

# CHAPTER 1. REGIONAL ECONOMIC DEVELOPMENTS AND PROSPECTS

## Fastest growth in the world – 7.9% in 2006

For the eighth consecutive year, developing economies in the Asia-Pacific region grew faster than those in all other regions at 7.9% in 2006, up from 7.6% in 2005 (figure 1.1). With Asian and Pacific developing economies accounting for more than one third of global growth in 2006, the region is becoming the locomotive of global growth (box 1.1). 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.

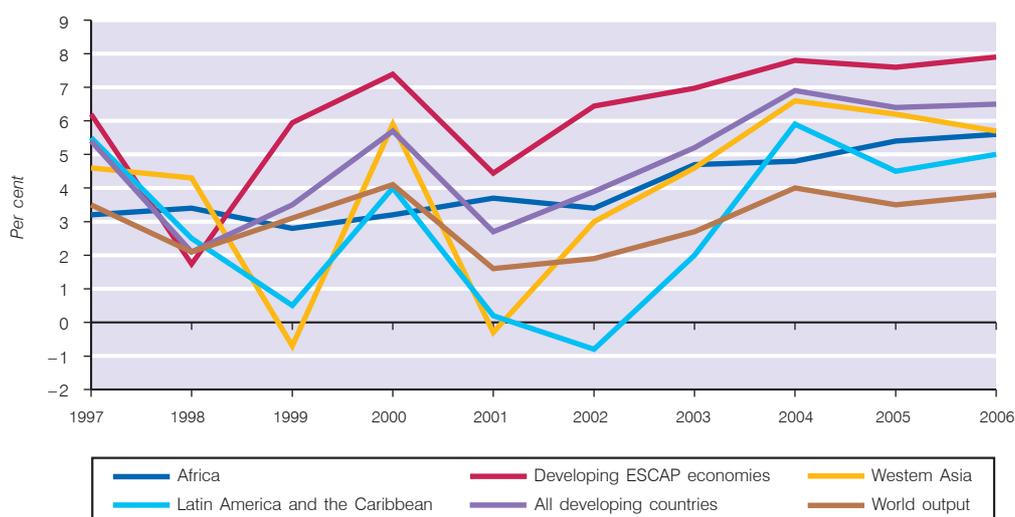
The continuing buoyancy of external demand remained a source of growth for many countries – as the anticipated slowdown in the United States failed to materialize and the continuing revival of the Japanese economy provided added stimulus. China served as an export platform for the region, while its appetite for raw

materials and fuels kept global oil and commodity prices high, aiding exporters throughout the region.

Exports of electronics continued to be a key source of growth in South-East Asia. Oil and gas exports remained strong in the Islamic Republic of Iran, as well as many economies of North and Central Asia, and the South-East Asian economies of Brunei Darussalam, Malaysia and Viet Nam. Service exports also performed well in 2006. Information technology and back-office services showed signs of continuing growth in India, while in Hong Kong, China financial and business support exports also grew rapidly. The economies of Cambodia and Macao, China were boosted by growing tourism.

Domestic demand drove GDP growth in South and South-West Asia, particularly on the back of high investments in India and Turkey. But it has been relatively weak in much of the two East Asian subregions, except for China.

Figure 1.1. Real GDP growth rising in developing ESCAP economies, 1997-2006



Sources: ESCAP, based on United Nations, *World Economic Situation and Prospects 2007* (United Nations publication, Sales No. E.07.II.C.2); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2006); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); Interstate Statistical Committee of the Commonwealth of Independent States, <[www.cisstat.com](http://www.cisstat.com)>, 26 February 2007; and ESCAP estimates.

Note: Data for 2006 are estimates.

### Box 1.1. The growing impact of the Asia-Pacific region on the world economy

The dynamic growth seen in the world economy in 2006 has largely been driven by developing Asia-Pacific countries. They accounted for more than 16% of world GDP in 2006 and one third of world GDP growth. In purchasing power parity terms, their contribution is much higher at 30% of world GDP in 2002-2004 and 58% of world GDP growth (box figure a).

By far the largest contribution to global growth since 2000 has been the dynamism of China and the emergence of India. China was responsible for 32% of world GDP growth in 2001-2004 (box figure a). And India's growth contribution nearly doubled over the past two decades to reach 10% in 2001-2004. As a result of their rapid growth China and India have marched up the rankings of the world's largest economies. China was the world's second largest economy in 2005 in PPP terms and India the fourth largest.

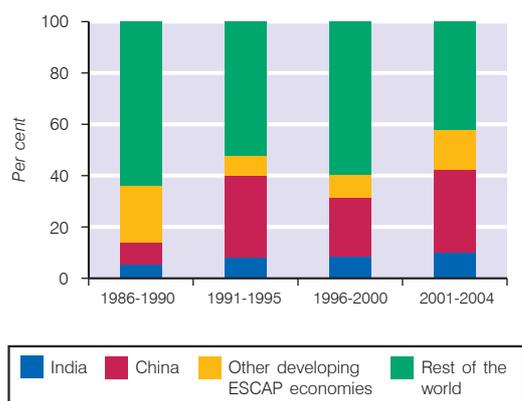
Developing countries in Asia and the Pacific are changing the global real sector through their ever-increasing levels of world trade and have nearly tripled their contribution to world trade since 1990 (box figure b); China has seen a nearly seven-fold increase in its trade and is now the world's third largest trading economy, after the United States and Germany. Its exports account for 90% of the world's toys, 50% of apparel and 16% of consumer electronics – it imports about 45% of global cement and 20% of aluminium and copper. China's global trade surplus was \$178 billion in 2006, roughly 75% higher than that of a year earlier. Trade with China provides a massive impetus to many countries' export prospects. China runs significant trade deficits with many economies – primarily global energy producers and neighbouring Asian economies supplying intermediate inputs.

China influences global monetary policy because of the sheer size of its economy coupled with its enormous amount of trade. China's low export prices have held inflation down. Its hourly compensation for manufacturing workers is still only 3% of that in the main industrial economies (Roach, 2006). Its fairly fixed exchange regime also contributes to low export prices. And its undervalued yuan affects exchange rate management in the rest of the Asian economies.

In 2001-2005, according to ESCAP analysis, inflation in the United States was reduced by 0.28 percentage points annually due to China's export price effect, 0.37 percentage points in the European Union, 0.70 points in Singapore and 0.65 points in Japan.

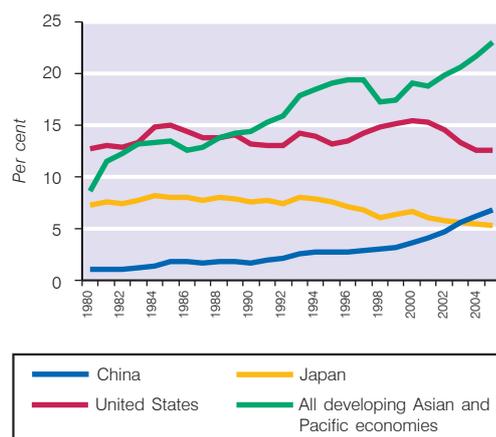
**Figure a. Contribution of developing ESCAP economies to global growth, 1986-2004**

(PPP constant 2000 United States dollar prices)



Sources: Calculations based on World Bank, *World Development Indicators 2006* (Washington, D.C., World Bank, 2006).

**Figure b. Total trade of ESCAP selected economies as a percentage of world trade**



Source: International Monetary Fund, *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., IMF, August 2006).

(Continued on next page)

**Box 1.1** *(continued)*

China does, however, exert upward pressure on global inflation by pushing up commodity prices. One third of the increase in global oil demand since 2000 has come from China, now the world's biggest consumer of aluminium, steel, copper and coal.

ESCAP analysis shows that China's demand for oil during the period 2001-2005 increased world oil prices by 22.5% – and inflation in the United States by 0.23 percentage points annually, 0.35 points in the European Union, 1.11 points in India, and 0.73 points a year in Thailand and the Philippines each.

So the positive and negative impacts of China on global inflation apparently cancel each other out. Countering the downward pressure on export prices and wages from low-cost production in China and the managed value of the yuan are raising world commodity prices due to high demand from China. It is likely that China's export prices will be on an upward trend because of increasing wages in China and a possible revaluation of the yuan.

These developments in China have kept interest rates in the United States lower than they would otherwise have been, with inflation held down by the aggregate effect of China on consumer prices and wages in the United States. China has also kept United States interest rates lower through its purchases of United States government debt. According to ESCAP analysis, China's purchases of foreign assets reduced the interest rate on United States 10-year treasury bills by 0.15 percentage points annually between 2001 and 2005.

Ten years after the Asian financial crisis, crisis-affected countries – Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand – have made great progress in reviving the strength of their economies. Between 1999 and 2006, average per capita income in these countries grew by more than 8%. Enormous strides were made in reducing the poverty and unemployment that had resulted from the events of 1997. More recently, the crisis-affected countries displayed robust GDP growth of more than 5% in 2006. They have taken significant macroeconomic policy measures to improve resilience to shocks: inflation is below pre-crisis levels, current account surpluses have averaged around 5% of GDP since 1999; there is less dependence on portfolio capital inflows; financial sectors have improved; and these countries have established considerable foreign currency reserves.

*“The impressive economic performance was against the backdrop of a riskier global environment”*

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 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.

### Successfully fighting inflation

High and volatile oil prices were one of the central sources of difficulty in macroeconomic management in the region in 2006. Inflationary pressures in oil-importing economies intensified with the relentless increase in oil prices through August 2006. Further reductions in fuel subsidies during 2006 by China, India, Malaysia and Taiwan Province of China added to inflationary pressures in their economies.

*“High and volatile oil prices were one of the central sources of difficulty in macroeconomic management in 2006”*

Governments across the region promptly responded to inflationary pressures by tightening monetary policies, which they had begun doing so in mid-2005.

Table 1.1. Rates of economic growth and inflation of selected economies in the ESCAP region, 2005-2007

(Per cent)

	Real GDP			Inflation <sup>a</sup>		
	2005	2006 <sup>b</sup>	2007 <sup>c</sup>	2005	2006 <sup>b</sup>	2007 <sup>c</sup>
<b>Developing economies<sup>d</sup></b>	7.6	7.9	7.4	4.3	4.3	3.8
<b>East and North-East Asia</b>	8.1	8.5	7.8	2.0	1.6	2.1
China	10.4	10.7	9.9	1.8	1.5	2.0
Hong Kong, China	7.3	6.2	5.7	0.9	2.0	2.3
Mongolia	6.2	7.5	6.0	9.5	5.1	..
Republic of Korea	4.0	5.2	4.8	2.7	2.5	2.5
Taiwan Province of China	4.0	4.2	4.1	2.3	0.6	1.7
<b>North and Central Asia</b>	7.1	7.5	7.1	11.8	9.4	8.8
Armenia	13.9	13.4	8.0	0.6	2.9	3.0
Azerbaijan	26.4	34.5	30.0	9.6	8.3	8.0
Georgia	9.3	7.0	5.0	8.2	9.2	7.0
Kazakhstan	9.5	10.5	10.0	7.6	8.6	7.5
Kyrgyzstan	-0.6	2.7	6.0	4.3	5.7	5.4
Russian Federation	6.4	6.7	6.4	12.7	9.7	9.0
Tajikistan	6.7	7.0	7.0	7.8	11.9	6.5
Turkmenistan	6.0	14.0	7.0	10.6	11.0	9.7
Uzbekistan	7.0	7.3	6.5	6.9	7.5	8.0
<b>Pacific island economies</b>	2.7	3.8	3.7	2.4	2.8	2.7
Cook Islands	0.1	1.8	3.5	2.5	3.0	1.5
Fiji	0.7	3.6	2.0	2.7	3.5	4.0
Papua New Guinea	3.3	3.7	4.5	1.7	1.7	1.5
Samoa	5.1	3.5	4.7	1.9	3.2	4.0
Solomon Islands	5.0	6.2	5.0	7.2	8.2	8.4
Tonga	2.3	1.9	0.9	9.6	7.2	..
Vanuatu	6.8	7.0	7.0	0.9	2.3	2.4
<b>South and South-West Asia<sup>e</sup></b>	8.0	7.8	7.4	6.7	7.6	6.2
Bangladesh	6.0	6.7	6.0	6.5	7.2	7.0
India	9.0	9.2	9.0	4.4	6.0	5.0
Iran (Islamic Republic of)	5.4	6.1	6.0	12.1	11.0	9.1
Nepal	2.7	1.9	4.3	4.5	8.0	6.0
Pakistan	8.6	6.6	7.0	9.3	8.0	7.0
Sri Lanka	6.0	7.0	6.5	11.6	13.0	7.0
Turkey	7.4	6.0	5.0	8.2	9.5	7.1
<b>South-East Asia</b>	5.6	5.9	5.6	6.0	6.8	4.4
Cambodia	13.4	8.0	7.0	5.8	5.0	4.0
Indonesia	5.6	5.5	6.2	10.5	13.1	6.8
Lao People's Democratic Republic	7.2	7.5	7.6	7.2	7.0	7.0
Malaysia	5.3	5.6	5.7	3.0	3.6	3.2
Philippines	5.0	5.5	5.6	7.7	6.5	4.5
Singapore	6.4	7.6	4.7	0.4	1.0	1.5
Thailand	4.5	5.0	4.7	4.5	4.6	3.6
Viet Nam	8.4	8.2	8.3	8.3	7.5	6.8
<b>Developed economies</b>	2.0	2.2	2.0	0.0	0.5	0.9
Australia	2.7	2.5	3.0	2.7	3.5	2.5
Japan	1.9	2.2	1.9	-0.3	0.2	0.7
New Zealand	2.1	1.9	1.8	3.1	3.4	2.0

Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); Interstate Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>, 26 February 2007; and ESCAP estimates.

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimate.

<sup>c</sup> Forecast.

<sup>d</sup> Based on data for 38 (developing) economies representing more than 95% of the population of the region (including the Central Asian republics); GDP figures in market prices in United States dollars in 2004 (at 2000 prices) have been used as weights to calculate the regional and subregional growth rates.

<sup>e</sup> The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2005/06 = 2005 for India and the Islamic Republic of Iran; and fiscal year 2004/05 = 2005 for Bangladesh, Nepal and Pakistan.

Exchange rate appreciation in many parts of the region also absorbed some of the price increases for oil and other imports. Developing economies in the Asia-Pacific region kept inflation under control at 4.3% in 2006, similar to that of the previous year (figure 1.2). Only Indonesia, the Islamic Republic of Iran, Sri Lanka, Tajikistan and Turkmenistan had double-digit inflation in 2006.

In December, India increased key interest rates for the fourth time in the year and raised the cash reserve ratio by 50 basis points to 5.55%. The Republic of Korea raised interest rates three times, in August reaching their highest level in five years. It also increased its reserve ratio for demand deposits by 2% to 7%, the first increase in 17 years. China increased its rates in April and August and raised the reserve ratio in November for the third time in the year.

South-East Asian countries were cautious about raising interest rates with inflation lessening by the fourth quarter. Indonesia lowered its benchmark interest rate in December for the seventh time in 2006, returning to single digits for the first time in more than a year. Also in November, Malaysia experienced its lowest inflation in 16 months. Malaysia has left its interest rate unchanged since April 2006, and Thailand has not increased its interest rate since June 2006 after two years of rate rises.

