Maintaining growth in an uncertain world

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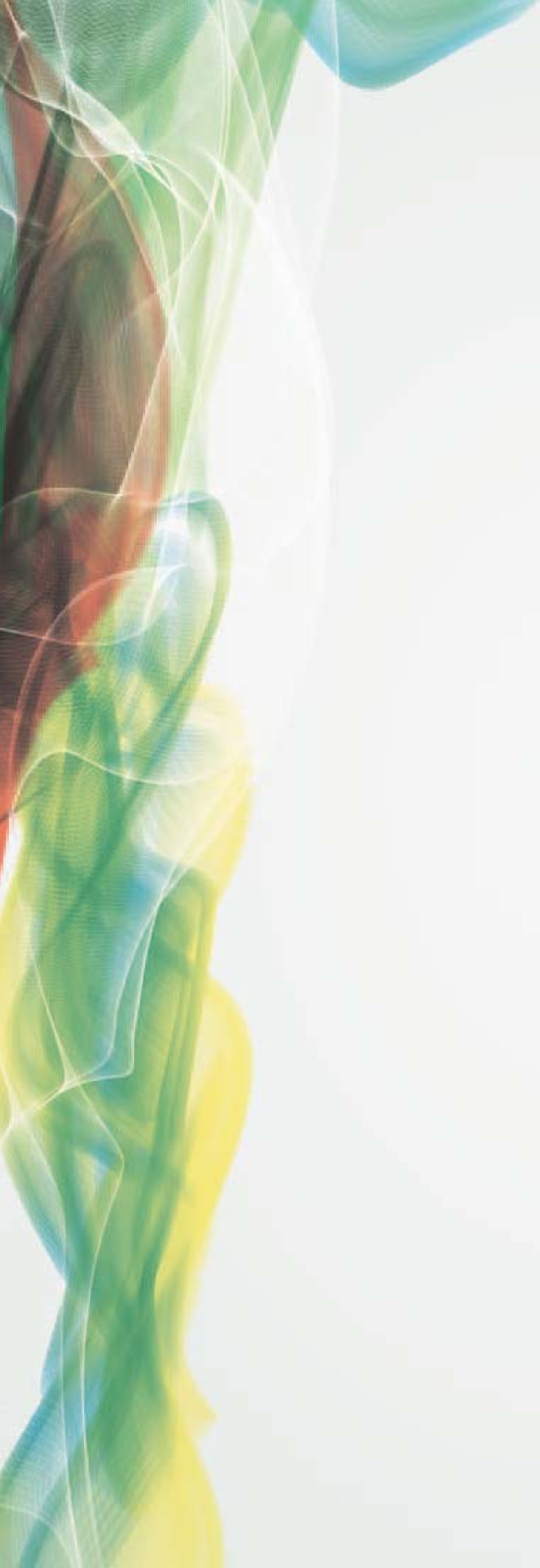


Maintaining growth in an uncertain world

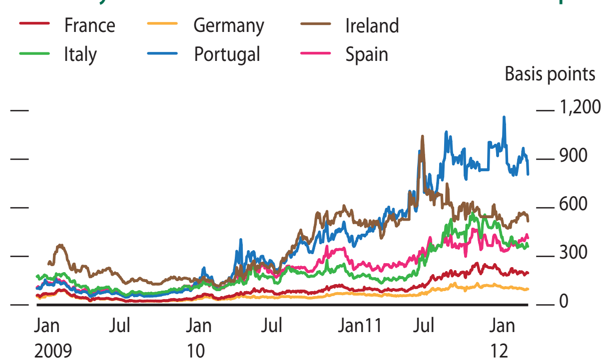
In 2011, the world's recovery from the 2008–2009 global financial crisis proceeded in fits and starts. The cautious optimism expressed by pundits in the early part of the year gave way to warnings of a "double dip" by midyear.

First, March's earthquake and nuclear disaster in Japan devastated its already faltering economy. Then the sovereign debt crisis in the eurozone periphery erupted, generating inadequate responses that were unable to convince financial markets that the situation would not get out of hand. Finally, partisan brinksmanship in the United States (US) over the national debt ceiling led to the first-ever loss of the triple-A rating on its long-term sovereign credit.

In the early months of 2012, caution rather than optimism is the more dominant sentiment for global prospects. The workout of Greece's sovereign debt in March 2012 did not convince investors that the crisis was fully resolved, as evidenced by continued elevated credit default spreads for other eurozone countries (Figure 1.1.1).

Developing Asia is feeling the weight of these weaknesses among the major industrial countries. Yet it has managed to grow, steadily. The worst of the global crisis may be past, but as 2011 demonstrated, policy makers need to be prepared for any eventuality. But the appropriate policy response is less clear than in the financial crisis years, given the current uncertain environment.

1.1.1 Ten-year US dollar-denominated credit default swaps



Source: Bloomberg (accessed 28 March 2012).

This chapter was written by Arief Ramayandi, Martin Bodenstein, Benno Ferrarini, Shikha Jha, Minsoo Lee, Donghyun Park, Pilipinas Quising, Changyong Rhee, Lea Sumulong, Akiko Terada-Hagiwara, and Joseph E. Zveglich, Jr. of the Economics and Research Department, ADB, Manila. Background materials from Steven Beck are gratefully acknowledged.

Steady growth amid global weakness

With sustained impulse from the major industrial economies unlikely for some time to come, economic growth in developing Asia will depend on its capacity to strengthen domestic demand and deepen trade ties with other fast-growing economies. Policy makers will need to navigate risks of commodity price spikes and volatile capital flows. But more importantly, they need to follow the only half-resolved eurozone debt problems closely, and be ready to act.

Major industrial economies: Erratic recovery

The disappointing growth performance of the major industrial countries in 2011, when growth of gross domestic product (GDP) fell to 1.2%, is expected to extend further into 2012 and even 2013 (Table 1.1.1). Fiscal consolidation efforts and weak private domestic demand growth will remain a drag on them. Japan's recovery from the March disaster has been uninspiring and developments overseas have also slowed the economy. In Europe, woes from the eurozone's sovereign debt crisis have given rise to a

1.1.1 Baseline assumptions for the international economy

	2010 Actual	2011 Actual	2012 *ADO 2012* projection	2013 *ADO 2012* projection
GDP growth (%)				
Major industrial economies [a]	2.8	1.2	1.1	1.7
United States	3.0	1.7	2.0	2.3
Eurozone	1.9	1.4	-0.5	1.0
Japan	4.4	-0.7	1.9	1.5
World trade (% change)				
Merchandise exports	14.5	5.8	3.8	5.4
Prices and inflation				
Brent crude spot prices (average, US$ per barrel)	79.6	110.9	111.0	106.0
Energy price index (2005=100, % change)	26.4	29.9	3.1	-3.1
Food index (2005=100, % change)	8.9	23.9	-9.0	5.0
CPI inflation (major industrial economy average, %)	1.2	2.4	1.6	1.8
Interest rates				
United States Federal funds rate (average, %)	0.2	0.1	0.1	0.1
European Union refinancing rate (average, %)	1.0	1.2	1.0	1.0
Japan interest rate (average, %)	0.1	0.1	0.1	0.1
US$ Libor [b] (%)	0.3	0.2	0.3	0.3

CPI = consumer price index.

a Average growth rates are weighted by gross national income, Atlas method (current US dollars).

b Average interbank quotations on 1-month loans.

Sources: US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp; World Trade Organization, http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary Fund, Primary Commodity Prices, http://www.imf.org; World Bank, Global Commodity Markets, http://www.worldbank.org; ADB estimates.

renewed recession. Positive news for these economies has come only from the US, which seems to have overcome a soft patch at the start of 2011 with late-year momentum expected to carry forward further into 2012. Yet even there, growth prospects are modest for the next 2 years.

The expansion in world trade (measured by merchandise exports) is expected to be modest, at around 3.8% in 2012, before picking up to 5.4% in 2013. Weak demand in several key economies remains the main factor in the slow growth. The anxieties felt after the global crisis hit, that economies would resort to protectionist measures, have largely quieted.

Looking at each economy in turn, budget cuts will strongly affect the US outlook. While the recovery in private demand will be able to offset them, it still lacks the momentum to take growth back up to precrisis rates. The housing market, though, is turning in some good news, as housing starts and permits have started to rise.

Against this, the unemployment rate is staying stubbornly high (Figure 1.1.2), despite some decline, and high household debt is crimping private consumption spending. Similarly, firms are reluctant to invest, given the modest growth outlook and significant spare production capacity. Still, inflation appears set to stay low and stable, suggesting that the Federal Reserve is unlikely to change the direction of monetary policy over the forecast period.

