues on the watch list

The region’s prospects, in both the short and long run, are naturally tempered by numerous forces. Considered in the report are five issues for policymakers to keep on their economic watch list:

Monitoring vulnerability to currency crises: Today’s uncertainty in financial markets warrants careful monitoring of economic vulnerability to recognize danger signals as early as possible. Relying on economic growth as an indicator can be misleading, masking the build-up of vulnerability and lulling policymakers into inaction. The 1997 East Asian financial crisis shows, in the run-up to the crisis, that good growth did precisely that. To assess a country’s vulnerability to a currency crisis through a sudden reversal of capital flows, ESCAP developed a composite vulnerability index with data from nine emerging countries in the Asia-Pacific region: five East Asian countries affected by the 1997 crisis and four other emerging countries. Crisis-affected countries, except for Malaysia, are displaying renewed vulnerability in 2006. Vulnerability is also a concern in some of the region’s other emerging economies.

Boosting domestic demand through private investment, especially in East Asia: The relatively low domestic demand in East Asian economies indicates that these economies have increased their reliance on exports to drive economic growth, exposing them to declines in external demand. Except in China, investment was the brake on demand, rather than domestic consumption, which remained fairly stable. Especially in crisis-affected economies, the decline in investment was due to a drop in private investment’s share in GDP, which has not yet recovered to its pre-crisis level. Shortages of capital funds are found to be hindering the recovery of private investment in these economies. A decisive policy response is needed to promote private investment in East Asian economies. Two critical reforms in the financial sector warrant attention. First, an improved system of risk management should be put in place so that banks are no longer excessively cautious when lending for investment activities. Second, to curb excessive growth of consumer credit, authorities should adopt minimum payment and income requirements for credit cards. Capital markets, which increased in importance after the crisis, should be further developed as an alternative source of funds for investors. Governments should also take measures to improve the investment climate for private investment, particularly in addressing corruption and improving customs clearance systems.

Reaping the one-off demographic dividend: The rapid decline in fertility and increase in life expectancy in the region is opening an historic, one-time only “demographic window” that provides an opportunity to spur economic growth. Whether countries capture this opportunity will depend on the social and economic policies and institutions they adopt to absorb a rapidly growing labour force. Not exploiting the demographic dividend can be costly. The report finds that a few key policies will help determine the ability of a country to exploit the demographic dividend: expanding access to basic education and improving its quality, more flexible labour markets, openness to trade and foreign investment, and well-developed financial markets.

Managing urban growth: Over the past three decades, many urban centres and surrounding areas in the Asia-Pacific region have been engines of economic growth. Yet, 570 million slum-dwellers in the region – more than half the world’s total – experience the cumulative impact of labour oversupply, tenure insecurity, poor infrastructure, pollution and congestion. If these challenges are not managed, economic growth will be offset by the higher costs of keeping urban centres functioning. The report examines what policy actions need to be undertaken to arrest the problem before it explodes.

Promoting green growth to sustain development: The Asian and Pacific region’s contribution to global GDP has been steadily rising over the past decade. As a result, the region shoulders a greater share of regional and global environment-related burdens. National policy failure to address the growing environmental pressures will eventually take their toll on economic growth. “Green growth” is a solution. It is the growth in GDP that maintains or restores environmental quality and ecological integrity, while meeting the needs of all people. ESCAP proposes a five-track approach to green growth: introducing green taxation and budget reform, developing sustainable infrastructure, promoting sustainable consumption and production, promoting green business, and monitoring progress through eco-efficiency indicators.

Gender inequality continues – at great cost

Gender discrimination has widespread ramifications and clear economic and social costs. The Asia-Pacific region has made good progress in reducing gender discrimination in recent years, but appalling disparities remain. The region is losing $42-$47 billion per year because of restrictions on women's access to employment opportunities – and another $16-$30 billion per year because of gender gaps in education. Those are just the economic costs – added to them are social and personal costs.

Gender discrimination in the region is most visible in the low access of women and girls to education and health services, to economic opportunities and to political participation. Female primary school enrolment can be as much as 26% lower than that of males. Such disparities are also reflected in access to health. The female-to-male ratio in the population is deteriorating, particularly in North and Central Asia, South Asia and the Pacific island countries, partly reflecting women's inadequate access to health services. In some countries, one in every 10 girls dies before reaching the age of one, and one in every 50 women dies during pregnancy and delivery. Meanwhile, violence against women continues, unabated, indicating how voiceless women are in households and in countries.

One of the fundamental reasons women are subject to discrimination is that they do not have a voice in decision-making at home or in society, even when the matters are directly related to themselves. They are powerless intellectually, materially and politically. With women accounting for half of the population, one would naturally expect that they should have at least equal representatives in elected bodies at the local, regional and national levels. However, the reality in the region is starkly different. Only seven countries had parliaments in which more than 20% of representatives were women, with New Zealand having the highest rate, at 28%.

The report proposes several specific recommendations in four critical dimensions: economic participation, education, health and empowerment. Best practices highlighted from across the region and elsewhere show that gender balance can be achieved with limited resources, but this requires changes at the household, societal and national levels. In particular, political leadership and commitment will go a long way towards correcting abject discrimination against women.