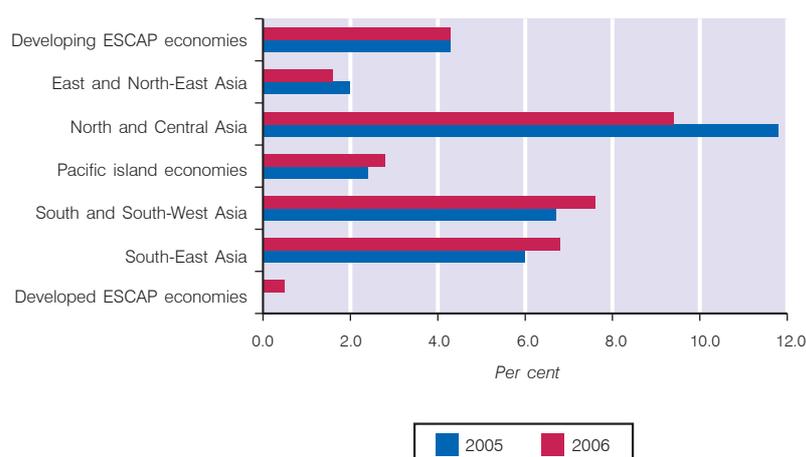
## Living with high oil prices

High and volatile oil prices posed major difficulties for macroeconomic management – stoking inflationary pressures, eroding current account surpluses and reducing foreign reserves in some countries. They passed \$70 per barrel in early August, in real terms surpassing their previous peak in the 1979-1980 shock (figure 1.3).

Prices have since trended downward, with some tensions eased in the Middle East, a hurricane season without major disruptions in the Gulf of Mexico and a warmer than usual winter in Europe and North America. But further disruptions by political instability in the Middle East and elsewhere cannot be ruled out, especially with the unusually low spare production capacity of major producers. Prospects for a continuing fall in prices to pre-2002 levels thus remain uncertain.

Aided by strong exports, high capital inflows and a benign global economic environment, regional growth has been resilient, despite high oil prices. But a slowing United States economy and declining global demand for electronics could change this in 2007. New oil price hikes would undermine regional economic growth, inflation and current account balances. In oil-dependent Asia-Pacific economies, the impact is much more pronounced than for industrial countries (table 1.2).

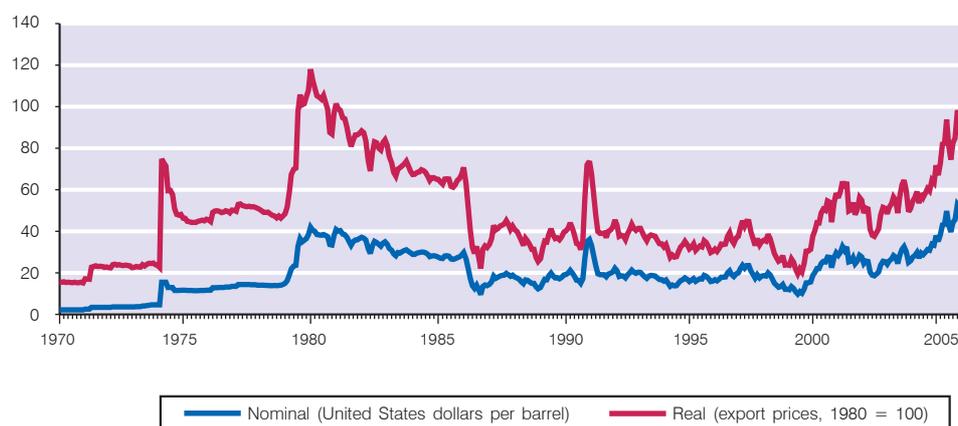
Figure 1.2. Inflation in the ESCAP region, 2005 and 2006



Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2006); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); Interstate Statistical Committee of the Commonwealth of Independent States, <[www.cisstat.com](http://www.cisstat.com)>, 26 February 2007; and ESCAP estimates.

Notes: Data for 2006 are estimates. Inflation rates refer to changes in the consumer price index.

Figure 1.3. Nominal and real oil prices rose to record highs in 2006



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, August 2006); PTT Public Company Limited; and ESCAP calculations.

Notes: Oil prices refer to Brent. Real oil prices are calculated only up to May 2006, given the limited data on export prices deflator.

Table 1.2. Impact of a 10% increase in oil prices on selected Asian economies

(Percentage change)

	Real GDP growth (December 2006)	Consumer price inflation (December 2006)	Current account as a per cent of GDP (December 2006)
China	-0.20	0.13	-0.33
Hong Kong, China	-0.13	0.07	-0.52
India	-0.13	0.78	-0.26
Indonesia	-0.20	0.48	-0.07
Malaysia	-0.20	0.60	0.20
Philippines	-0.33	0.61	-0.20
Republic of Korea	-0.07	0.33	-0.52
Singapore	-0.33	0.52	-0.39
Taiwan Province of China	-0.07	0.20	-0.65
Thailand	-0.33	0.72	-0.39
<b>Developing Asian economies</b>	<b>-0.16</b>	<b>0.44</b>	<b>-0.31</b>
United States	-0.10	0.12	-0.12
European Union	-0.20	0.20	-0.20
OECD	-0.17	..	..

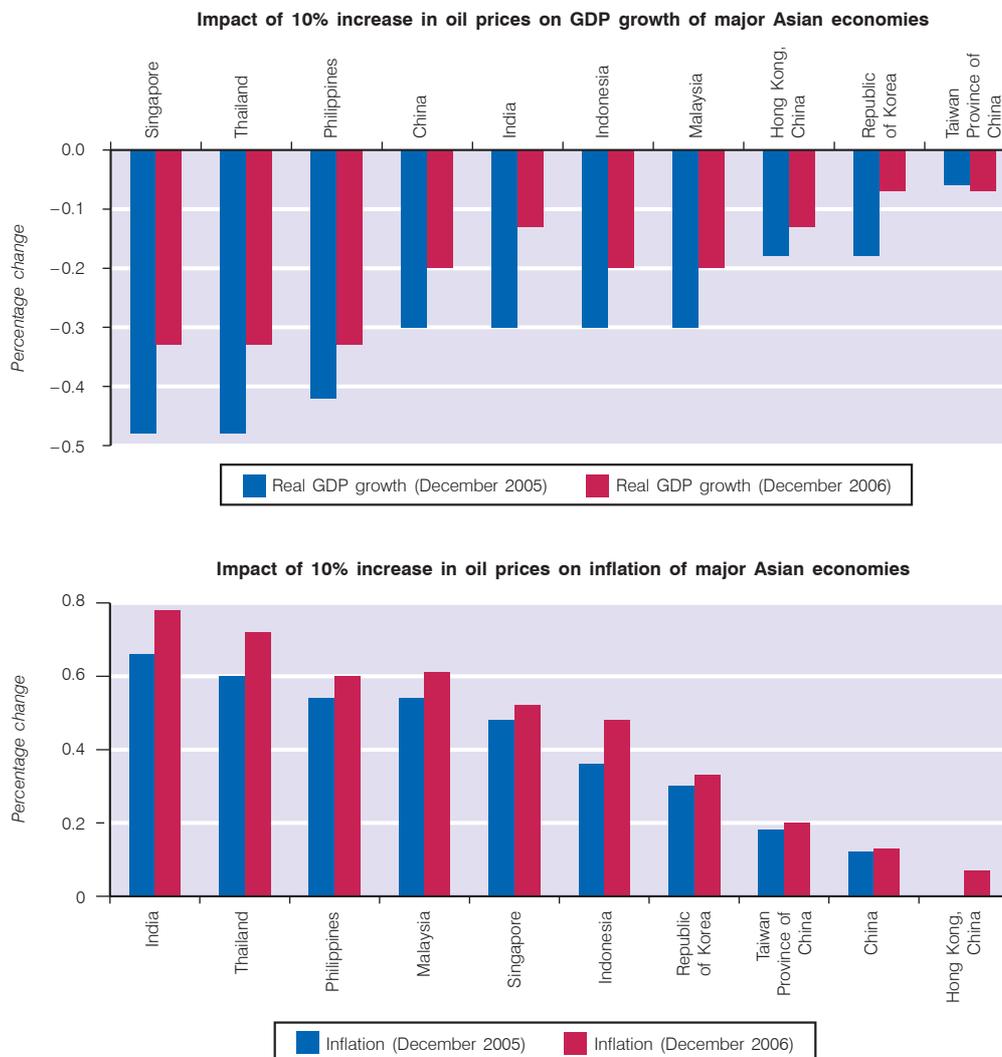
Source: ESCAP calculations.

ESCAP simulations indicate that emerging Asia's growth would be reduced by 0.16 percentage points if there is a sustained 10% increase in world oil prices. Singapore, Thailand and the Philippines would be hardest hit because of their oil intensities. While consumer price inflation would increase for all emerging Asian economies, the effects would be mostly felt in India, Thailand, the Philippines and Malaysia. Current account balances would deteriorate in all emerging Asian countries, particularly in Taiwan Province of China, Hong Kong, China, and the Republic of Korea. In emerging Asia, current account balances would deteriorate on average by 0.31 percentage points of GDP.

*Emerging Asia's growth would be reduced by 0.16 percentage points if there is a sustained 10% increase in world oil prices*

The region's economies are learning to live with high oil prices by shifting demand from oil to other sources of energy, increasing oil efficiency in production and promoting energy conservation (box 1.2). So any negative impact has declined – a 10% rise in oil prices would, as noted, shave 0.16 percentage points

Figure 1.4. Declining impact of rising oil prices on growth and inflation



Source: ESCAP calculations, based on the Oxford Economic Forecasting Model.

off current growth, down from 0.27 percentage points in 2005 (figure 1.4). Because the reductions in oil import volumes have been greater than price increases, the expected deterioration of current account balances as a percentage of GDP has eased slightly from a year ago. But inflationary pressures from further oil price increases appear higher, as countries in the region move away from fuel subsidies and pass higher oil prices on to consumers and producers.

Oil dependency is being reduced, but not enough. Since 2000, the Republic of Korea has seen the oil intensity of its production decline by 27%, India by

25% and China by 10% (figure 1.5). But their oil intensities are still considerably higher than in the more energy-efficient United States. ESCAP estimates that increasing energy efficiency in the major energy users of developing Asia would have a significant impact on world oil prices and growth in the region. Reducing oil intensity in China, India and the Republic of Korea to match that in the United States, would, on average and over the next five years, reduce world oil prices by around 20%, while the GDP of developing Asia would improve by 1.4% a year. China would see its GDP growth accelerate by 3% a year on average, India by 1% and the Republic of Korea by 0.5%.

### Box 1.2. Reducing oil dependency – country experiences

Improving transport efficiency could lead to substantial fuel savings for consumers, up to two or three times the additional cost for new vehicles. Between 2005 and 2030, the estimated savings of the global oil-import bill would be \$1.9 billion with an additional investment of \$800 billion in more efficient cars and other oil-consuming goods.

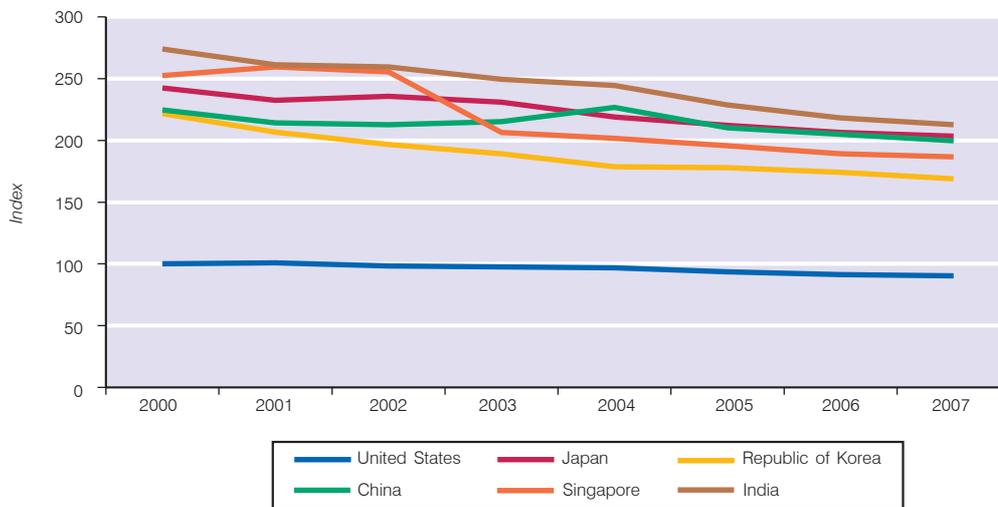
Several countries are implementing programmes to encourage alternative fuels, such as compressed natural gas (CNG), liquefied petroleum gas, biofuel, biodiesel, electricity and hydrogen.

- Thailand is pursuing oil and energy savings and alternative energy, such as biodiesel and ethanol, aggressively promoting energy efficiency in all sectors. The measures come in the wake of estimates that oil consumption accounts for 11% of GDP. An energy conservation fund, set up in 1992, promotes energy efficiency.
- In the Philippines, energy conservation is encouraged in public buildings. The operating hours of gasoline stations have been reduced. Import tariffs for fuel-intensive vehicles have been increased. And energy efficiency programmes are being enhanced across all sectors. The Government recently issued an executive order removing all import duties on components, parts and accessories for hybrid, electric, flexible fuel and CNG vehicles. This measure reflects its wish to become a manufacturing centre for vehicles running on alternative fuels, curbing air pollution and reducing dependency on imported oil in the process. Oil consumption in the Philippines dropped almost 7% between 2004 and 2005, even though total energy consumption increased by 1.4%. Oil made up 58% of the fuel mix in 2005, compared with 63% in 2004.
- In February 2006, Pakistan announced a decision to introduce CNG buses to cut an estimated \$700 million from the diesel import bill every year. The Government is encouraging CNG as a cheap and environmentally friendly fuel, and almost 900,000 vehicles already use it.

The oil market will likely remain volatile. But key stakeholders need to contain such volatility and seek win-win solutions for all. They could establish a regular forum of oil exporters and importers in the Asia-Pacific region. And they should do more to diversify their energy options and improve the energy efficiency and the eco-efficiency of their economic growth by changing consumption and production patterns. Further research and development is needed to promote wider use of alternative energy sources, coupled with greater diffusion of advanced fossil fuel and renewable energy-efficient technologies. As many Governments have come to realize, there are some real alternatives in managing the risks of oil prices.

Sources: IEA/OECD (2006); Thailand (2006); and Sina Corporation (2006); and IANGV (2006).

Figure 1.5. Trends in oil intensity in production for selected countries in the Asia-Pacific region



Source: ESCAP calculations, based on Oxford Economic Forecasting Database.

Notes: Data for 2006 and 2007 are estimates. Oil intensity index is calculated by taking the ratio of demand for oil to GDP, using the United States oil intensity ratio in 2000 as the base.