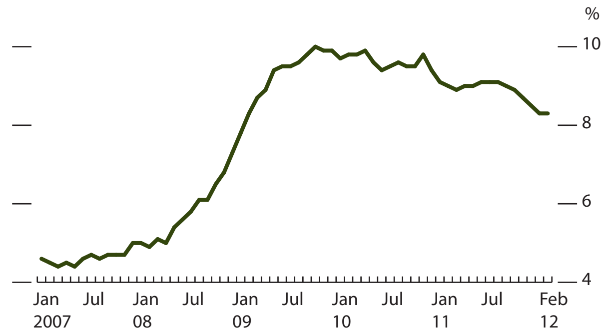
The eurozone, where GDP contracted in the last quarter of 2011, is the main global concern. Political controversy about the right approach to resolve the sovereign debt crisis (discussed in detail in Box 1.2.1, below), an interest rate increase by the European Central Bank (ECB) in July, as well as deep fiscal cuts across the bloc, all played a role.

In 2012, the eurozone is on course to see recession because of the implementation of fiscal consolidation measures, although with major differences among countries. The expected loss in momentum is reflected in softening industrial confidence (Figure 1.1.3). In sharp contrast to 2011, however, the ECB, by bringing interest rates back down and pumping about €1 trillion into eurozone banks, has removed doubts about its willingness and ability to act as lender of last resort, easing the impact of political disagreement among member countries on the course of the debt crisis.

In Japan, although reconstruction efforts started to be felt in the second half of 2011, supply-chain disruptions after Thailand's floods in August–November 2011, a persistently strong yen (Figure 1.1.4), and faltering foreign demand contributed to stymie any real improvement in macroeconomic conditions.

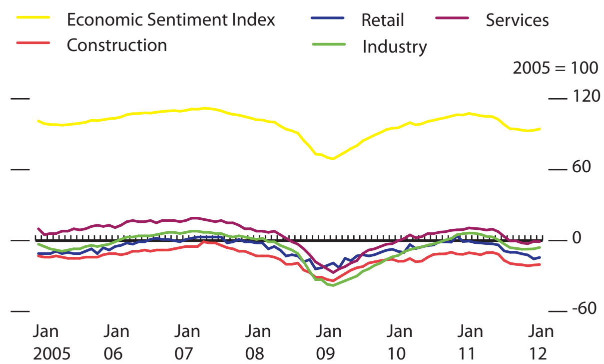
Japan's 2012 performance should be somewhat better because of the low base last year (when the economy contracted) and continued reconstruction expenditure. Growth will taper off to 1.5% in 2013, which is close to the economy's potential growth rate, as no further supplementary budgets are likely.

1.1.2 Unemployment, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 28 March 2012).

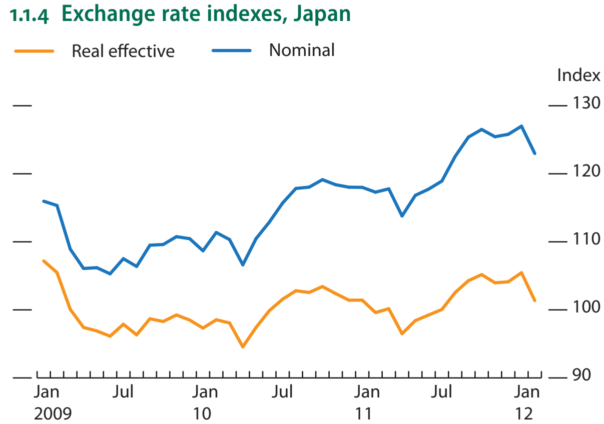
1.1.3 Economic sentiment index and subindexes, eurozone



Notes: Since January 2012, the weighting scheme used to calculate composite indicators and the long-term average are revised in January. This can lead to slight revisions in past data (see User Guide for more information) during that month.

Source: Directorate General for Economic and Financial Affairs. http://ec.europa.eu/dgs/economy_finance/index_en.htm (accessed 8 March 2012).

1.1.4 Exchange rate indexes, Japan



Note: An increase in the index denotes appreciation.

Source: CEIC Data Company (accessed 31 March 2012).

Growth in developing Asia: Moderating, but persistent

Developing Asia started to feel the impact of the most recent global slowdown late in 2011. Its growth moderated to 7.2% for the full year—down from the post–global financial crisis rebound of 9.1%. This was partly the effect of the higher base after the strong growth in 2010, but also the impact of normalizing fiscal and monetary policy. This moderating trend is expected to continue into the near future, taking regional growth to 6.9% in 2012, before it picks up to 7.3% in 2013 (Figure 1.1.5). Domestic private demand is driving growth, helping narrow current account surpluses, while inflation pressures are currently in check.

Importance of private domestic demand

As the global recovery seemed to be taking hold in late 2010 and early 2011, authorities in developing Asia began to normalize monetary and fiscal policy. Consequently, the effects of the policy stimulus—launched to cushion the global crisis impacts—dissipated, and the role of domestic private demand became more important in driving developing Asia.

However, the slowdown in the major industrial countries in mid-2011 (especially the heightened uncertainty emanating from the eurozone) and the deteriorating terms of trade from elevated oil prices helped slow the region's growth. As a result, the engines of growth in 2011 were not as uniform and robust as those in 2010. Among 10 leading economies, which account for 93% of the region's output, investment's contribution to growth dropped sharply in seven (Figure 1.1.6).

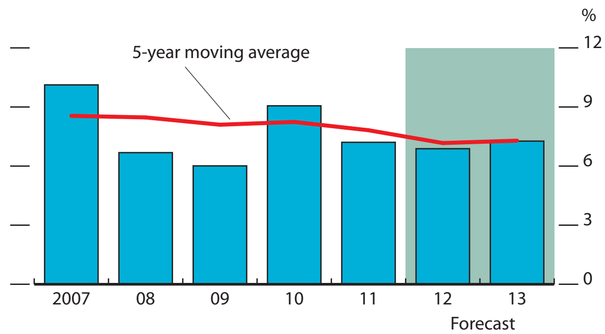
Investment weakened sharply toward end-2011, weighing on the outlook for the coming quarters, particularly in open economies such as Hong Kong, China; the Republic of Korea; Malaysia; Taipei,China; and Thailand. The fading contribution of investments in 2011 is characterized by inventory destocking in four out of six economies (Figure 1.1.7), a trend that resembles the path in the immediate postcrisis year.

Assuming that the global economy gradually picks up toward end-2012, private investment and restocking of inventories are expected to drive capital formation this year, though moderately. (In Thailand, it will be public investment, to support post-flood reconstruction.) The PRC economy is set to make a soft landing after growth averaged above 10% in the 5 years 2007–2011—steadily declining credit growth suggests investment will likely moderate—unless the authorities push through a further stimulus to mitigate the effects of the decline in trade.

Backed by the steady improvement in labor markets, however, private consumption appeared to hold up well in 2011, albeit to a lesser degree. Unlike the previous year, it became the one common growth driver in 2011.

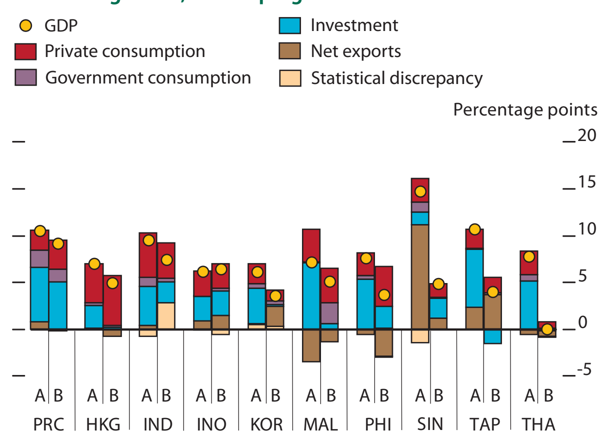
Up-to-date unemployment data are sparse, but among nine

1.1.5 GDP growth, developing Asia



Source: Asian Development Outlook database.

1.1.6 GDP growth, developing Asia

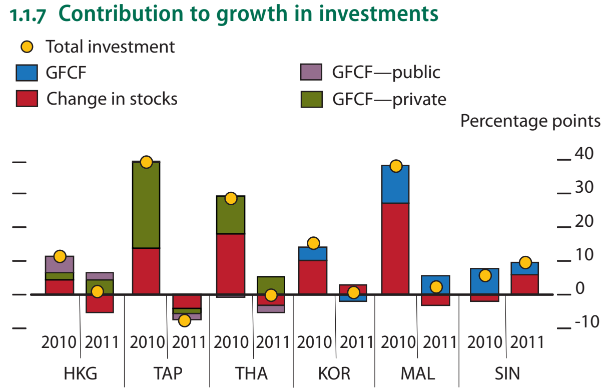


A = 2010; B = 2011.