## Pressure on currencies to appreciate

Asian currencies were strong in 2006, reflecting larger-than-expected current account surpluses and capital flows, including those for speculative purposes. High interest rates in some countries, investor appetite for risk and excess global liquidity attracted record portfolio flows to the region. Major currencies appreciated significantly, even with the sudden portfolio capital outflows in mid-2006 that sent stock markets reeling and currencies depreciating across the region. By the end of 2006, the Thai baht had appreciated by 13% against the United States dollar – the highest in the region. The Korean won reached a nine-year peak against the United States dollar and the Japanese yen. The Indonesian rupiah, Singapore dollar and Phillipine peso all appreciated by close to 8% against the United States dollar.

*“Currency appreciation in 2006 did not seriously erode the competitiveness of exporting industries”*

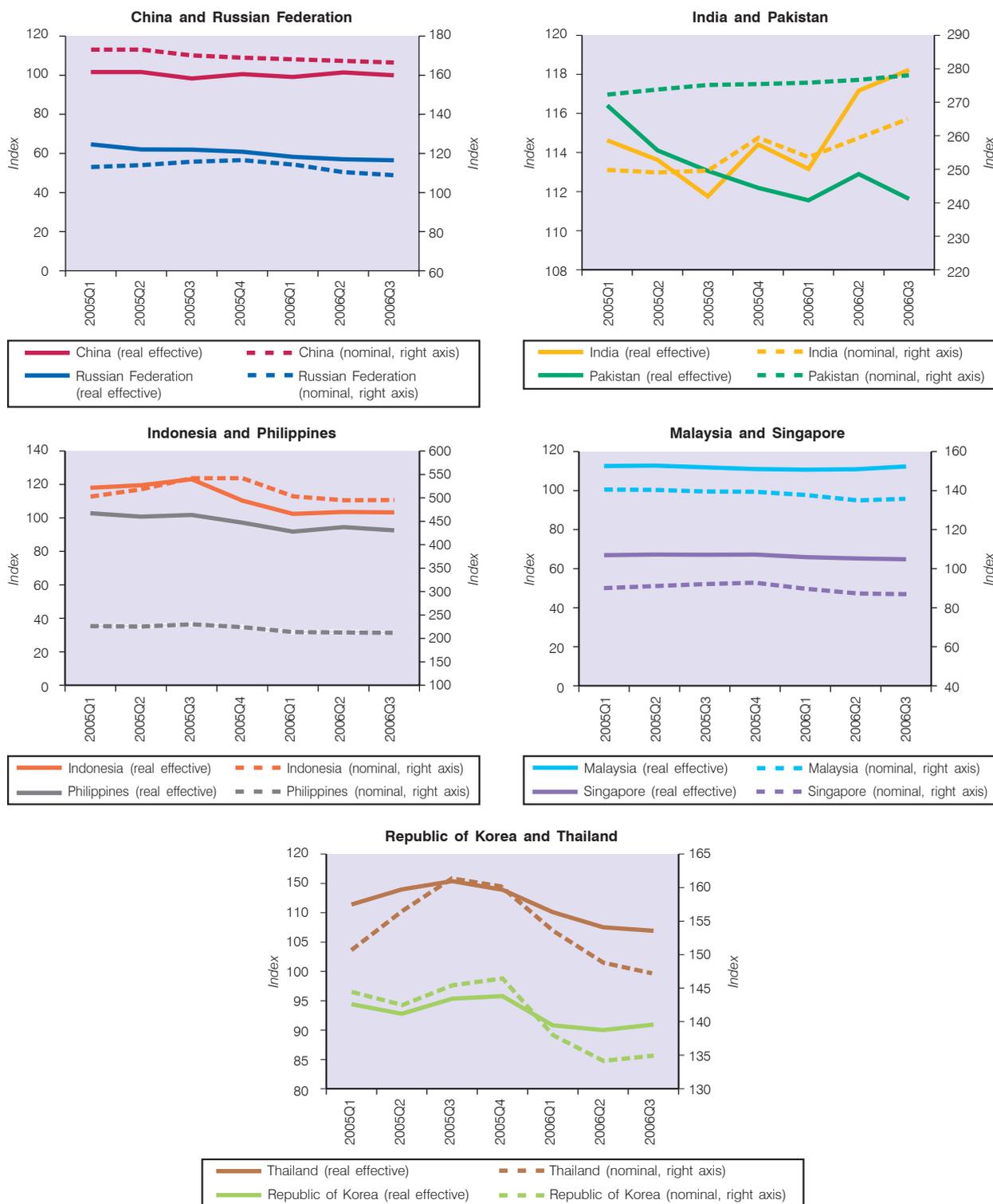
Despite widespread fears, currency appreciation did not seriously erode the competitiveness of exporting industries. Movements in real effective exchange rates, the most appropriate measure to gauge competitive-

ness, show that the appreciation was smaller than the nominal appreciation against the United States dollar (figure 1.6). For example, in real effective terms the Thai baht appreciated by only about 3% by the third quarter of 2006, the Korean won by a negligible 0.16%. And exports from these countries continued to perform well, implying that any loss of competitiveness through currency adjustments may not have been significant.

Even so, policymakers responded to fears of adverse effects on exports by intervening in foreign exchange markets and accumulating foreign reserves to reduce upward pressure on their currencies. In a dramatic move, Thailand imposed capital controls on short-term flows, which resulted in the Thai stock market losing close to 15% in one day. Markets recovered the following day when the authorities partly reversed the measures.

Containing inflationary risks and preventing exchange rates from appreciating presents a dilemma. It is impossible to juggle all three policy objectives – free movement of capital, control over exchange rates, and an independent monetary policy to manage inflation (see box 2.3 in chapter 2). Yet, in 2006 many policymakers in East Asia tried to do just that. As interest rates rose to combat inflation and authorities accumulated foreign exchange reserves to keep exchange rates from appreciating, liquidity built up beyond desired levels, exacerbated by speculative flows. In response, central banks took some unorthodox steps. The Bank of Korea and the People’s Bank of China increased reserve requirements on bank deposits, while the Bank of Thailand introduced capital controls.

**Figure 1.6. Less movement in real effective exchange rates compared to nominal rates, 2005-2006**  
 (1990 = 100; except for Russian Federation 1999 = 100)



Source: Calculated from International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

## Record level of foreign reserves

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 (figure 1.7). China, India, Republic of Korea, Russian Federation, Hong Kong, China, and Taiwan Province of China accounted for more than 82% of the total reserves. Eclipsing Japan to become the world's largest reserves holder, China accounted for 40% of the reserves of developing countries in the region (close to \$1 trillion).

*“The prudent level of reserves necessary to safeguard a country from financial instability should be balanced against the potential capital losses and quasi-fiscal costs”*

While the huge appetite for reserves in the Asia-Pacific region is partly a reaction to the Asian financial crisis, the large increase in 2006 points to continuing efforts to push down the region's currencies by official intervention. It is time to consider seriously the benefits and costs of holding excessive reserves, by balancing the prudent level of reserves necessary to safeguard a

country from financial instability against the potential capital losses and quasi-fiscal costs.

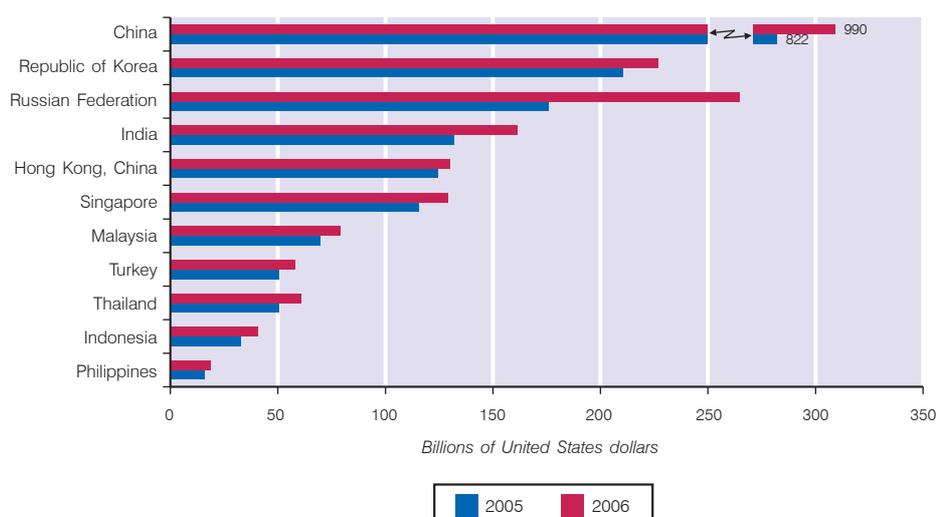
The conventional wisdom is that countries should have enough reserves to cover their short-term external debt, and large reserve holders in the region have adequate cover (table 1.3). India's reserve cover is 21 times its short-term external debt. This ratio has increased over 2005 levels in all countries, except in Pakistan and Thailand. In the meantime, some of the cost factors have been rising. Since the majority of reserves are in United States dollar-denominated assets, the continuing weakening of the United States dollar during 2006 led to capital losses.

Central banks can incur costs when issuing government securities to absorb excess liquidity, if interest rates on government securities are higher than the corresponding rates earned on foreign reserve holdings. It may be time for countries to channel reserves into more productive investments, such as infrastructure.

## Strong exports – but high oil prices take a toll on current accounts

Current account balances deteriorated across the region in 2006, mainly as a result of rising oil imports – though the impact was somewhat cushioned by an appreciation of currencies that made imports cheaper

Figure 1.7. Unprecedented level of foreign reserves in the developing ESCAP region, 2005 and 2006



Source: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

Notes: Foreign reserves exclude gold. Data for 2006 refer to October or latest available month.

**Table 1.3. Ratio of foreign exchange reserves to short-term external debt in selected Asia-Pacific countries, 2005 and 2006**

	2005	2006Q3 <sup>a</sup>
China	6.6	7.6
India	17.5	21.1
Indonesia	1.3	1.6
Malaysia	4.5	5.0
Pakistan	3.3	2.8
Philippines	0.3	0.4
Russian Federation	1.1	1.3
Thailand	3.2	2.9

Source: Oxford Economic Forecasting Model Database.

<sup>a</sup> Except Indonesia and Pakistan, where the latest data are from 2006Q2.

(table 1.4). Strong exports in many countries offset some of the effects of rising oil prices. The region's exports grew at an impressive 18%, about the same as in 2005, while import growth picked up to 19%, from 17% a year before.

*“The region’s exports grew at an impressive 18% in 2006, while import growth picked up to 19%, from 17% a year before”*

The region's exports benefited from healthy global demand. Robust growth in the United States was a key driver of demand, supported by improving demand in Europe and Japan. South-East Asian economies benefited from the cyclical upswing in demand for electronic products that began in mid-2005. Apparel exports across the region have performed better than expected after the global liberalization of apparel in 2005, in part due to the enforcement of restrictions on Chinese imports into the United States and the European Union. There is also evidence that apparel-exporting countries have diversified their production and export destinations and maintained their price competitiveness in world markets. The revival of the Doha Development Round would be of help to this region, which has benefited from freer trade in developing its economies (box 1.3).

The region's economies are increasingly driven by trade linkages with China (see policy research feature 2.1). Firms are linked in supply chains to the Chinese production hub. Inputs are being sourced from abroad for further processing, with China the final export platform. China's imports from Asia were up 19% in 2006 to \$526 billion, or 66% of its total imports. The positive

effect on regional exports is reflected in China's growing trade deficit with the major economies of the region, except India. But some countries are competing with China for their exports to third markets.

*“India is emerging as a force in manufacturing exports, dominated by capital-intensive engineering, chemicals and petroleum products”*

India is emerging as a force in manufacturing exports. Until recently, India's services exports, especially those related to outsourcing and IT, have been a success story. But manufacturing exports have surged, growing 37.3% year-on-year in United States dollar terms between April and September 2006. Manufactured exports are dominated by capital-intensive engineering, chemicals and petroleum products. The main engineering products are iron and steel, feeding large global demand, especially from China. India's automotive sector is also expanding rapidly.

## Getting the best out of bilateral and regional trade agreements

The lingering uncertainties about the Doha Development Round are partly responsible for the proliferation of bilateral and regional trading agreements in the Asia-Pacific region. The 62 members and associate members of ESCAP have implemented 62 bilateral trade agreements (BTAs). Another 11 regional trade agreements (RTAs), with an average of eight members, are also in effect. Most of these agreements were signed after 2000, a new trend.

More frequently trade agreements are between partners with different economic and political power in different development hemispheres (North and South). Not surprisingly, negotiations may be driven by the partner with greater bargaining power, possibly tilting the net outcome in favour of that partner. Civil society, including academia, is increasingly questioning the quality of such agreements, not just for trade flows but for their impact on larger developmental goals.

*Civil society is increasingly questioning the quality of bilateral and regional trade agreements, not just for trade flows but for their impact on larger developmental goals*

“Bad” outcome agreements are not only those associated with “large” and “small” country combinations. Any agreement leading to price distortions, misallocations of resources and net trade diversions

should be considered inferior agreements that do not improve welfare. Even where agreements remain only “paper agreements,” not implemented for a variety of reasons, the negotiating and opportunity cost of not

**Table 1.4. Current account balances of selected developing economies and North and Central Asian economies, 2003-2006**

(Per cent of GDP)

	Current account balance as a per cent of GDP			
	2003	2004	2005	2006 <sup>a</sup>
<b>East and North-East Asia</b>				
China	3.1	3.5	7.2	7.1
Hong Kong, China	10.4	9.5	11.1	10.1
Republic of Korea	2.0	4.1	2.1	0.4
Taiwan Province of China	9.8	5.7	4.7	6.1
<b>North and Central Asia</b>				
Kazakhstan	-0.9	1.1	-0.9	0.2
Kyrgyzstan	-5.2	-4.6	-8.4	-12.8
Russian Federation	8.2	9.9	10.9	10.0
Turkmenistan	0.7	-4.4	1.9	2.6
Uzbekistan	8.7	9.7	10.1	10.7
<b>South and South-West Asia</b>				
Bangladesh	0.3	0.3	-0.9	0.9
India	2.3	-0.4	-1.1	-1.6
Iran (Islamic Republic of)	0.6	0.9	7.5	7.4
Nepal	2.6	2.9	2.2	2.4
Pakistan	4.9	1.9	-1.4	-3.9
Sri Lanka	-0.4	-3.2	-2.8	-5.3
Turkey	-3.4	-5.2	-6.4	-8.0
<b>South-East Asia</b>				
Indonesia	3.4	0.6	0.3	0.8
Malaysia	12.8	12.6	15.7	13.2
Philippines	4.4	2.4	2.5	2.4
Singapore	24.1	24.5	28.5	25.9
Thailand	5.6	4.2	-2.1	1.2
Viet Nam	-4.7	-2.0	0.4	0.9

Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); and ESCAP estimates.

<sup>a</sup> Estimates.

### Box 1.3. Making the Doha Development Round a success

The Doha Development Round was suspended in July 2006. Estimates of the direct losses from a failure to fully liberalize trade vary from \$79 billion to \$175 billion annually. Among developing countries, East Asia will lose the most (38%). These estimates do not include indirect losses, which could be considerable. The resulting spread of bilateralism and regionalism may distort the global trading system and induce tremendous welfare losses. It could also reverse unilateral economic reforms to comply with WTO requirements.

Looking at the reasons for the suspension of the Doha Development Agenda, Governments could consider the following actions to help move the round towards successful completion.

- Overcome the “you first” mentality in negotiations and stop perceiving liberalization as a concession to others. It should be looked on as an opportunity to tap other markets for cheaper resources, better technology, innovative ideas and greater knowledge.
- Adjust the negotiation process to make it more flexible and consider sectoral and plurilateral tracks.
- Give more prominence to special and differential treatment, which could create the “policy space” requested by many developing countries.
- Promote the development-oriented “Aid for Trade” framework to build trade capacity.
- Work within regional trading agreements capable of delivering new rules.

The future of WTO, and by implication multilateralism, is in the hands of its members.

Sources: Mehta and P. Kumar (2006); and Lamy (2006).

pursuing alternative policy options could be substantial for smaller developing countries. And with each additional agreement, the advantages of trading under transparent rules-based and non-discriminatory principles at the multilateral level are slowly being eroded. Many analysts suggest that BTAs and RTAs, rather than easing trade, fragment markets and increase trade costs, reducing trade volumes and global and national welfare.

ESCAP analysis shows that existing BTAs and RTAs do not stand up to scrutiny (table 1.5). While most agreements aspire to an eventual free trade area (typically 10-15 years down the road), countries are settling for framework agreements that do not contain explicit operational details on how to achieve this. Typically, agreements between developing countries are short on modes of implementation, agreements on rules of origin and information on what recourse is available for non-compliance.

Indeed, these agreements signal that free trade and trade integration are not the core issues. Governments may be using the agreements to put together a framework of cooperation in several (non-trade-related)

areas, often with strategic political and foreign policy objectives as the driving forces.

### *Checklist for a better trade deal*

The proliferation of BTAs and RTAs is now a fact of life. Policymakers across the region, particularly in smaller economies, might use a check list to help minimize costs and maximize benefits to the economy. The checklist here examines issues to consider at the conceptual, design, negotiation and implementation phases of an agreement:

- Why is the proposed trade agreement with a particular trading partner(s) important to the country?
- Is the main objective to enhance goods trade, services trade and/or foreign direct investment, ensure support for overall economic reform (as a stability anchor), or for political and security cooperation?
- Is it possible to obtain the same results through other liberalization tracks (unilateral, multilateral)?

- Might any sectors in the economy and social segments be adversely affected by the agreements, and what are the planned measures to ease those effects? Will this require excluding such sectors from the agreement?
  - Which sectors will benefit? And can measures be implemented to ensure that adjustment costs in “losing” sectors are alleviated to ensure a more equitable distribution of the gains from trade?
  - Are the likely production restructuring, employment, revenue and other socio-economic welfare effects consistent with the objectives of a long-term development plan for the country?
- Policymakers should aim, as a rule of thumb, to bring the preferential agreement as close as possible to the WTO-compliant agreement. From the vast literature on the issue – key areas of relevance to the Asia-Pacific region are (see Limão, 2006; Plummer, 2006; and Zhai, 2006):
- For trade in goods, a comprehensive coverage of products is the best approach, by using a “negative listing” approach with few (if any) exceptions covering tariffs and quantitative barriers and speedy elimination of those exceptions. In contrast, the “positive listing” approach is the worst mechanism because the exclusion of products used as inputs in an industry that has not been excluded exaggerates the protection of value added in that industry. In addition, this type of listing will also divert trade by promoting more trade between partners of the agreement at the cost of more efficient and lower cost non-partners.
  - Broad coverage in services and a reasonable period for implementation is the desired outcome. Some

**Table 1.5. Comparison of trade agreements in Asia and the Pacific with the good practice model**

<i>Area</i>	<i>Current state of affairs (actual agreements)</i>	<i>Number of PTAS examined</i>	<i>Good practice model</i>
Liberalization in goods	Liberalization still based on positive listing; full liberalization over longer transition of 10 years.	*31 PTAs with positive listings * 33 PTAs with negative listings	Agreement based on negative listing and covering both tariffs and non-tariff barriers.
Rules of origin	Bilateral cumulation, some diagonal cumulation; product-specific rules.	*33 PTAs	Simple and transparent in style; low and symmetrical in terms of demand; consistent across all agreements.
Comprehensive coverage of the “other than goods” sectors	Only smaller share of agreements include preferential commitments in the “other than goods” areas; coverage is variable and far from comprehensive.	11 - mobility of labour 24 - services 22 - competition 23 - government procurement 26 - trade facilitation 33 - investments 28 - intellectual property rights	Comprehensive scope accounting for all sectors with exclusions necessary only for appropriately designed policy space.
Consultations and dispute settlement	Only small proportion of agreements covers dispute settlements. Largely relies on consultations.	32 PTAs cover this area more specifically.	Avoid duplication with the WTO dispute settlement whenever possible.
Consistency and compliance with WTO	About one third of all PTAs in force are not notified to WTO.	16 BTAs, 5 country-bloc 4 RTAs are not notified to WTO	Notification to the WTO and regular update of non-members; open for accession of third parties.
Transparency	Some countries do not place electronic versions of the agreements on the Internet.	About 10-15% of agreements are not updated.	Making full text available to all partners in English and in electronic form.

Sources: Compiled from the ESCAP Asia-Pacific Trade and Investment Agreements Database (APTIAD), November 2006; and Goode (2005).

Note: The information was compiled for 117 BTAs and RTAs that had a legal text in an updated and electronic format in English.

services are relatively easier to liberalize (tourism, movements of some professional services), some are highly sensitive. Educational, postal and some transport services are highly protected worldwide. Countries need to assess the benefits of liberalizing these sectors to modernize and to increase competition and efficiency.

- Including clauses for transparency, consultation and dispute settlement is important for the agreement's smooth functioning. The dispute settlement model of the North American Free Trade Agreement (NAFTA) is heralded as a good practice.
- Using simple and transparent rules of origin, customs procedures and standards will minimize the confusion and administrative costs common to most agreements. The US-Singapore trade agreement provides a good example because the "integrated sourcing initiative" allows Singapore to apply rules of origin to selected products produced elsewhere.
- Including competition policy, mobility of people and mutual recognition of various standards can lead to deeper integration and should thus feature in negotiations.

*“Policymakers should aim to bring the preferential agreement as close as possible to the WTO-compliant agreement”*

An ESCAP analysis shows that consolidating bilateral and regional agreements into a smaller number of larger agreements under a harmonizing framework will bring significant benefits. Of course, harmonization is difficult, complicated by the heterogeneity of the economies in the agreements. Negotiations can start in areas that are less controversial and have clear evidence of the high costs of not consolidating. Measures for harmonizing rules to reduce transaction costs for business were discussed at the 14<sup>th</sup> APEC Ministerial Meeting (Hanoi, Viet Nam, 18-19 November 2006). Leaders committed themselves to completing a comprehensive model for trade negotiating teams by 2008 to facilitate a fast-track approach towards WTO consistency and multilateral liberalization. ESCAP could build on this work, by extending it to its non-APEC members.

## Outlook for 2007 – continuing dynamism amid rising risks

For developing economies in the Asia-Pacific region, economic growth is projected at 7.4% in 2007, slower than the 7.9% in 2006 (figure 1.8). The external environment is expected to be less favourable, mainly due to the slowing United States economy. With an easing in consumer demand and a cooling housing market, its GDP is expected to grow at 2.2%, down from 3.2% in 2006. The European Union's GDP is expected to grow at 2.4% in 2007, slipping from 2.7% in 2006. A moderate decline in global electronics demand in 2007 may dampen the Asia-Pacific region's prospects. And the easing of commodity prices, including those of oil, will come as a mixed blessing.

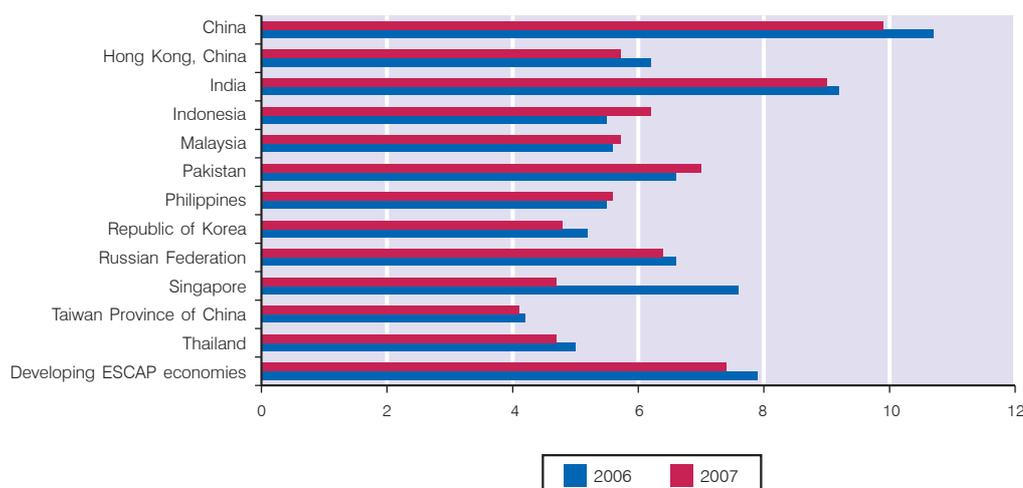
*“Growth momentum in the region is expected to come from China, India and Japan”*

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.

- In China growth is expected to be about 9.9% in 2007, less than the 10.7% growth in 2006. Exports and investment will still be the driving forces. A stronger yuan and weaker electronics demand would reduce exports, while tighter domestic policy would slow investment.
- India is expected to grow at 9.0% in 2007, led by services and accelerating industrial production. This growth will be on top of 9.2% achieved in 2006. The Reserve Bank is likely to continue to nudge interest rates up over the next 12 months, and the programme of fiscal consolidation now under way is set to continue.
- In Japan, ongoing fiscal consolidation, exchange rate appreciation and the slowdown of the United States economy will push growth down to 1.9% in 2007, from 2.2% in 2006.

Figure 1.8. Real GDP growth forecast for selected developing economies in the ESCAP region  
(Per cent)



Source: ESCAP estimates and forecast.

Notes: Data for 2006 are estimates. Data for 2007 are forecasts.

A rebound in economic growth in South-East Asian economies will add to the growth momentum of the region. Domestic demand, particularly investment, is expected to pick up.

- In Indonesia, investment would be boosted by lower interest rates and new pro-business regulations that are coming into effect.
- In Malaysia, strong electronics exports and higher development spending under the Ninth Plan (2006-2010) would boost investment.
- In the Philippines, energy reforms would strengthen the investment climate and raise investor confidence, leading to more investment.
- In Thailand, GDP growth is expected to be about 4.7% in 2007. But with ongoing political tensions, the macroeconomic outlook will still be subject to greater downside risks than in other South-East Asian economies.

In North and Central Asia, growth is projected to slightly ease to 7.1%. The Russian Federation is projected to grow at 6.4% in 2007. The country is expected to benefit from strong export earnings, although commodity prices are expected to ease in 2007. Domestic demand will also receive a boost from high foreign exchange earnings. Meanwhile, significant progress in resolving banking system problems is also expected to improve private investment.

Political instability could act as a significant drag on growth over the medium term in several countries in

the Asia-Pacific region. From Fiji to Sri Lanka, investment and tourism are likely to be the main casualties of increased political instability that emerged in 2006. Geopolitical tensions are also weakening investor and consumer confidence in the Islamic Republic of Iran and on the Korean Peninsula.

## Inflation – less of a problem

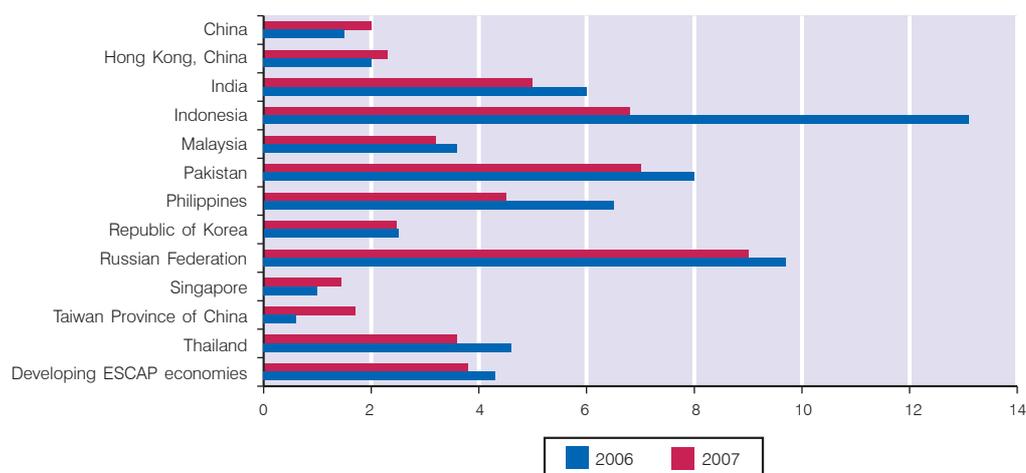
Inflation in developing Asia-Pacific economies is projected at 3.8% in 2007, down from 2006 (figure 1.9.). The fall in oil prices is expected to lessen inflationary pressures, while tight monetary policies across the region are expected to reduce inflationary expectations. The exchange rates, expected to appreciate further in 2007, would also reduce inflationary pressure in the region. Even in India, Indonesia and Malaysia – which have continued to remove oil subsidies and allowed retail oil prices to reflect international prices – inflationary pressures are expected to be subdued. For some East and North-East Asian economies – such as China and Hong Kong, China, and Taiwan Province of China – tightening labour and land markets will bring inflationary pressures, partly offset by tightening monetary policy and appreciating exchange rates.

## Managing exchange rates – the biggest challenge in 2007

Nominal exchange rates in most of the region, especially in East and South-East Asia, appreciated signifi-

**Figure 1.9 Consumer price inflation largely under control**

(Per cent)



Source: ESCAP estimates and forecast.

Notes: Consumer price inflation refers to changes in the consumer price index. Data for 2006 are estimates. Data for 2007 are forecasts.

cantly against the United States dollar in 2006, despite interventions to keep currencies down. This appreciation is expected to continue in 2007 with the large United States current account deficit and the continuing flow of capital into the region.

*“Currency appreciation is expected to continue in 2007 with the large United States current account deficit and the continuing flow of capital into the region.”*

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. As outlined in chapter 2, monetary authorities can choose any two of three policy options: monetary autonomy, exchange rate targeting and capital convertibility – but not all three.

Thailand decided to break the link between these three policy options when the authorities imposed capital controls in December 2006 to thwart speculative short-term capital inflows. However, experience has shown that capital controls may not be a long-term, sustainable solution. First, the design and actual implementation of such controls are fraught with difficulties (Eichengreen *et al.*, 1995; ul Haq *et al.*, 1996; Fischer, 2001). Second, they may lead to a significant deterioration of the overall investment climate, a situation that South-East Asian economies in particular cannot afford, as they have seen a steady decline in investment share in GDP since the 1997 crisis (see discussion on domestic demand below). Finally, as economic agents, particularly speculators, become accustomed to such interventions and gradually identify ways and means of circumventing them, they become increasingly ineffective (Edwards, 1999; Corbo, 2002; and Corden, 2002).