Note: 10 countries with available data on GDP by expenditure.

Source: CEIC Data Company (accessed 15 March 2012).

1.1.7 Contribution to growth in investments



GFCF = Gross fixed capital formation; HKG = Hong Kong, China; KOR = Rep. of Korea; MAL = Malaysia; SIN = Singapore; TAP = Taipei,China; THA = Thailand.

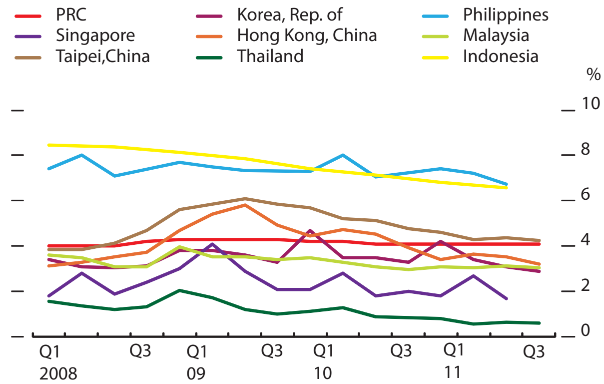
Note: Economies for which data are available.

Source: CEIC Data Company (accessed 15 March 2012).

East and Southeast Asian economies, unemployment has declined to closer to pre–global crisis rates, if not below (Figure 1.1.8). While rising real wages in some countries may continue lifting consumer sentiment a little, the chances appear slim.

Indeed, retail sales—showing signs of deceleration in four economies in East Asia that account for around two-thirds of developing Asia's GDP—suggest that private consumption may slow this year (Figure 1.1.9). Of the nine economies, relatively bright spots for retail sales are in Southeast Asia: Indonesia and Viet Nam are forecast to maintain growth this year and to accelerate further next year. Thailand showed a sharp deterioration in retail sales after the devastating flooding, but is expected to join the relatively resilient economies of the subregion this year in recovery. Other more open economies in Southeast Asia, however—Malaysia and Singapore—may follow the East Asian economies.

1.1.8 Unemployment



Source: CEIC Data Company (accessed 15 March 2012).

Varying growth drivers across subregions

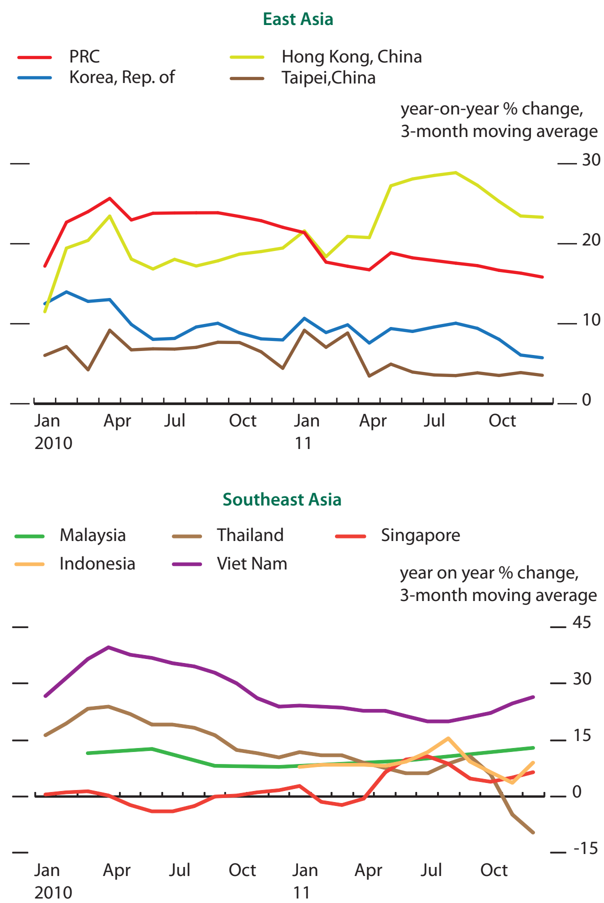
From the collapse of Lehman Brothers in September 2008 through the initial stages of the global recovery in 2010, external factors generally dominated developing Asia's outlook such that countries and subregions largely moved in sync. In contrast, 2011 has seen general factors give way to country-specific factors driving the outlook.

As external demand has swung less widely—although it is still softer than before the global crisis—country- or subregion-specific shocks are playing an important role, leading to variation among economic trends at those levels. Factors include natural disasters, the availability of resources, and the strength of domestic demand.

The deteriorating global outlook in the second half of 2011 affected directly the contribution to growth of net exports and indirectly investment and consumption. The deteriorating terms of trade from elevated oil prices also contributed (Figure 1.1.10). East Asia's vulnerability to slowing external demand—especially from major industrialized countries—is well illustrated by the Republic of Korea's slump. That country's growth rate in 2011 fell by a full percentage point below what had been forecast but consistent with altered expectations concerning the eurozone, the US, and Japanese economies. Investment was flat, as businesses and investors became much more cautious. Despite the uncertain global context, exports increased by 20% and accounted for more than 50% of GDP growth.

This is generally the storyline for all five countries in East Asia. In some cases negative net exports (e.g., the PRC) or a narrowing of a positive net export position (Hong Kong, China) are seen. In Taipei,China, a sharp drop in the growth of exports was more than offset by an even bigger drop in import growth. East Asia's exports of goods and services, or the buildup for a surge in exports, as with Mongolia's mining sector, were—and remain—the dominant factor in growth. East Asia's growth projections for 2012 and 2013 rest importantly on the outlook for external demand.

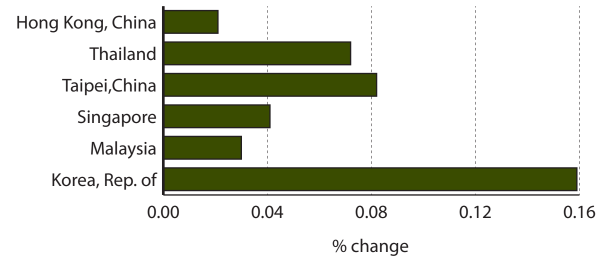
1.1.9 Retail sales



Source: CEIC Data Company (accessed 15 March 2012).

East Asia's growth will moderate to 7.4% in 2012 but will still lead the other subregions (Figure 1.1.11). An uptick to 7.7% is forecast for 2013. Growth for the PRC is forecast to moderate to 8.5% and 8.7% in the next 2 years (though this still exceeds the growth envisaged in the 12th Five-Year Plan). Hong Kong, China; the Republic of Korea; and Taipei,China are all expected to experience continued growth below their potential growth, which for these countries is in the range of 4–5%.

1.1.10 Terms of trade, East and Southeast Asia



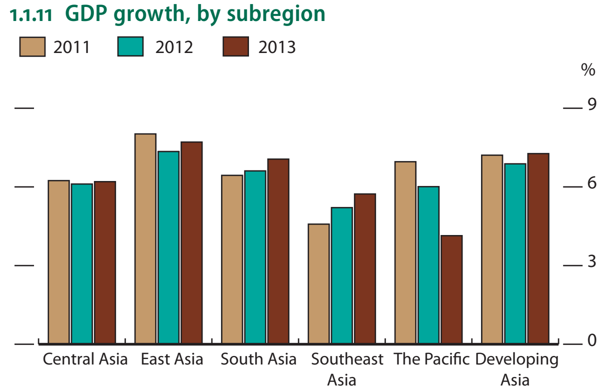
Note: Terms of trade is computed as ln(2010 peak/2011 trough).
Source: CEIC Data Company (accessed 2 April 2012).

In Southeast Asia, GDP growth decelerated to 4.6% in 2011, hard hit by weakened export markets (as in East Asia), domestic policy tightening, and natural disasters disrupting trade and production—only partly redeemed by strong growth in the largest economy, Indonesia. Rising inflation in the first half of 2011 prompted monetary policy tightening in most countries. Furthermore, fiscal stimulus instituted during the global recession continued to be withdrawn in several countries. In particular, government outlays fell steeply in the Philippines, in part because an introduction of governance reforms delayed decisions and disbursements, hurting GDP growth.