*“Greater exchange rate flexibility should take away the “one-way bet” that encourages even more capital inflows than otherwise.”*

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. The fear of exchange rate volatility and the resultant economic costs are well founded when foreign exchange markets are not well equipped to hedge against fluctuations. Small and medium-sized exporters in the region are not able to make use of hedging instruments to manage risks, so attention is needed to develop such instruments and further strengthen and deepen financial markets.

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 will have to forego the practice of sterilized intervention and allow the real exchange rate to appreciate through increases in the price level.

Interventions by monetary authorities to keep currencies down have partly led to inflated asset values in some countries in recent years. The situation has been further exacerbated by a global liquidity bonanza that saw borrowing in cheap foreign currencies, especially the yen, to buy international assets. Asia-Pacific equity markets rose by 29% in 2006. Indonesia, for example, saw a 55% rise for the year. Some countries have also seen large housing price rises over recent years, fuelled by growing household debt. One example is the housing market in the Republic of Korea. Apartment prices in Seoul rose by more than 24% in 2006, and house prices rose nationally by more than 11%. Authorities will have to be vigilant about the wider impacts of active exchange rate management.

## Current account surpluses – to deteriorate slightly

The current account surplus for emerging Asian economies is expected to deteriorate slightly in 2007, though it will remain high. For 12 emerging Asian economies, it is projected to be 4.5% of GDP, compared with 5.1% in 2006 (figure 1.10). Domestic demand is expected to rebound, particularly for investment in South-East Asian economies and consumption in China. Further appreciation of exchange rates and the reduced global demand in electronics and IT components would also contribute to the decline in current account surpluses. In China, a moderate decline in the current account surplus is expected because of policy measures supporting consumption, reduction in oil subsidies and greater exchange rate flexibility.

## Downside risks not to be ignored

The growth forecast of Asia-Pacific economies in 2007 is rather robust but the increased level of vulnerability indicators observed in some of the major economies over the last 12 months (see section on the vulnerability index) suggests that the baseline forecast will be

increasingly tilted towards the downside risks. Six downside risks merit attention:

**An oil price shock.** Oil prices should ease further in 2007, but low spare capacity and tight supplies could renew pressure on prices.

**An abrupt cooling of housing markets in the United States.** An abrupt adjustment in housing prices could reduce economic growth in the United States, a key export destination of emerging Asia, especially East Asia. Recent data shows that the housing market in the United States is now softening, with a falling demand for mortgages and a declining rate of increase in housing prices. The market adjustment has so far been orderly. However, a sharper than expected decline in housing prices still cannot be ruled out.

*“A sharp and abrupt depreciation of the United States dollar will lead to a real appreciation of regional currencies by about 33%”*

**A disorderly unwinding of global imbalances.** The steadily rising current account deficit and a significant increase in United States international debt positions

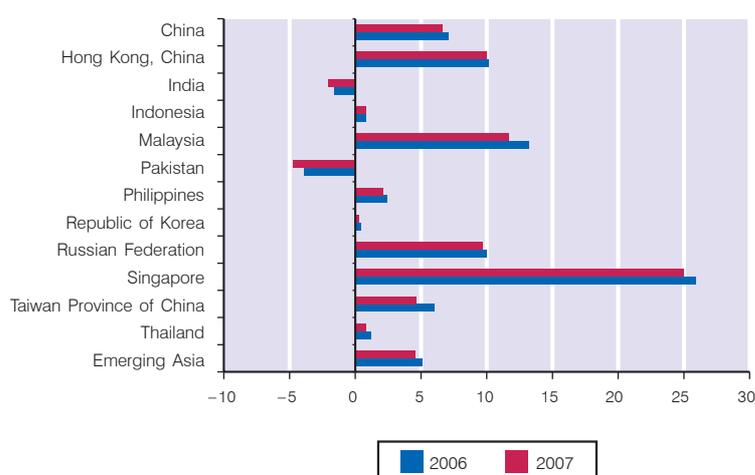
could lead to a rapid loss of investor confidence. If that happens, it would lead to a rapid fall in the United States dollar and a sharp contraction of economic growth in the United States.

- A sharp depreciation of the United States dollar would lead to a drastic reduction in the foreign exchange reserves of the Asia-Pacific region, the majority of which are held in United States dollar-denominated assets. The depreciation of the United States dollar together with the slowdown in United States growth would also negatively affect Asian exports.
- The disorderly adjustment of the United States dollar could also lead to global financial market turmoil. United States interest rates would increase dramatically in response to the sizeable depreciation of the United States dollar, thereby significantly reducing equity prices. Meanwhile, a sharp adjustment in financial risks would lead to abrupt price corrections in equity markets and cause considerable volatility and instability.

ESCAP estimates show that a sharp and abrupt depreciation of the United States dollar could bring the United States current account deficit to a sustainable 3% of GDP within one year, but at significant cost to its trading partners, particularly in Asia. On average, Asian currencies would experience an immediate, real appreciation of about 33%, with Singapore, the

**Figure 1.10. Current account balances of selected developing economies in the ESCAP region, 2006 and 2007**

(Per cent of GDP)



Source: ESCAP estimates and forecast.

Notes: Emerging Asia comprises selected developing Asian economies. Calculations based on the weighted average of real GDP figures in United States dollars in 2004 (at 2000 prices) of those developing Asian economies. Data for 2006 are estimates. Data for 2007 are forecasts.

Philippines, Malaysia and Thailand experiencing appreciations of more than 45%. Current account balances across the region would decline by about 2.3 percentage points.

**A reversal of the sustainability of the Japanese economic recovery.** Even though consumer price inflation in Japan has been in positive territory since January 2006 after seven years of negative price growth, and economic growth performance has been impressive for the last three years, the sustainability of the Japanese recovery is still vulnerable to risks. The high level of public debt could reduce consumer and investor confidence and threaten the Japanese recovery. Maintaining the ongoing process of fiscal consolidation to address ballooning debts will be crucial to ensure a sustainable recovery.

**Economic “overheating” in China.** The Government of China has implemented a number of policies to cool down the rate of investment growth. And signs exist that these cooling policies are helping. However,

most of the policies were administrative measures that could only be effective in specific sectors (ESCAP, 2006a). Implementing a tight monetary policy under a rather fixed exchange rate regime and in the face of increasingly open capital account could make it difficult to control liquidity and ensure that investment growth curtailed. Thus, there is a risk of further acceleration in investment growth resulting in overheating of the Chinese economy. ESCAP estimates that if China’s GDP growth declines to 7%, its trend rate for the past two decades, net exports in developing Asia (excluding China) would decline by almost 2 percentage points, GDP growth by 0.2 percentage points.

**An avian flu pandemic.** A full-blown pandemic could generate significant economic and social costs in the region (ESCAP, 2006b). The structure of the poultry industry in the region, consisting of many small-scale operations, makes the region more vulnerable to the disease. The disease has spread significantly during 2006 and cases of human-to-human contagion are suspected in some countries, such as Indonesia.

## 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 here are five issues for policymakers to keep on their economic watch list:

- Monitoring vulnerability to currency crises.
- Boosting domestic demand through private investment.
- Reaping the one-off demographic dividend.
- Managing urban growth.
- Promoting green growth to sustain development.

### Monitoring vulnerability to currency crises

In mid-2006, Asia-Pacific equity markets experienced their biggest drop since 2004. They continued falling throughout May and June. After a brief respite at the end of June, they were volatile again in July. All countries in the region were affected, suffering record falls for the year. The volatility reversed a sustained period of rising values for financial assets.

Markets took a significant dip again in February 2007, and more turbulence cannot be ruled out. Further hikes in developed country interest rates – particularly in the United States, the Euro Zone and Japan – are possible if inflation shows signs of gaining momentum. Renewed oil price rises could trigger such hikes. An abrupt unwinding of global imbalances, leading to a deep depreciation of the United States dollar, would do the same. The result may be a global economic slowdown, with Asian economies contracting with lower demand for their exports. All these factors may reduce the appetite of investors for Asian financial assets, and shocks could be amplified by investor overreaction and by contagion from portfolio outflows in other countries.

*“Relying on economic growth as an indicator of vulnerability can be misleading”*

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.

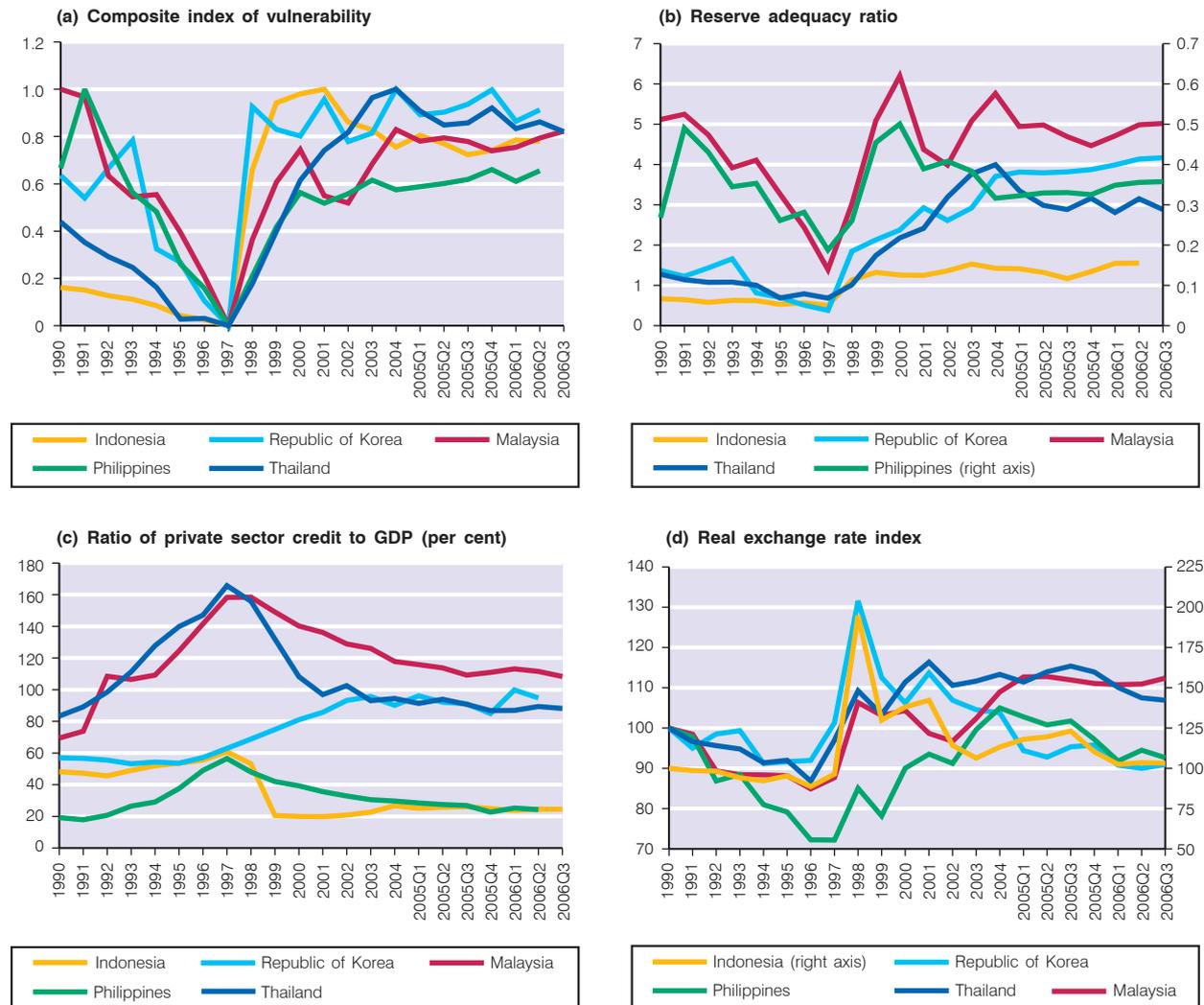
To assess a country's vulnerability to a currency crisis through a sudden reversal of capital flows, ESCAP developed a composite vulnerability index covering nine emerging countries in the Asia-Pacific region with data: five East Asian countries affected by the 1997 crisis – Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand; and four other emerging countries – China, India, Pakistan and the Russian Federation. The composite index combines three aspects of vulnerability to crisis: inadequacy of foreign exchange reserves to cover short-term debts, excessive expansion in private domestic credit, and real exchange rate appreciation (see appendix 1 for concepts and measures). In the run-up to the 1997 financial crisis, the composite index exhibited a persistent downward trend in all of the crisis-affected countries (figure 1.11). It bottomed out in 1997, when the crisis began. That downward trend was not, by contrast, observed in such non-crisis countries as China, India and Pakistan (figure 1.12).

### *Some crisis-affected countries are becoming more vulnerable*

Crisis-affected countries, except for Malaysia, are displaying renewed vulnerability in 2006. They were less vulnerable to financial crisis in 2000-2004 than in the mid-1990s, as the upward trend of the vulnerability composite index shows (figure 1.11a). But the recent reversal merits closer examination. Two factors are in play: the appreciation of their nominal exchange rates driven by short-term capital inflows; and the pass-through of higher oil prices into non-traded goods, adding to inflationary pressures.