Growth in Southeast Asia is seen picking up to 5.2% for 2012 and to 5.7% in 2013. The pickup in 2012 largely reflects recovery in Thailand from major flooding as growth rebounds from 0.1% in 2011 to 5.5% in 2012. The Philippines will also contribute by picking up from bouts of weakness last year in electronics and government investment. Indonesia will continue its solid performance, expanding by 6.4% in 2012 and 6.7% in 2013.

Economies in Southeast Asia would generally benefit for much of 2012 from space for easing monetary policies, and fiscal stimulus if global trade and financial conditions deteriorate further. Still, slowing world trade and international financial uncertainties will damp economic activity, notably in trade-dependent Malaysia and Singapore, where growth is set to slow this year.

1.1.11 GDP growth, by subregion



Source: Asian Development Outlook database.

For South Asia, growth in 2011 fell sharply to 6.4% from 7.8% in 2010. The fall was largely determined by the marked slowdown in India where growth fell to 6.9% from 8.4% in 2010, mainly reflecting its marked monetary tightening in the face of persistent inflation and slumping investment. Growth in Pakistan declined in 2011 because of disastrous flooding, although Bangladesh and Sri Lanka did well on brisk exports.

South Asia will see growth improve a shade in 2012 to 6.6%. The pace of India's growth is projected to edge up to 7.0% in 2012 and 7.5% in 2013, providing most of the lift for subregional growth to reach 7.1% in 2013. Despite recovery from flooding, Pakistan's growth will advance only slightly in both years as electricity will remain a bottleneck on the supply side. Growth in Bangladesh is expected to be limited to about 6%, well below the government's objective, as policies will need to contain inflation and a deterioration in the balance of payments.

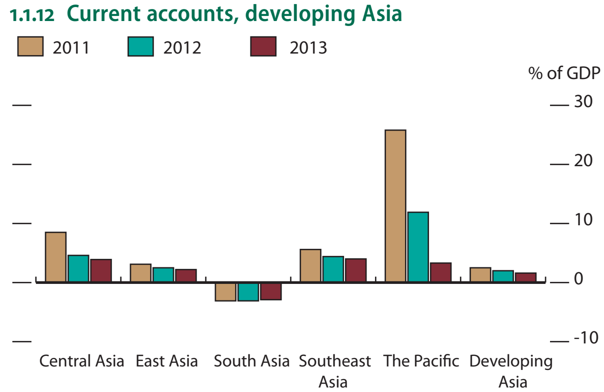
In Central Asia, growth declined in 2011 to 6.2% from 6.6% in 2010, as a drop in oil production led to virtually zero growth in Azerbaijan, where closure of one of its three oil platforms for safety reasons caused a drop in oil output. Yet six of the eight countries saw higher growth, on continued economic recovery in the Russian Federation and the US, plus stronger eurozone demand for commodities. For Kazakhstan, the economy expanded by 7.5% as a steep rise in natural gas exports offset a decline in oil production, and good weather more than doubled its grain output.

Central Asia should just about keep up the momentum at 6.1% in 2012 and 6.2% in 2013. This year's outturn reflects the combination of a weak eurozone and slower growth in the Russian Federation, offset by a bounceback in growth in Azerbaijan. In 2013, a more favorable outlook for the global economy, including the Russian Federation, is expected to raise growth rates in five countries, balanced by declining growth in three.

Pacific countries are quite insulated from events in the eurozone. Robust expansion in the resource-exporting economies of Papua New Guinea (accounting for roughly half of Pacific GDP), Timor-Leste, and Solomon Islands, and strong growth in the tourism-oriented economies of Cook Islands, Fiji, Palau, and Vanuatu, lifted subregional growth to 7.0% in 2011—making this the only subregion to post faster growth in 2011 than 2010.

Yet the Pacific is forecast to slow to 6.0% and 4.1% over the next 2 years due to lower resource export revenue, the winding down of infrastructure projects that stimulated growth in 2011 (Papua New Guinea, the Marshall Islands, and Vanuatu), lower international agricultural prices, and flooding impacts (Fiji). While tourism is expected to continue to support growth, remittances are not expected to recover in the near future in view of the weak economic outlook.

1.1.12 Current accounts, developing Asia



Source: Asian Development Outlook database.

Narrowing current account surplus

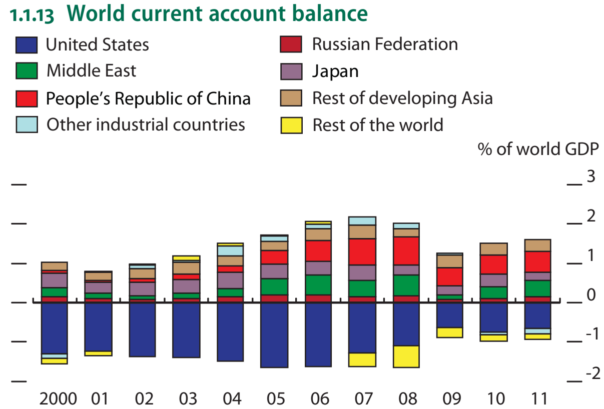
Developing Asia's current account surplus continued narrowing, to 2.6% of GDP in 2011 from 4.0% the previous year. Contributing factors were a moderation in demand for exports and the upward impact on imports of solid domestic demand and higher prices for imported oil and commodities. The surplus is expected to decline further in 2012 to 1.9% of GDP, marking the combined impact of most regional economies' continued growth in demand for consumer and capital imports and of soft global demand for exports (Figure 1.1.12).

Global imbalances further widened as a share of global GDP in 2011, though they remain well below their precrisis peaks (Figure 1.1.13). On the deficit side, the rise in saving and fall in investment in the US was offset by the widening deficit in major eurozone economies.

On the surplus side, resource-rich economies in the Middle East as well as the Russian Federation expanded their current account surpluses, backed by the surges in oil and commodity prices. Although declining as a share of its own GDP, developing Asia's robust growth increased the relative size of the region such that it continued to account for about half the global current account surplus (1.6% of world GDP) in 2011.

This suggests, then, that efforts for structural adjustments in various sectors are needed. With a more favorable growth outlook vis-à-vis the US, eurozone, and Japan, developing Asia could take the opportunity of further strengthening its domestic policies to support the structural adjustments toward a better balance between domestic and external demand, leading to more sustainable growth.

1.1.13 World current account balance



Sources: ADB calculations using data from International Monetary Fund, World Economic Outlook Database, September 2011; *Asian Development Outlook* database.

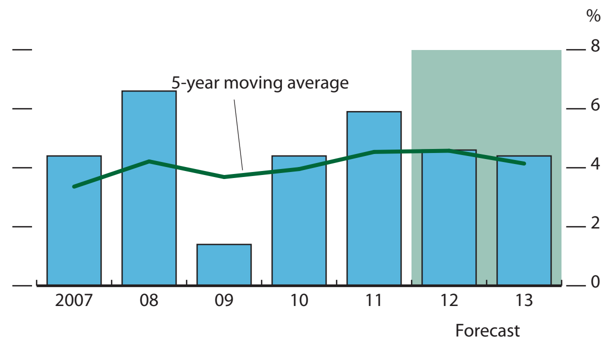
Inflation subdued—but oil could give a nasty shock

The recent rising trend in global commodity prices is expected to pause, tempering inflationary pressures (Box 1.1.1). Despite the recent surge in crude oil prices driven by Middle East political instability, the average oil price is forecast at $111 per barrel in 2012, roughly its 2011 average. Continued slow recovery in industrial countries and decelerating economic growth in emerging economies will damp growth in oil demand.

In 2013, oil prices are forecast to diminish a little to $106 per barrel. Although staying high, food prices are projected to decline in 2012 and 2013 from their 2011 peak, reflecting improved supply prospects and weak demand growth.

Across subregions, higher food and fuel prices drove up inflation in developing Asia to 5.9% in 2011 from 4.4% in 2010 (Figure 1.1.14). In Central Asia, South Asia, and the Pacific, average inflation rates reached around 9% in 2011 while it was more moderate in East and Southeast Asia, where inflation continued to be contained at around 5%. Among the five subregions, though still at a relatively higher level at 9.4%, South Asia was the only subregion that managed to avoid the hike last year. This was due to India's sustained monetary tightening (at a cost to economic growth) to combat persistent high inflation, which damped inflation from 9.6% in 2010 to 9% 2011 and managed to offset the climb in Maldives and Pakistan.