Increased vulnerability in Thailand also stems from a decline in the ratio of foreign reserves to short-term debt. The United States dollar value of oil imports rose as higher oil prices eroded current account balances and slowed the accumulation of reserves. Meanwhile, short-term capital inflows increased, building up short-term debt from \$12 billion in 2004 to \$21 billion in 2006Q3. As a result, the ratio of reserves to short-term debt declined to 2.9 in 2006Q3 from 3.3 in 2004. For Indonesia, the Philippines and the Republic of Korea the vulnerability of foreign reserves is limited because the build-up of short-term debt is slower than foreign reserve accumulation, so the ratio of foreign reserves to short-term debt increased. The build-up of private

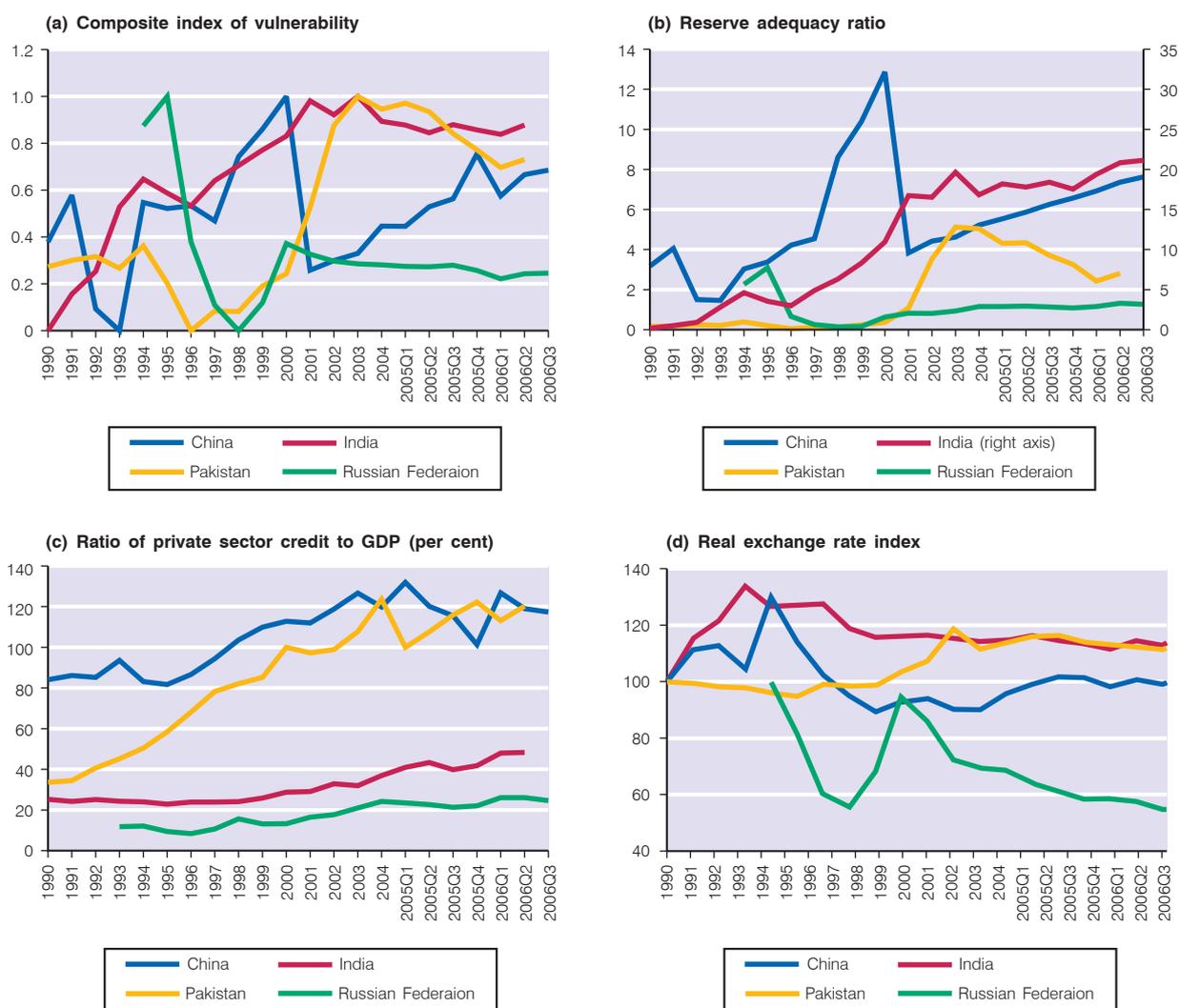
Figure 1.11. Vulnerability in crisis-affected countries



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); Oxford Economic Forecasting Model Database; CEIC Data Company Ltd; and ESCAP calculations.

Notes: The composite index lies between 0 and 1. An increase in the index reflects a reduction of a country's vulnerability. An increase of the real exchange rate index (1990 = 100) refers to a real depreciation.

Figure 1.12. Vulnerability in other emerging economies



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); Oxford Economic Forecasting Model Database; CEIC Data Company Ltd; and ESCAP calculations.

Notes: The composite index lies between 0 and 1. An increase in the index reflects a reduction of a country's vulnerability. An increase of the real exchange rate index (1990 = 100) refers to a real depreciation. The 1994 is set as the base year (=100) in the case of the Russian Federation's real exchange rate. The (quarterly) GDP of Pakistan is approximated by industrial production index.

domestic credit has also been a less of a concern. Indeed, the problem is low domestic credit, which may constrain domestic demand and the potential for growth.

*“Economic vulnerability seems less of a concern in Malaysia, as the real appreciation was rather limited and the foreign reserve adequacy ratio improved.”*

Economic vulnerability seems less of a concern in Malaysia, even though vulnerability increased slightly in 2005 due to a real exchange rate appreciation and a decline in the foreign reserve adequacy ratio. But since the first quarter of 2006, vulnerability has declined as the real appreciation was rather limited and the foreign reserve adequacy ratio improved. In the third quarter, the nominal exchange rate slightly depreciated against the United States dollar. In addition, the financial sector has been rather robust, with ongoing financial reforms and private domestic credit kept manageable.<sup>1</sup>

### *Vulnerability is a concern in the region's other major emerging economies*

Pakistan experienced some deterioration after the first quarter of 2005, but its vulnerability index has nonetheless improved steadily over the past seven years (figure 1.12). The main contributor to the deterioration was the oil price hike and the high oil import dependency, eroding current account balances and foreign reserves. The oil price hike also pushed up the real exchange rate. Consumer price inflation rose from 2.9% in 2003 to 8.4% in 2006Q3. Short-term capital inflows increased from \$1.9 billion in 2004 to \$4.1 billion in 2006Q2, building up short-term debt and reducing foreign reserves in relation to that debt. A significant build-up of private credit also took place.

In the Russian Federation, commodity price increases over the past five years have led to a persistent and

significant appreciation of the real exchange rate. By 2006Q3 the real exchange rate had appreciated by more than 26% from its level in 2001. Because the country is an oil exporter, higher oil prices led to a surge in trade and current account surpluses, increasing the money supply and domestic prices. The current account surplus increased from 8.2% of GDP in 2003 to 11% in 2006, while broad money (M2) increased from 92% of GDP to 130%. Consumer price inflation in 2006, though declining slightly, was still close to double digits. Even though the Russian Federation has tightened monetary policy and established a special stabilization fund for oil to absorb the massive monetary inflows, the real exchange rate is still appreciating.

Concerns about economic vulnerability in China and India are muted even though their indexes are worsening slightly because of the rise in private domestic credit. “Overheating” remains a possibility, but the economic fundamentals in both countries are still strong. Foreign reserve adequacy has been increasing over the past five years, and there has been no evidence of any significant real exchange rate appreciation. In China successive current account surpluses and high levels of foreign direct investment boosted its foreign reserve adequacy, even though short-term capital inflows and debt have been building. In India continued inflows of foreign direct investment maintain high foreign exchange reserves, even though the current account balance was in deficit for the past three years.

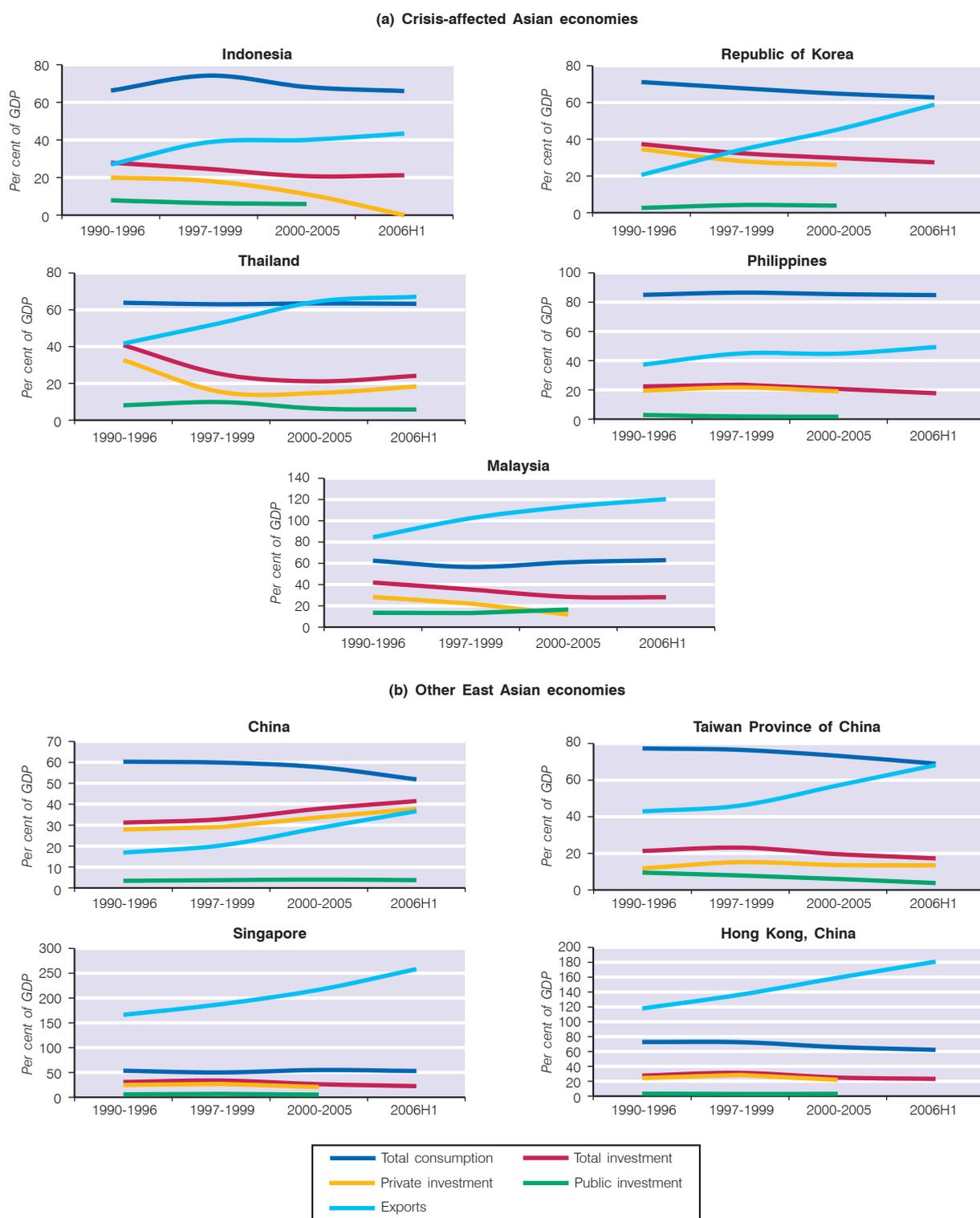
### *Boosting domestic demand through private investment, especially in East Asia*

The relatively low domestic demand in East Asian economies has given rise to two concerns. One is that it is a source of widening global imbalances. The other is that these economies have increased their reliance on exports to drive economic growth, exposing them to significant declines in external demand. Understanding the causes of weak domestic demand and identifying policy measures to correct it are important for growth in East Asia and in the region.

Since the Asian financial crisis, the contribution of domestic demand to economic growth has declined in East Asia, except in China (see box 1.4). The share of domestic demand in GDP in Thailand dropped by 19 percentage points in 2000-2006, compared with pre-crisis levels, followed by Malaysia and the Republic of Korea (figure 1.13). Meanwhile the share of exports has been rising steadily. Investment was the brake on demand, rather than domestic consumption, which remained fairly stable, except in the Republic of Korea.

<sup>1</sup> The ratio of non-performing loans to total commercial bank loans was about 5.6% in 2005-2006, compared with more than 10% in 2001-2002. The capital adequacy ratio is well above 8%, the international standard, reflecting tighter prudential regulation, better risk management and higher bank profits.

Figure 1.13. Declining private investments and increasing reliance on exports



Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and ESCAP calculations.

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. Private investment was badly hit in Indonesia, where its share in GDP fell by nearly half, followed by Thailand and Malaysia. The share of public investment has been relatively constant.

*Private investment's share in GDP has not yet recovered to its pre-crisis level in East Asia*

The picture in China is very different. Domestic demand has been relatively high, rising from 92% of GDP in 1990-1996 to 96% in 2000-2005 on the back of the tremendous increase in investment. The investment share in China increased from 31% in 1990-1996 to a high of 42% in 2005. The share of consumption, by contrast, declined from 60% in 1990-1996 to 52% in 2005, with most of the reduction coming from private consumption (box 1.4). Investment in China grew almost 20% faster than its long-term trend, while private consumption declined by 10%, the steepest fall in the region (figure 1.14).

Construction contributed much to the falling share of investment in GDP in East Asia. It accounts for well over half of total investment, more than one third of which is residential investment. The decline began in Thailand in early 1997 when a large real estate company defaulted on its foreign debt, and investments in the rest of the countries dropped quickly throughout 1997 and 1998 (figure 1.15a). Among non-crisis economies, Singapore was hardest hit.

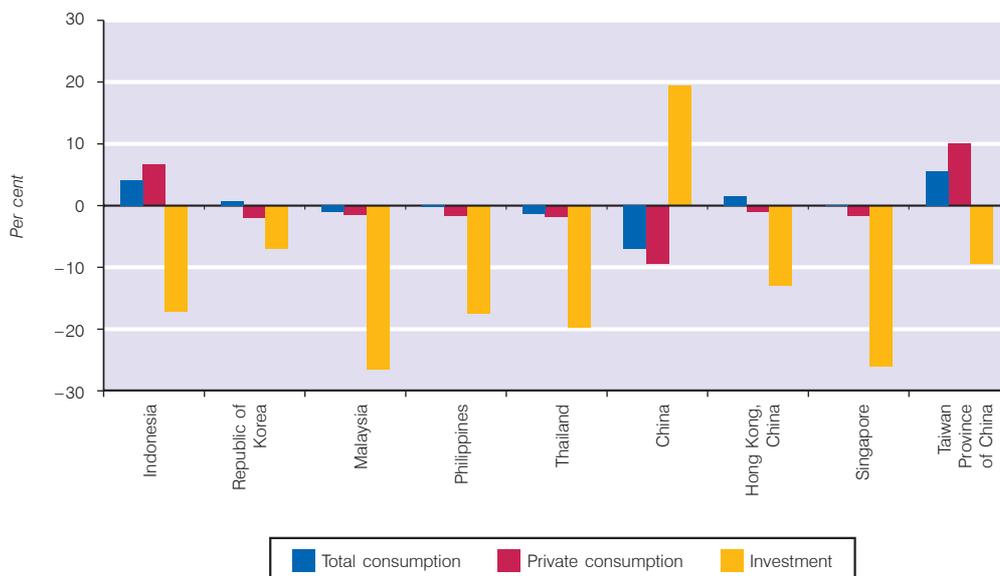
Investment in machinery and equipment also declined during the crisis period, if more moderately (figure 1.15b). It has yet to recover.

The decline of construction investment could represent a healthy adjustment to the boom of the early 1990s, especially in residential investment. But the decline in machinery and equipment raises concerns about growth's sustainability, since this investment component is tied to an economy's production capacity.

### *Credit shortage limits private investment*

Shortages of capital funds are hindering the recovery of private investment in East Asia. The stock of private domestic credit as a percentage of GDP declined after

**Figure 1.14. Percentage differences between the recent shares of disaggregate demand and its long-term trend**



Sources: CEIC Data Company Ltd; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and ESCAP calculations.

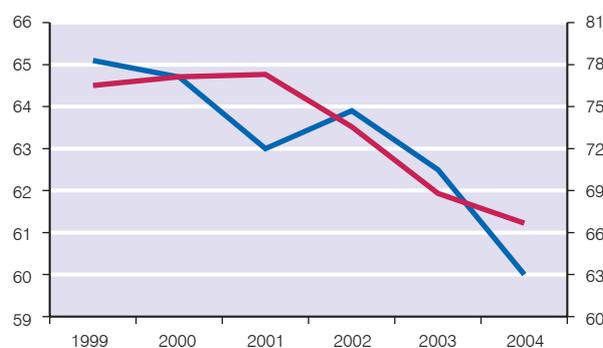
Note: The long-term trend is the average level of each component in 1980-2005, while the recent share is the average level in 2000-2005.

### Box 1.4. Why the falling share of consumption in China? Precautionary savings could be the main reason

China's declining share of private consumption in GDP is partly due to the falling share of disposable income in GDP, down from 65% in 2000 to 60% in 2004. Because the share of household disposable income fell less than the share of private consumption in GDP, the marginal propensity to consume has also declined – from 77% in 2001 to 66% in 2004 (box figure).