1.1.14 Inflation, developing Asia



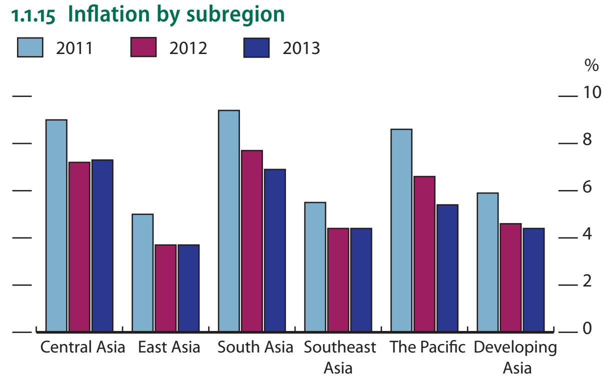
Source: Asian Development Outlook database.

In Central Asia during 2011, average inflation increased from 7.0% in 2010 to 9.0%. Prices climbed faster in every country except Armenia, where monetary tightening and an improved harvest restrained them. The increases were especially sharp in the Kyrgyz Republic and Tajikistan, where spikes in food prices during the first half of the year caused average inflation rates roughly to double. For the Pacific, the rise in inflation in Papua New Guinea and Timor-Leste drove up the subregional average from 5.5% to 8.6% in 2011.

For East Asia as a whole, inflation was 5% in 2011, up from 3.1% in 2010. The rebound of growth in East Asia in 2010, tying over into the early part of 2011, alongside rising food, oil, and other commodity prices, sparked the inflation resurgence. Highly accommodative monetary policies and the residue of fiscal stimulus were other factors. Likewise in Southeast Asia, higher food and fuel prices drove up inflation to 5.5% from 4.1%. Average inflation exceeded 5% in half the 10 countries.

Inflation in developing Asia is set to recede as economic activity softens. Assuming relatively steady global oil prices and easing food prices in 2012, regional average inflation is forecast to slow to 4.6%. Besides the external price developments, domestic policies may play a role in, for example, South Asia, where some reduction in heavy fuel and power subsidies are expected, and will set a floor for any reduction in inflation. For 2013, further deceleration is expected in South Asia and the Pacific, while other subregions are seen continuing flat, taking the regional average down to 4.4% (Figure 1.1.15).

1.1.15 Inflation by subregion



Source: Asian Development Outlook database.

Still, policy makers cannot take this favorable trend in inflation for granted, and among the three main risks to the outlook, the risk of a spike in inflation looms.

Risks to the outlook

Commodity price spikes

Despite the nominal heights discussed above, commodity prices are well below their 1970s' real terms levels—even the 2007–2008 price spike failed to take them back. Recent price volatility, though, as measured by the standard deviation of price movements, is higher. Indeed, commodity prices are becoming more volatile and, as such, disruptive, heavily affecting poor households (too many subsidies are mistargeted or are slow to come into play), as well as low-income countries that are heavy food and fuel importers.

Commodity price spikes by themselves will not produce sustained inflation, but they can hinder economic growth by raising macroeconomic vulnerability, eroding producer profits, or hitting household incomes. With non-OPEC oil supply providing little cushion to total supply (and the ever-present possibility of unplanned outages), the relatively benign view of near-term oil price movements could switch overnight if geopolitical tensions blow up. For food, market sentiment is affected not so much by low production prospects but more by uncertainty on the sufficiency of supply to meet ever-increasing demand under extreme weather disturbances.

Food price spikes as well are a key risk to the inflation outlook, given the weight of food in the region's consumer price indexes. In addition to the knock-on effects of oil price movements, natural disasters—the frequency of which has multiplied 10-fold between 1960 and 2010—play havoc on food price expectations. With greater uncertainty about the sufficiency of supply to meet ever-increasing demand under extreme weather disturbances, market sentiments can shift abruptly.

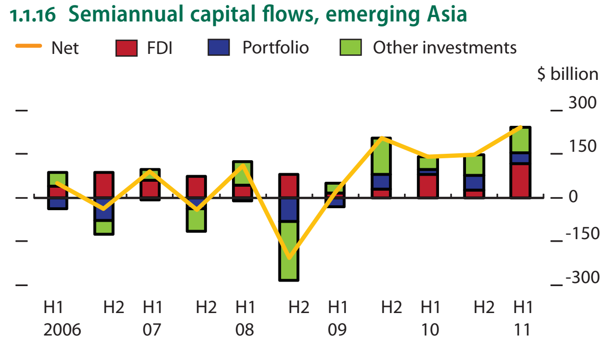
Volatile capital flows

Investor uncertainty over the advanced economies' recovery prospects intensified capital-flow volatility—capital tends to flee the region when global risk aversion intensifies, and to return when it eases. Inflows to Asia rebounded strongly after their huge drop during the last global economic downturn (Figure 1.1.16), but the movements are erratic.

The trend slowed in the first 3 quarters of 2010, then surged again through the first half of 2011. This pickup was driven by huge increase in net inflows of currency and deposits (Figure 1.1.17), as regional policy makers raised interest rates to deal with inflationary pressures. But the worsening debt crisis in Europe and the downgrade by Standard and Poor's of US long-term sovereign credit rating in the third quarter of 2011 caused investor sentiment to swing. As investors became much more risk averse, net capital inflows to the region plunged (though just stayed positive).

Trends vary among the countries of developing Asia. Flows to the PRC—with its high inflows of FDI—tend to dominate regional figures. Although trends in the components contributing to the net inflows are similar, the spike in the

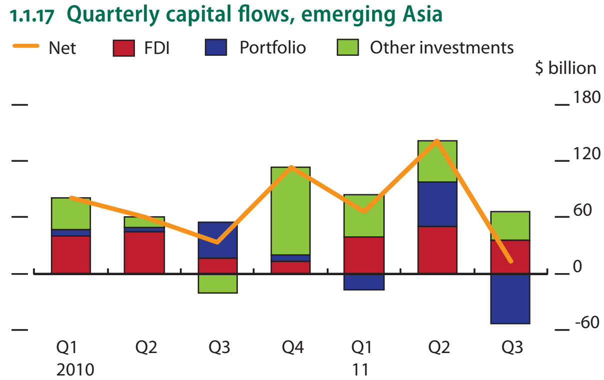
1.1.16 Semiannual capital flows, emerging Asia



Notes: 1. Emerging Asia consists of People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. 2. Other investments comprise trade credits, loans, currencies and deposits and others.

Source: ADB estimates based on data from CEIC Data Company (accessed 15 March 2012).

1.1.17 Quarterly capital flows, emerging Asia



Notes: As previous figure.

Source: ADB estimates based on data from CEIC Data Company (accessed 15 March 2012).

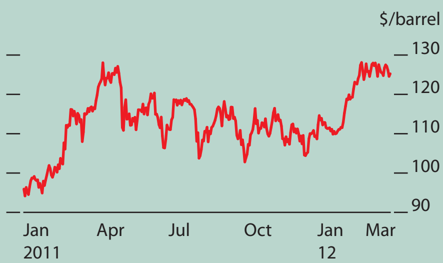
1.1.1 Key commodity price trends and prospects

Recent oil price movements

Wide gyrations characterized the oil price path in 2011. The promise of a firming global recovery in the early part of the year led to an initial spike, but prices fell back as the optimism faded. Political instability in the Middle East clouded oil supply expectations, adding further volatility to prices. The spot-market price of Brent crude ended the year 14% higher than it began it, averaging $111 a barrel for the year. The annual average price far exceeded the previous record of $98 set in 2008—the year of the inflating and bursting of the oil price bubble.

The first quarter of 2012 has seen another spike in prices, of more than 15% (Box figure 1). Oil futures prices have been as volatile as spot prices, amid heightened political and economic tensions.

1 Price of Brent crude



Source: Bloomberg (accessed 30 March 2012).

Supply factors drive oil price volatility

Supply-side constraints are the primary factors behind the recent upsurge in oil prices. Supply interruptions have surfaced in South Sudan, Yemen, Syria, and Libya. Conflict has exacerbated the existing tight supply conditions by creating geopolitical nervousness. Moreover, the output of Iran, the world's third-largest crude oil exporter, has fallen to a 10-year low, crippled by US sanctions against financial institutions that deal with Iran. It may fall further as the EU embargo on Iranian oil imports takes full effect by mid-2012.

Spare capacity is quite tight. According to the International Energy Agency, Saudi Arabia's was only 1.9 million barrels per day (mb/d) in February 2012, against 11.9 mb/d of declared capacity. More widely, OPEC's spare oil production capacity declined to an average of 2.8 mb/d in the first 2 months of 2012 from an average of 4.5 million for the same period a year earlier.

In mid-March, the agency lowered its full-year 2012 non-OPEC production forecast from 0.9 mb/d to 0.73 mb/d. Strategic petroleum reserves have not been used to mitigate supply constraints as countries such as France, Germany, and the US are trying to boost (or maintain) their reserves. Moreover, output of the petroleum substitute, ethanol, is on the decline.

Despite this, supply conditions are expected to improve in 2012. Global oil supply is projected to rise by about 2 mb/d, more from OPEC than non-OPEC countries. Saudi Arabia has increased its production to counter the reduction from other countries, and its output is at a 30-year high, though this comes at the expense of further squeezes on spare capacity. Libyan output is rapidly recovering to prewar levels. Output is also expected to rise in Angola, Iraq, and Nigeria, as tensions ease there. Many producing countries are adopting modern technology to extract more oil from the fields. These changes should counter shortages arising from Iran.

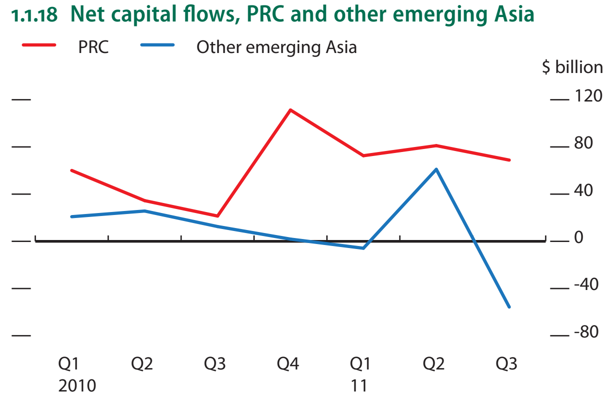
Demand factors dominate the oil price outlook

Oil demand had been picking up in 2010 as the world economy bounced back from the trough of the global economic crisis, but slowed sharply in 2011 to only 0.8% growth. Soft demand in advanced economies affected commodity demand directly and indirectly by tempering the growth of emerging markets (and hence their energy demand).

total net capital inflows was not observed elsewhere in Asia (Figure 1.1.18). Further, driven by massive portfolio outflows, net capital inflows to developing Asia (excluding the PRC) dived deep into a negative territory in the third quarter of 2011 as global risk aversion intensified. Some slowing indication in the strength of the net capital inflows was also apparent for the PRC, particularly due to much slower inflows of portfolio and other investments (the more volatile part of capital inflows).

Given the likely prolonged period of loose monetary policy in the major industrial countries, an easing of global risk aversion could cause another round of strong capital flows to developing Asia. This could complicate regional policy makers' efforts by once again stoking inflation and pressuring exchange rate appreciation. Yet the risk of sudden and massive outflows also remains if global risk aversion becomes acute. Such an

1.1.18 Net capital flows, PRC and other emerging Asia



Notes: Other emerging Asia consists of Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

Source: ADB estimates based on data from CEIC Data Company (accessed 15 March 2012).

1.1.1 ***(continued)***

So while prices are expected to remain elevated above $100 per barrel in 2012 and 2013 because of the relatively tight supply conditions, soft demand will suppress oil price growth.

The oil price is expected to remain around its 2011 level in 2012 (about $111 per barrel), slipping to $106 in 2013 (Table 1.1.1 above), as continued soft demand growth in the major industrial countries and some increase in supply eases market conditions a little.

Recent food price developments

Food is usually the main contributor to agricultural price movements (Box figure 2). Generally flat after the collapse in 2008, prices surged in 2011 to average 24% more than a year earlier. Although slowing by year-end, the benchmark food price index of the World Bank lingered at levels seen in the 2008 peak, especially after the pickup in early 2012.

Grain prices (including corn, rice, and wheat) led other food prices. From the third quarter of 2011 corn and wheat prices retreated, reflecting improved supply from better weather. Rice prices, however, gained strength, mainly due to policy changes in Thailand, the world's top exporter. Rice prices rose in July as Thai farmers withheld rice from the export market following a government pledge to pay farmers above the market rate. International prices then stayed firm as the government implemented the policy in early October.

This, coupled with the harmful effects of floods in several countries in Southeast Asia (including Thailand itself and Viet Nam) supported rice prices. On the other hand, India relaxed export restrictions, which helped check price increases.

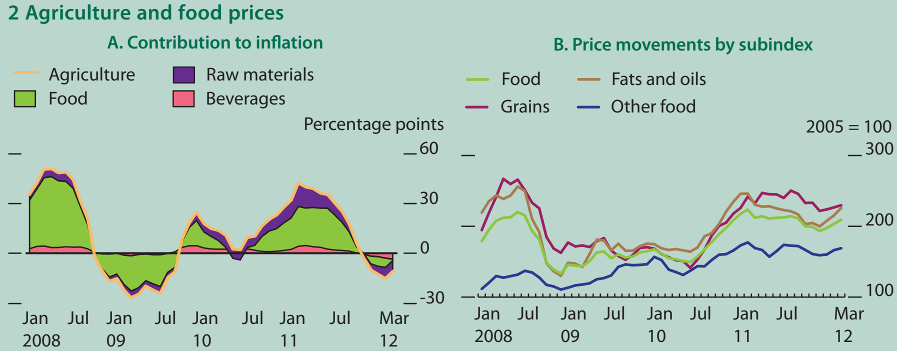
Food price prospects

The food price pickup in early 2012 stemmed from worries about poor weather in South America and Europe, renewing concerns about food security: March 2012's food price index was barely 6% below its February 2011 peak. Notwithstanding elevated and volatile prices in the short term, the full-year projection for 2012 shows a more comfortable picture.

According to the February 2012 World Agricultural Supply and Demand Estimates of the US Department of Agriculture, global production and stocks are generally stronger as harvests of major cereals are at record levels. Increased production of wheat is expected from major exporters (Australia, Canada, and EU-27), as well as from smaller producers. Corn production is also projected to increase. India, Pakistan, the PRC, and Egypt are expected to produce more rice, developing Asia's major staple crop.

Taken together, food prices in 2012 are projected to decline by 9% from 2011's levels on improved supply prospects and weak demand growth resulting from slowdowns in emerging and advanced economies. But a pickup in demand in 2013 should lead prices to rebound somewhat.

2 Agriculture and food prices



Source: World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 5 April 2012).

event could squeeze international capital markets and local financial systems, sharply undercutting economic activity.

The biggest shadow: How will the eurozone debt crisis play out?

Even with developing Asia's growing weight in the world economy, the global crisis offered a vivid reminder of the region's vulnerability to the major industrial economies' downturns. And just a few years after that crisis, developing Asia now faces another major external threat to its growth—this time from Europe. The sovereign debt crisis afflicting Greece and other eurozone economies is the single biggest downside risk to the current global outlook. If the worst case materializes, is developing Asia in a position to counteract the effects?

Eurozone uncertainties and developing Asia

The eurozone sovereign debt crisis still awaits a fundamental resolution, despite signs of progress made by the key players—the European Financial Stability Facility (EFSF) and its planned replacement, the European Stability Mechanism (ESM), and the European Central Bank (ECB) (Box 1.2.1). As agreement was reached on an orderly solution for Greece's debt, the immediate risk of disorderly default appears to be receding, and with it, the risk that the situation could morph into full-fledged financial instability, in tandem with a global liquidity crisis.

Almost all member countries of the eurozone have adopted fiscal austerity measures, to secure fiscal sustainability in the bloc and to affirm their long-term commitment to the euro. These measures, coupled with banks' moves to repair their balance sheets, have changed the nature of the eurozone's problems from immediate crisis and financial instability to protracted, feeble growth.

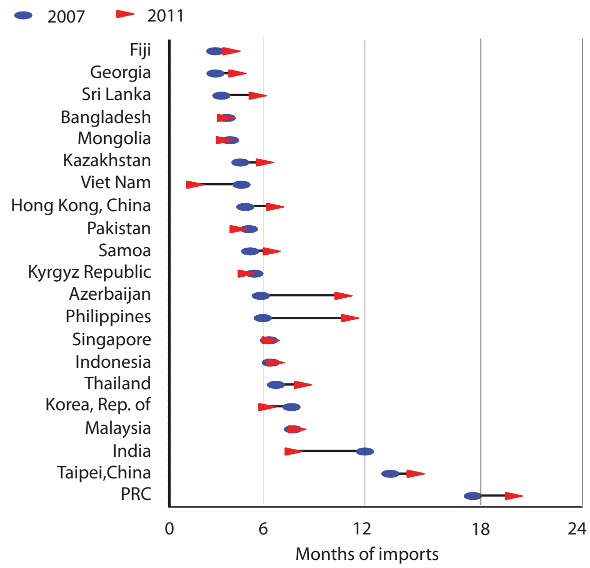
For developing Asia, the nature of the primary risk has changed as well, from financial contagion to slower export growth. The eurozone—and the EU more broadly—is an important trade partner for the region and a major source of its FDI and other capital inflows. As discussed throughout this part of *Asian Development Outlook 2012*, the on-off nature of the euro crisis has been a factor in developing Asia's slower growth in 2011 and is clouding its near-term outlook.