**Figure. Declining trend in disposable income and private consumption, 1999-2004**

(Per cent)



— Household disposable income as a per cent of GDP  
 — Private consumption as a per cent of disposable income (right axis)

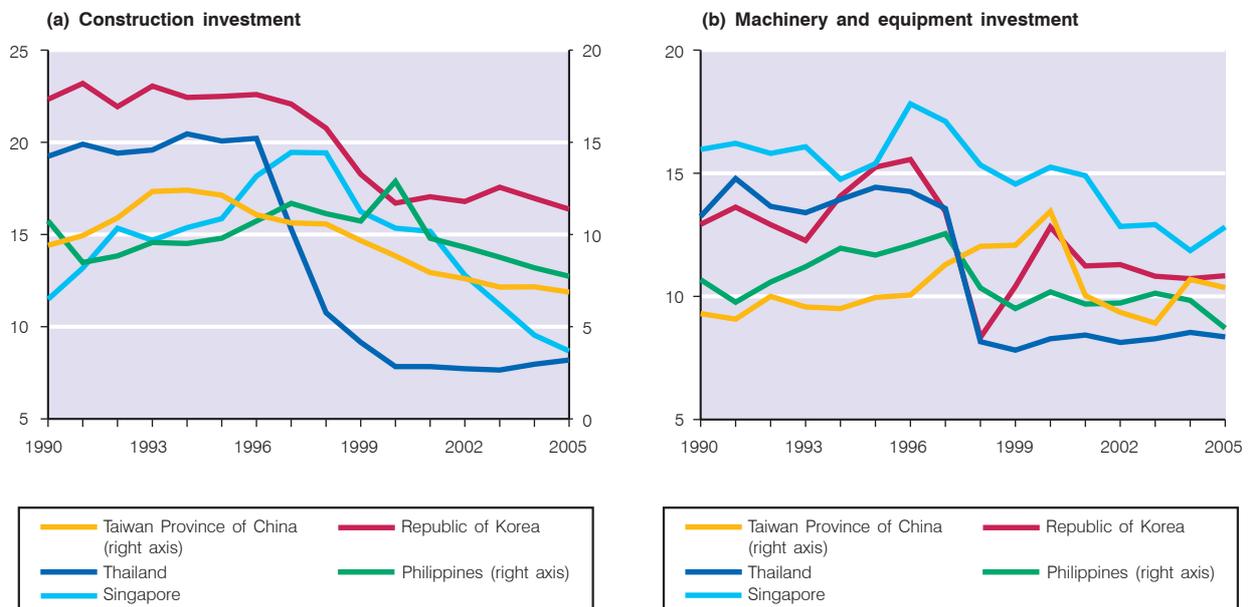
Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); World Bank, *World Development Indicators 2006* (Washington, D.C., World Bank, 2006); and ESCAP calculations.

How can China's economy be rebalanced towards greater reliance on consumption?

- Fiscal policy can do much to reduce precautionary savings. Higher budgetary spending on education, health care and pensions would lower precautionary savings and promote consumption. In addition, local government could ensure that households have access to publicly delivered social services.
- Financial markets need to be further developed to facilitate consumer borrowing. A wide range of household credit instruments should be promoted to help households smooth their consumption by facilitating borrowing against future income. Greater participation of households in equity markets would diversify their portfolios and allow them to benefit from rising market values of firms. This would in turn enable them to increase their consumption. China's insurance market could also help households to pool their risks and protect themselves against adverse shocks, such as large health care expenses or job losses.

**Figure 1.15. Construction and machinery and equipment investment in selected East Asian economies, 1990-2005**

(Per cent)



Source: CEIC Data Company Ltd.

the crisis. It is unlikely that the lower stock of credit was due to a fall in demand for loans because capacity utilization in these economies rose after the crisis, except in Hong Kong, China, Malaysia and Singapore. Credit shortages were even more pronounced in Thailand and Indonesia because loans were allocated more for consumption. The share of individual consumption loans to total loans in Thailand reached 24% in the first half of 2006, up from 12% between 2000 and 2005, and reached 33% in Indonesia, up from 26%.

The excess capacity in Hong Kong, China, in Malaysia and in Singapore makes the case of declining private investment likely, rather than credit shortages, leading private enterprises to postpone their investment plans.

### *Decisive policy responses needed*

Further financial reforms are needed to promote private investment in East Asian economies. Although progress has been significant in strengthening financial systems after the 1997 crisis, more can be done to ensure that prudent investors have access to credit. For this to happen, two critical reforms are needed.

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 have increased in importance after the crisis, should be further developed as an alternative source of funds for investors. The shares of equities and debt securities in GDP have increased in East Asia (see the policy research feature 2.4). But they remain much less important than bank loans. In addition, only large corporations use capital markets. For example, in Thailand more than 70% of total bonds and long-term debt securities between 1999 and 2005 were issued by corporations with assets above 50 billion baht.

Governments should also take measures to improve the investment climate for private investment. The three main features of the investment climate are: (1) macroeconomic stability, including macroeconomic policy, policy credibility and certainty; (2) adequate infrastructure; and (3) good governance, including political stability. Governance is emerging as a major consideration in private investment decisions.

According to the investment climate survey by the World Bank,<sup>2</sup> there are two areas where Governments in developing East Asia need to work most to improve their investment climate. First, businessmen view corruption as a major impediment to doing business. Survey respondents in China (73%), Indonesia (44%), Philippines (45%) and Viet Nam (37%) stated that they had to pay bribes to get things done. Governments need to avoid complicated regulations to enhance transparency and limit policy discretion, leaving less room for corruption. They can provide data and applications online, standardize application forms, simplify filing requirements and standardize international practices.

*“Corruption and customs clearance are two areas where Governments in developing East Asia need to work most”*

Second, it still takes a long time to clear goods through customs in several developing East Asian economies. Claiming imported goods from customs took 7.2 days in the Philippines, 6.7 days in the Republic of Korea and 7.3 days in India, compared with the developing country average of 6 days. Electronic filing of all documents for trading, time limits on customs clearance and one-stop service facilities can shorten these delays.

## Reaping the one-off demographic dividend

Total fertility rates fell from a high of 6 children per woman in 1950-1955 to 2.4 in 2000-2005 in the region. There was also a remarkable decline in mortality rates preceding the fertility decline. This sequence of declines in mortality and fertility created a bulge in the age distribution, concentrated on the younger ages. Over time, the bulge has moved upward through the age structure to produce a large and rising working-age population – with fewer dependent children and older persons to support. The growth in the labour force, along with increasing savings resulting from

falling dependency ratios, can provide a tremendous boost to investment and growth. This window of opportunity opens only once in a lifetime, closing within a generation as the population ages and dependency increases.

All subregions in the Asia-Pacific region, while at various stages of the demographic transition, have experienced significant increases in the proportion of working-age population since the 1970s (figure 1.16). They are either entering the peaks of the demographic bulge or reaching it – and in both cases are well placed to reap the “demographic dividend” before their populations start ageing once again.

*“Population dynamics have produced a large and rising working-age population across the region”*

The demographic transition has been fastest and most pronounced in East and North-East Asia, where the working-age population, about 57% in 1970, is expected to peak at 72% in 2010, before declining rapidly. North and Central Asia and the Pacific are also at advanced stages of the demographic transition, peaking in 2010 as well. In South-East Asia and South and South-West Asia, swelling numbers should peak around 2025, and then settle in a long plateau in the case of South Asia. There is naturally diversity within subregions. The transition is fairly advanced in Thailand, with the numbers of young people declining. It is peaking in Viet Nam, while the peak will be much later in the Philippines.

The one-off opening of a demographic window will not automatically translate into economic growth. It merely creates the potential for growth. Whether countries capture this “demographic dividend” will depend on the social and economic policies and institutions they adopt to absorb a rapidly growing labour force (Kinsella and Phillips, 2005).

East Asia shows what is possible.<sup>3</sup> Some studies suggest that the demographic dividend accounts for one fourth to two fifths of East Asia’s “economic

<sup>2</sup> The survey covered 41,000 firms in 77 developing countries, measuring business perceptions of the investment climate. Data are available at <<http://www.enterprisesurveys.org/>>.

<sup>3</sup> East Asia refers here to China; Hong Kong, China; Macao, China; the Democratic People’s Republic of Korea; Japan; Mongolia; and the Republic of Korea.

### Box 1.5. India – less reliant than many others on exports for growth

Domestic demand is important for promoting economic growth in India (box table). Private consumption is by far the largest contributor, with a stable share over the last 25 years and a large contribution to GDP growth. Private investment, in contrast to East Asian economies, has edged up over the years, steadily increasing from 14% of GDP in 1990-1996 to 18% in 2005. Its contribution to GDP growth also increased, from 0.8 points in 1997-1999 to 1.5 points in 2000-2005. There have been no significant changes in investment either in construction or in machinery and equipment, and the high share of machinery and equipment investment supports medium- and long-term growth (box figure).

**Table. Components of GDP, 1990-2005**

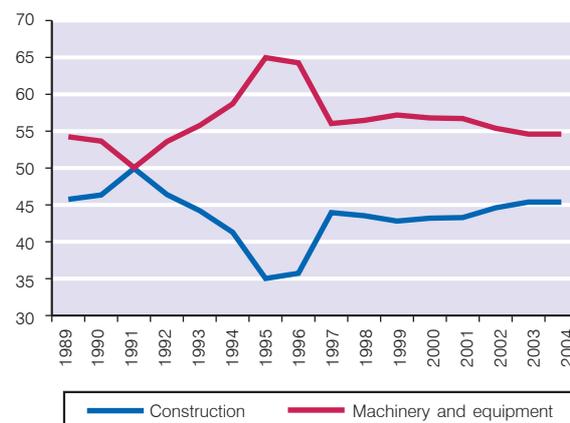
(Per cent)

	Total consumption			Total investment		Net exports		
	Private	Public		Private	Public	Exports		
Share in GDP								
1990-1996	77.1	66.0	11.1	22.6	14.3	8.2	-0.7	9.5
1997-1999	77.1	64.9	12.2	21.7	15.3	6.3	-1.6	11.3
2000-2005	76.1	64.2	11.9	22.7	16.7	6.0	-1.2	14.9
2005	73.9	62.5	11.5	24.6	18.2	6.5	-2.0	19.0
Contribution to GDP growth								
1990-1996	3.7	3.3	0.4	1.3	1.2	0.1	-0.1	1.0
1997-1999	5.2	3.7	1.5	0.9	0.8	0.1	-0.4	1.0
2000-2005	3.6	3.2	0.4	1.9	1.5	0.4	-0.1	2.4
2005	4.0	3.1	1.0	3.7	2.7	1.0	-0.9	5.6

Sources: CEIC Data Company Ltd.; and ESCAP calculations.

**Figure. Construction and machinery and equipment investment in GDP, 1989-2004**

(Per cent)



Source: CEIC Data Company Ltd.

miracle” (Boom, Canning and Sevilla, 2003). The phenomenal growth of per capita income, which rose by more than 6% a year between 1965 and 1990, is partly credited to the working-age population growing nearly four times faster than the dependent population. With the benefits of a good education and a liberalized trade environment, this huge workforce was absorbed into the labour market, increasing the subregion’s capacity for economic production.

*“The one-off opening of a demographic window will not automatically translate into economic growth – but not exploiting it can be costly”*

The East Asian and Latin American demographic transitions closely resemble one another, but Latin America did not reap the demographic dividend because of weak governance, inward-oriented economies and persistent macroeconomic instability (Boom, Canning and Sevilla, 2004). These conditions were not conducive to the higher level of investment and production that would have absorbed the growing labour forces.

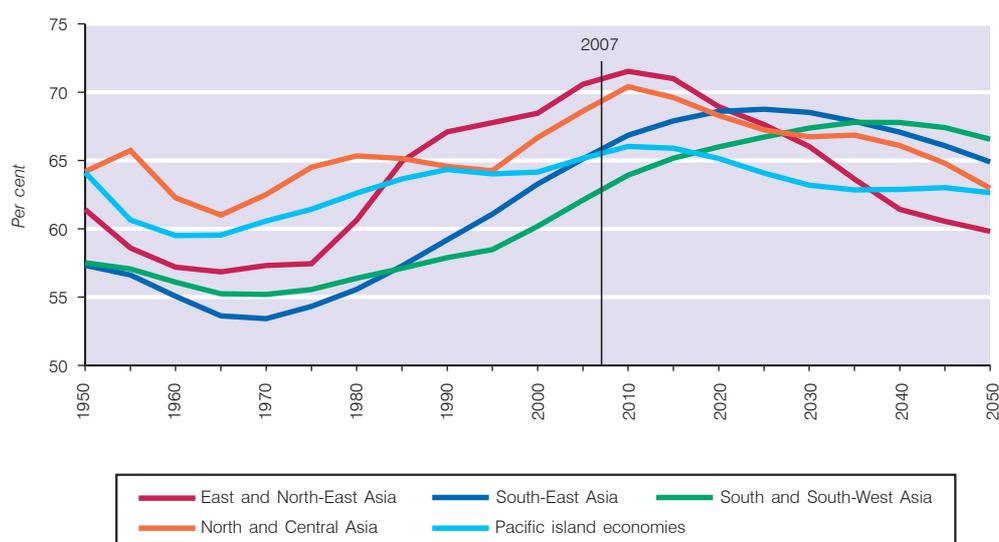
Not exploiting the demographic dividend can thus be costly. High unemployment, especially among youth, wastes human resources and can lead to higher crime,

social unrest and political instability, with further ramifications on socio-economic prospects. Jobless growth and high and rising unemployment among youth (aged 15-24) in the region may indicate inadequate preparation to reap the benefits of the demographic dividend. It is worrying that despite growing at 6% a year in the past decade, the Asia-Pacific region has seen unemployment rise steadily. Youth have been the most affected, as they make up only one fourth of the working-age population but half of the unemployed.

Success stories from East Asia and elsewhere show that a few key policies may determine the ability of a country to exploit the demographic dividend:

- Expanding access to basic education and improving its quality will create a better educated labour force. Having a cadre of young people with good basic education and technical skills that match the demands of the labour market is crucial. Higher investment in education is feasible because of rising savings from the low dependency ratios during the demographic transition (Wongboonsin and Guest, 2005).
- More flexible labour markets can better absorb the rapidly growing working-age population. Particular attention should go to easing regulations on the entry of young people and improving flexibility and mobility across sectors. Rigid employment protection laws and excessively high minimum wages need to be carefully reviewed and reformed because they are the main barriers preventing young people from entering labour markets.

Figure 1.16. Demographic dividend – percentage of the population aged between 15-64 in ESCAP subregions



Source: United Nations, *World Population Prospects: The 2004 Revision* (United Nations publication, Sales No. E.05.XIII.7).

- Openness to trade and foreign investment will offer job opportunities if exports specialize in labour-intensive products, a major factor in East Asia's success.
- Well-developed financial markets will mobilize the savings of the working-age population for productive investment. Throughout the Asia-Pacific region, the demographic transition has generated conditions for higher savings, but channeling them into investments has become a challenge for many countries, particularly in the aftermath of the 1997 financial crisis.