Although continued weakness in the eurozone has been factored into the forecasts, what if the situation worsens? Examining the nature of developing Asia's finance and trade links with the eurozone will help identify where the vulnerabilities lie.

Vulnerability to finance and trade shocks from the eurozone

Developing Asia is in a good position to withstand another external shock. Foreign exchange reserves exceed the 3-month import coverage rule of thumb in almost all economies (Figure 1.2.1). For the PRC, the figure is a whopping 20 months. Taipei,China as well has reserves equivalent to more than a year's worth of imports. The global crisis had little impact on these levels, and most economies—except for India, the Republic of Korea, and Viet Nam—have maintained or further bolstered their reserves since then.

1.2.1 Foreign exchange reserves, selected developing Asian economies, 2007 and 2011

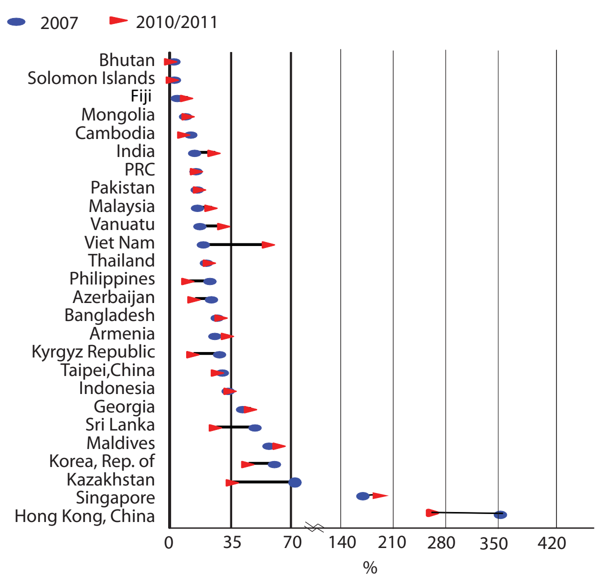


PRC = People's Republic of China.

Note: Latest data for Azerbaijan, India, and Sri Lanka refer to 2010. Imports refer to goods and services except for Kyrgyz Republic and Samoa, in which only goods imports are included.

Sources: ADB calculations based on data from *Asian Development Outlook* database, CEIC Data Company, and International Monetary Fund, International Financial Statistics online database (all data accessed 30 March 2012).

1.2.2 Short-term debt-to-reserves ratio, selected developing Asian economies



PRC = People's Republic of China.

Note: Latest data refer to 2010 for Armenia, Azerbaijan, Bangladesh, Bhutan, Cambodia, Fiji, Georgia, Kazakhstan, Kyrgyz Rep., Mongolia, Pakistan, Solomon Islands, Sri Lanka, Thailand, Vanuatu, and Viet Nam. For the rest, latest data refer to Q3/Q4 2011.

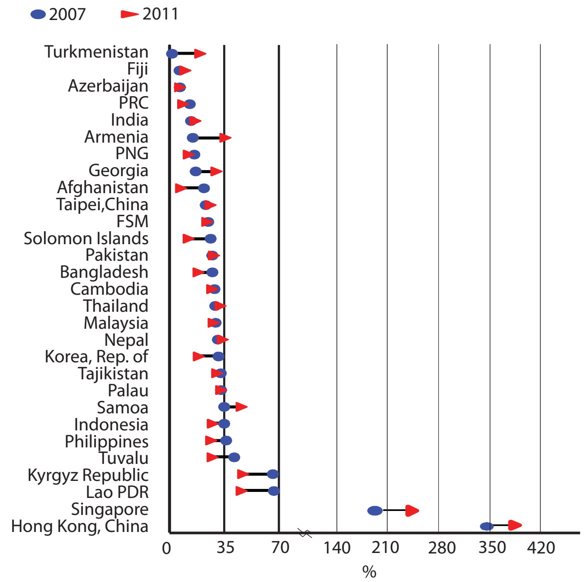
Sources: As previous figure.

External debt indicators in developing Asia are also quite low (Figure 1.2.2). For most economies, short-term debt is less than 30% of foreign exchange reserves, and as low as 11% in the Philippines and 16% in the PRC. The exceptions are Hong Kong, China (250%) and Singapore (200%)—the region's global financial hubs—as well as the Republic of Korea (46%) and Viet Nam (58%). Similarly, other than the two financial centers, external debt is low as a share of GDP (Figure 1.2.3). Further, the ratios of both short-term external debt to reserves and of external debt to GDP have fallen in several countries from their precrisis levels in 2007. The low external debt exposure—particularly short-term debt—shows that the region is well placed to see out a temporary credit crunch.

Looking at some standard indicators of banking soundness, developing Asia's commercial banks—the largest component of its finance sector—are generally strong. Risk-weighted capital-adequacy ratios ranged from 11.8% in PRC to 20.4% in Armenia (Figure 1.2.4) (versus an average of 15.5% in the US and 17–18% in Brazil and the Russian Federation). The region's banks also generally have low rates of nonperforming loans. In Hong Kong, China and Taipei,China, less than 1% of loans are nonperforming (Figure 1.2.5). The average for the region is about 4%, similar to levels in the US.

Yet the 2008–2009 global crisis demonstrated that a strong enough shock emanating from the major industrial countries can still have heavy consequences for developing Asia's stability.

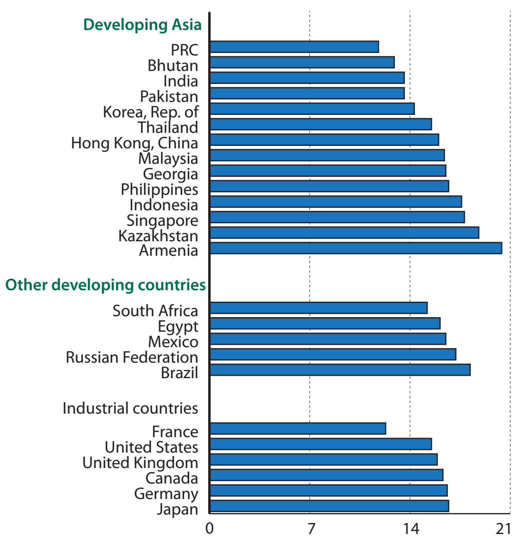
1.2.3 External debt-to-GDP ratio, selected developing Asian economies



PRC = People's Republic of China; FSM = Federated States of Micronesia; PNG = Papua New Guinea.

Source: Asian Development Outlook database.

1.2.4 Risk-weighted capital adequacy ratio, selected developing Asian economies, 2011

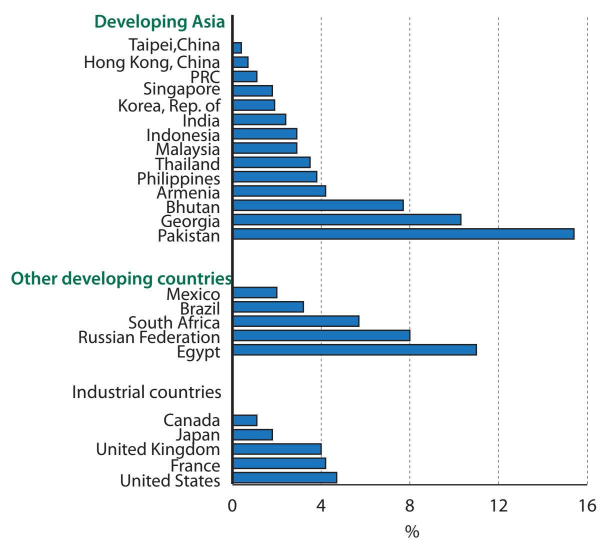


PRC = People's Republic of China.

Note: 2011 data refer to various months. Latest data for France, Egypt, India, Japan, and United Kingdom refer to 2010 (various months).

Source: International Monetary Fund, *Financial Soundness Indicators*, September 2011.