Getting the policy and institutional environment right helped East Asia benefit from the demographic dividend. The rest of the Asia-Pacific region now needs to do more. Policymakers need to be aware of the relevance of the demographic dividend and its potential benefits and costs so that they can put the right policies in place.

## 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 (UN Habitat, 2006). If this is not dealt with economic growth will be offset by the higher costs of keeping urban centres functioning.

Sanitation coverage in many Asian cities has improved significantly over the past two decades, even in urban areas in some of the poorest countries (UN Habitat, 2006, p. 87). Some urban authorities in the region have also realized that to create livable cities, municipal policies and practices have to be driven by a quest for political and infrastructural inclusion. Yet, many cities continue to suffer the neglect of policymakers.

Cities do have higher per capita outputs and incomes, but personal wealth and institutional control over economic assets are concentrated in certain areas of a given city. On the socio-economic side of growth, "capability poverty" is instructive (Sen, 1997). Urban centres are commonly regarded as sites of opportunity. What is overlooked, however, is that large percentages of the urban population are excluded from the opportunities offered by urban areas to those who are better educated, healthier and more affluent and who possess a more effective political voice through access to institutions and personal networks (UN Habitat, 2003). Recent UN Habitat data show that while female literacy

is generally higher in cities, the intracity discrepancies between slum and non-slum areas are remarkable. In Indonesia and the Philippines, illiteracy in deprived urban neighbourhoods approaches that in rural areas rather than better-serviced urban areas. Whereas the prevalence of diarrhoea among children aged under five in Viet Nam, Nepal, Pakistan and Kyrgyzstan is higher in rural areas, in Bangladesh, Indonesia, Kazakhstan and Uzbekistan it is higher in urban areas. And in Kazakhstan and Nepal, children under five living in urban slums are more likely to contract respiratory infections (UN Habitat, 2006, p. 199).

National Governments must pay attention to the city-specific facets of urban poverty by adopting complementary policies (but not at the expense of fighting rural poverty). Urbanization as an empirical demographic trend is irreversible, and unless urban areas are managed well, slum growth will accompany urban growth, hampering the sustainability of cities as motors of national economies. The link between intracity inequities and their effect on national economic development is tangible, and the resulting need for pro-poor policies in cities is obvious. To many managers and activists at the municipal level, this argument is familiar. But at the national policy level, the notion that eradicating urban poverty is key to any effective national poverty reduction strategy deserves greater awareness. Such a strategy should be marked by strong institutions to ensure secure tenure and efficient land markets and settle land-related disputes. Slum-dwellers should be included in political decision-making. Basic sanitation and transportation systems should be extended to poor neighbourhoods. Technical and financial support should be provided for disaster mitigation. And land should be freed up for low-income housing.

*In Thailand and Malaysia urban development has benefited greatly from well-managed urban land markets*

Some city authorities in Asia have shown that an institutionally flexible approach to tackling urban poverty is both feasible and economically prudent. They have shown that the urban poor are key to sustainable economic development. If they are included in the formal urban fabric, productivity gains are more equitable and more sustainable. If they remain excluded, the fiscal, managerial and political burden on city and national Governments will only continue to grow.

In Thailand and Malaysia, urban development has benefited greatly from well-managed urban land markets that consider the needs and demands of low-income dwellers. In Singapore, housing has been made affordable by embedding housing policies in a coherent long-term planning framework, with transparent needs-based allocation as one of the pillars (Yuen, 2005). In some Indonesian cities, performance-based budgeting has helped balance local accounts, limit corruption and make urban development processes more accessible and transparent to all residents (ADB, 2006).

## Promoting green growth to sustain development

The Asia 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. Indeed, consumption pressures in more than half the region's countries – their ecological footprints – exceed the available bio-productive area (productive natural resource endowment) per capita (ESCAP, 2006c). National policy failure to address the growing environmental pressures will eventually take their toll on economic growth.

Evidence already shows that the economic base provided by the environment is being undermined in the region. Land has been eroded, fisheries depleted, forest and coastal ecosystems degraded and air and water polluted. While afforestation and reforestation have slowed the loss of forest cover, natural forests are in decline, driving the rapid global decline in biodiversity. For example, some 60% of the region's mangrove forests have been converted to aquaculture.

The costs of water shortages are evident in industry and agriculture, the biggest users of water at 20% and 70% respectively. India's industrial water use, for example, is expected to almost quadruple by 2050 (India, 2004), but water shortages could slow industrial activities, as parts of India have already experienced. In China, water shortages have been responsible for an estimated annual loss of \$28 billion in industrial output in recent years (China, 2004).

Air and water pollution impose enormous costs on human health and the environment. Asia harbors seven out of ten of the world's most polluted cities. In Dhaka the total economic cost of suspended particulate matter alone was 3-4% of GDP (Azad, Sultana and Jahan, 2003). In many countries, only a small portion of solid waste is properly disposed of (40% in the Philippines, 20% in China), with the rest contaminating rivers and groundwater.

*The most severe impacts of climate change will be in the Asian and Pacific region, with poor countries likely to suffer earliest and the most*

Greenhouse gas emissions and climate change will have significant impacts on the region. The Stern Report, recently released by the Government of the United Kingdom, predicts that if consumption and production patterns continue along “business as usual”, climate change will cut global GDP by up to 20%, create 200 million “climate” refugees through drought and floods (Myers, 2005) and cause a severe global recession. The most severe impacts of climate change are predicted to be in the Asian and Pacific region, with poor countries likely to suffer earliest and the most:

- Crop yields are expected to decline by up to 70% for typical crops in northern India if the temperatures rise by 2-3°C, placing 30 to 200 million people at risk of hunger.
- The already dry areas of southern China and the Indian subcontinent will lose 30% of their water availability if temperatures rise by 2°C, while parts of South Asia could receive 10% more water and experience regular floods.
- A temperature increase of 3-4°C would cause sea levels to rise and storms in coastal areas and islands. Many Asian coastal cities – such as Hong Kong, Shanghai, Mumbai, Kolkata, Karachi and Tokyo and many island economies – will risk inundation at massive economic and social cost.

### *Clean up now*

“Grow now, clean up later” does not apply in a region with such a limited natural resource base and with such a large and growing population directly dependent on natural resources. Moreover, the cost of preventing the loss of the economic base provided by the environment is only a small fraction of the cost to repair it, if the damages are reversible. Indeed, the cost to “clean up” now is, in many cases, much smaller than policymakers would expect. More than 90% of the resources harvested from nature are wasted in producing food, machines, vehicles and infrastructure. A priority is finding economic growth strategies that support and reinforce environmental sustainability.

“Green growth” is a solution. This is the growth in GDP that maintains or restores environmental quality and ecological integrity, while meeting the needs of all people. It fundamentally changes the way societies operate by improving efficiency in the use of the environment for production and consumption. Such “eco-efficiency” in national development planning can decouple economic growth from its negative environmental impacts and make environmental sustainability and economic growth complementary.

The efficient use of natural resources is often pro-poor because the poor, particularly in rural areas, are the most affected by shortages of water, losses of land, forests or fisheries, and other forms of environmental degradation.

### *Five tracks to green growth*

Conventional environmental management has focused on improving environmental performance by controlling and regulating pollution and effluents from production processes. Environmental regulation remains a part of green growth, particularly to reduce pollution. But a broader array of policies, economic instruments and management practices are required to fundamentally change consumption and production patterns. ESCAP proposes a five-track approach to green growth:

*“Green taxes could generate revenues to reduce other distorting taxes – thereby overcoming resistance to new taxes”*

**Track 1. Introducing green taxation and budget reform.** Many tax and subsidy policies indirectly promote environmentally damaging activities. Moreover, the price of natural resources does not typically capture the full social and environmental cost of their use, an incentive for waste and inefficiency. Environmental taxes, by contrast, internalize environmental costs – but may not be popular. To overcome resistance to new tax structures, “green taxes” could generate revenues to reduce other (distorting) taxes. They should be combined with reforms of fiscal budgets that align public revenues and expenditures with environmentally sound considerations.

Germany taxes energy and environmentally harmful transport, using the revenues to reduce the social security tax that companies pay. The net effect: a protected environment and new jobs. Other benefits

include the move to petrol-saving vehicles, greater use of public transport, better building insulation, electricity savings and greater energy efficiency in production.

**Track 2. Developing sustainable infrastructure.** Governments need to plan for environmentally friendly infrastructure that fosters efficient use of resources and minimizes pollution as cities grow, highways lengthen and water, energy and sanitation services expand. But failing to recognize the environmental realities of rapid urbanization in infrastructure decisions creates unnecessary costs related to air and water quality, waste management, transportation and congestion. Infrastructure projects rarely consider long-term ecological impacts. Nor do they consider infrastructure investment’s external effects or hidden costs of pollution, health and social impacts and overuse of energy, water and raw materials.

**Track 3. Promoting sustainable consumption and production.** Governments throughout the region are promoting cleaner production. For example, Russia’s Cleaner Production Programme has more than 1,700 engineers and specialists from 500 industrial and agricultural production enterprises working to develop and implement projects focused on resource savings. The projects range from waste management to alternative energy sources. The annual economic benefits of the pilot projects alone were 5-7 times the value of the initial investment.

More needs to be done to promote cleaner consumption. In Bangladesh, where only 15% of the population is served by the electricity grid, Grameen Shakti provides soft financial options for home solar systems in rural and remote off-grid areas. Today, more than 65,000 systems with an installed capacity of 3.25 MW are up and running. The users report higher incomes, better children’s education and higher quality of daily activities.

**Track 4. Promoting green business.** Corporations and small and medium enterprises across the region are becoming the agents of change for environmental sustainability (box 1.6). They have turned protecting the environment into business opportunities by enhancing the eco-efficiency of their production systems. Less use of resources, less energy-intensive production, more use of non-conventional and renewable energy sources and re-use of production waste products for new production processes have proven cost-effective and profitable. Eco-efficient and less material-intensive production may also sharpen the competitive edge of countries in the region in global niche markets for environmentally conscious consumers in industrial countries.

**Track 5. Monitoring progress through eco-efficiency indicators.** To enable countries in the region to move towards green growth strategies, eco-efficiency indicators are needed, particularly if environmental considerations are to be incorporated in national economic development planning. These indicators can assess a country's pattern of economic

growth, monitor policy outcomes that promote eco-efficiency and allow comparisons of eco-efficiency measures across countries. Such a tool will help countries in their efforts to decouple economic growth from its negative environmental impacts. These indicators will also provide a powerful advocacy tool to influence consumption and production patterns.

### Box 1.6. Pro-poor green business: Lekhani Paper and Power Project in Nepal

Approximately 2 billion people still have no access to electricity, relying on expensive fuel-based lighting that often provides poor light. White light-emitting diodes combined with solar photovoltaic technology are now seen as a viable way of providing clean, sustainable and affordable light to thousands of homes while also creating income generation opportunities.

One promising solution can be found in Lekhani, Nepal. The "Paper and Power" Project initiated by a private company aims to help the rural poor through income-generating activities at the village level. Its Home Employment and Lighting Package (HELP™) provides implementation costs and improving livelihoods. The project also helps generate revenues to help pay for the lighting system by producing paper and paper products from a wide range of locally available plant resources. Subsequent revenues become a new source of income for the family. The project is being co-funded by the UNDP Global Environment Facility Small Grants Programme and private business.

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*Source:* Based on the description of the project at <<http://www.hlf.org.np/lekhani.htm>>.

## Appendix 1: Composite index of vulnerability to currency crisis – concept and measurement<sup>1</sup>

Vulnerability refers to susceptibility to a currency crisis – rapid financial capital outflows in anticipation of a sharp currency depreciation (devaluation), leading to reserve depletion, financial instability and economic contraction. Vulnerability itself does not lead to a currency crisis. A crisis happens when a trigger changes vulnerability into collapse.

### Measurements of vulnerability to currency crisis

Three factors determine a country's vulnerability to a currency crisis:

*Reserve adequacy.* Reserve adequacy assesses foreign exchange reserves in relation to short-term debts. A broad definition of short-term debts is used, covering non-FDI items with maturity of less than one year. After sudden capital outflows, the authorities might defend the currency and allow reserves to decline until confidence is restored. This policy is possible if, and only if, a country has adequate foreign reserves to offset potential capital outflows (short-term foreign liabilities).

*Financial fragility.* The total outstanding institutional credit lent to the private sector as a ratio of GDP is a widely used indicator of banking system soundness. A country with a rapid build-up of bank credit would have a more fragile banking system and more bad loans. In addition, a rapid build-up of credit may imply a growing share of lending to less creditworthy borrowers – a sign of a weakening banking system.<sup>2</sup>

A sound banking system is necessary when policymakers use interest rate policy to respond to a sudden decline of capital outflows. An interest rate increase helps maintain relative expected returns to investment by compensating for the potential loss of return due to the (expected) exchange rate depreciation, easing the downward pressure on reserves. An increase may also lower domestic absorption (private

consumption and investment), reducing the negative value of the net balance on current accounts – and again easing the downward pressure on reserves. But if domestic financial institutions are unhealthy, an interest rate increase is likely to lead to a domestic credit squeeze, bank failures and business bankruptcies and, ultimately, economic collapse.

*Real exchange rate.* The real exchange rate is approximated by available domestic and world price indices and nominal exchange rates. The real exchange rate is  $EP^*/P$ , where  $E$  denotes the nominal exchange rate,  $P^*$  is an index of foreign prices (approximated by producer (wholesale) prices) and  $P$  is an index of domestic consumer prices.  $E$  and  $P^*$  are weighted averages computed across trading partner countries.

A persistent and significant appreciation of the real exchange rate forces the Government to try to stem the capital outflow. To lower the pressure from the sudden outflows, the real exchange rate must depreciate to reduce the current account deficit. To stabilize the currency, authorities might implement a monetary or fiscal contraction to reduce non-tradable prices, leading to real depreciation rather than currency depreciation. But if the required magnitude of recession is too large, authorities may not be able to use this avenue.

### Composite index of vulnerability

The composite index provides a single measure of a country's vulnerability to a currency crisis.

To obtain a composite index, the three constructed indicators are converted into an index (1990 = 100) to unify measurements.<sup>3</sup> To combine them with equal weight, the geometric average is taken. The final step is to standardize the averaged value to create a composite index. The standardization method in this study is based on the following formula:<sup>4</sup>

$$V_{i,t} = \frac{X_{i,t} - \text{Min}X_{i,t}}{\text{Max}X_{i,t} - \text{Min}X_{i,t}}$$

where  $i$  = country and  $t$  = period. The variable  $V_{i,t}$  will be between 0 and 1. The higher the value of  $V_{i,t}$  the lower the vulnerability to a currency crisis.

<sup>1</sup> Most of the material in this appendix is drawn from Athukorala, P. and P.G. Warr (2002), pp. 33-57 and works cited therein.

<sup>2</sup> Although the standard indicators of banking system health, such as non-performing credit ratio and the capital adequacy ratio are examined, these measures have limitations. During a credit boom, creditors can arrange credit rollover through their banks (a process known as evergreening) and historical summary measures become adequate indicators of future performance.

<sup>3</sup> The ratio of private domestic credit over GDP is reversed in order to solve the directional problem in explaining the composite index.

<sup>4</sup> See the application of this formula in Briguglio (1995), pp. 1615-1632.

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