1.2.5 Bank nonperforming loans to total loans ratio, selected developing Asian economies, 2011



PRC = People's Republic of China.

Note: 2011 data refer to various months. Latest data for Egypt, France, India, Japan, Rep. of Korea, Philippines, Singapore, and United Kingdom refer to 2010 (various months).

Sources: CEIC Data Company (accessed 20 March 2012); International Monetary Fund, *Financial Soundness Indicators*, September 2011.

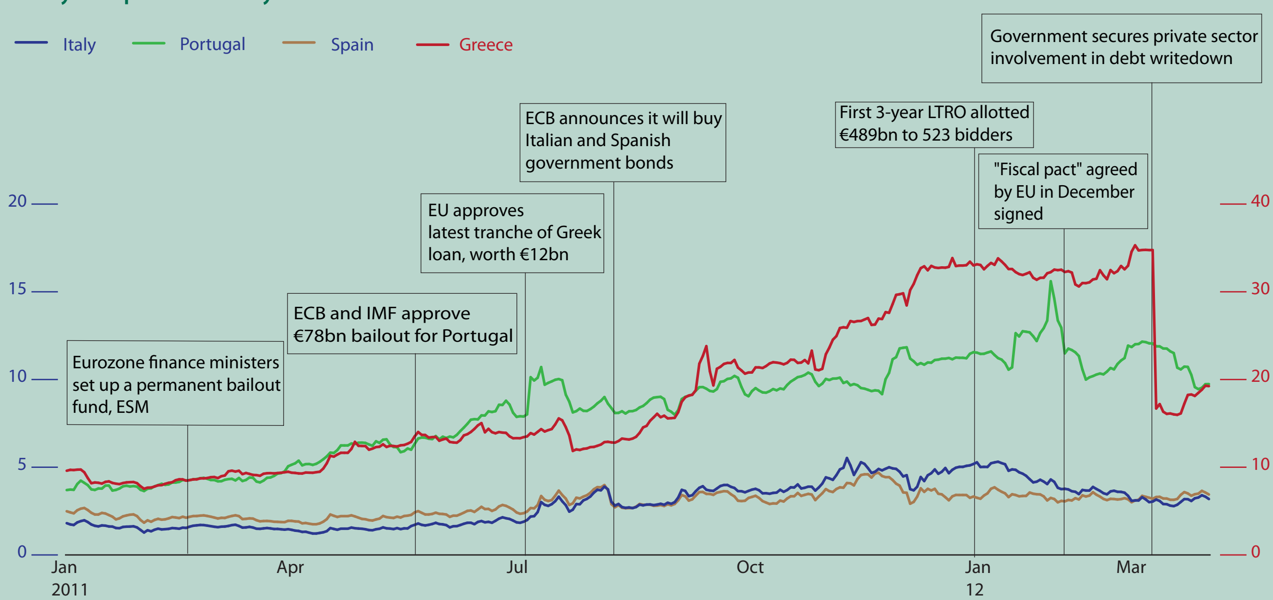
1.2.1 Palliatives not permanence for the eurozone crisis

The eurozone sovereign debt crisis was a constant theme in 2011, keeping global financial markets on edge. High-level meetings among European policy makers, and with their US counterparts and IMF representatives, were all too frequent, but the markets usually felt the outcomes were inadequate, as reflected in rising bond yield spreads (Box figure 1). Whenever fears about a Greek default or a contagion to Spain or Italy intensified, European policy makers were forced to embrace increasingly bold measures.

By the beginning of 2012, Greek government debt had been restructured successfully and the European banking system granted enough liquidity to weather additional market turmoil and to satisfy the refinancing needs of the large and vulnerable Spanish and Italian economies.

In addition, the European Financial Stability Facility (EFSF) has been strengthened, and fiscal austerity measures are to be implemented to help guarantee the euro's long-term sustainability. Starting mid-2012, the EFSF will be replaced

Bond yield spreads and key events in the eurozone crisis



ECB = European Central Bank; EFSF = European Financial Stability Facility; ESM = European Stability Mechanism; EU = European Union; IMF = International Monetary Fund; LTRO = long-term refinancing operation.

Note: Government bond spread is the difference between the government bond yield and that of Germany.

Source: Bloomberg (accessed 2 April 2012); BBC News. http://www.bbc.co.uk (accessed 31 March 2012); The Institute of International Finance, Inc. 2012. Euro Briefing. January and February; Athens News. http://www.athensnews.gr/portal/1/53964# (accessed 3 April 2012).

If, in this instance, the eurozone crisis were to worsen, with a consequent tightening in global credit conditions, there could be knock-on effects to the region's banking system, but the impact may be moderate. As has already occurred to some extent, eurozone banks would further cut bank lending abroad to repair balance sheets back home. This could affect developing Asia because eurozone is an important source of its foreign bank loans: its borrowings from eurozone banks amounted to around $440 billion in September 2011, equivalent to 14% of the region's total foreign bank financing, though the impact would also depend on how much an economy relies on external borrowing (Table 1.2.1).

East Asia, South Asia, and Southeast Asia get about 12–17% of their total foreign bank borrowings from eurozone banks, Central Asia and the Pacific around 50%. Just five economies—the PRC; Hong Kong, China;

1.2.1 *(continued)*

by the permanent European Stability Mechanism (ESM), which will have €700 billion in its armory.

Although it was already apparent in the first half of 2011 that Greece would need further funding and, possibly, debt relief, restructuring only saw the light of day in 2012. Germany and other northern European countries were seeking active private involvement while other countries demanded more support through the EFSF.

In March 2012, voluntary private sector participation in the restructuring of Greek government debt reached 95.7%. Thus about €197 billion of government debt held by private investors was exchanged into new bonds, reducing the net present value of its debt by €107 billion through reduced interest costs and deferred maturities.

Soon after the agreement with private debt holders was secured, the European Union approved the second bailout package for Greece, amounting to €109 billion from the EFSF. The IMF subsequently approved new support to Greece of €28 billion in March 2012 through its Extended Fund Facility, a mechanism designed for countries undertaking reforms to address deep-seated structural weaknesses, and disbursed €1.65 billion ($2.2 billion).

In light of the losses imposed on private bondholders, it will take time for Greece to regain access to bond markets. Until then, the country will depend on IMF/EU loans. As Greece has fallen into a deep recession with high unemployment and few signs of improving its competitiveness, relationships with other European countries—who envisage pushing down Greek debt from 164% of GDP in 2011 to 120.5% by 2020—will likely remain tense.

Over the year, pressure also built on Portugal, Spain, and Italy, but while news in March 2012 from Italy seems encouraging, that from Spain and Portugal appears more troublesome.

Plagued by stubbornly high budget deficits, Spain may experience increasing pressure from its eurozone partners to pursue stronger fiscal consolidation efforts. With the country already in recession, social and economic pressure will continue to build, making further consolidation politically difficult.

Portugal has been in a difficult economic situation for a long time. In April 2011, it lost access to financial markets and has received funding from the EFSF and the IMF since then. Portuguese government debt has been downgraded to junk status, as investors have become increasingly skeptical of the government's ability to rein in its fiscal deficits.

Although the EFSF and ESM have received much attention in public discussion, the major player in this crisis has been the European Central Bank (ECB). As leveraging the EFSF has turned out to be difficult and direct debt purchases by the ECB were politically very controversial, the ECB moved toward its own version of quantitative easing to mitigate pressures in European sovereign debt markets and difficulties in the continent's banking sector.

In its two, 3-year, long-term refinancing operations (LTROs), the ECB pumped about €1 trillion into the banking system, which narrowed interest-rate spreads on eurozone sovereign debt. While LTROs have always been part of the ECB's monetary policy tool kit, repo auctions normally play the dominant role. The two LTROs in December 2011 and February 2012 differ from earlier ones in their time period (3 years instead of 3 months) and the conduct of the bidding, as the ECB decided to fix the interest rate and leave the volume of the operation adjust to the liquidity demand. They have been successful—the credit default swap rates on European sovereign debts fell steeply after they were announced.

After going through many phases, no one is arguing the problems have been solved: a fundamental long-term solution to the euro crisis will require yet stronger political commitment from all member countries.

Republic of Korea; India, and Singapore—account for about three-fourths of developing Asia's total borrowing from eurozone banks.

A better measure of vulnerability is the ratio of external bank borrowing to domestic credit because this gives an indication of the importance of outside financing in domestic financial intermediation. Borrowings from eurozone banks are equivalent to 4–8% of domestic credit in India; Indonesia; Republic of Korea; Taipei,China; the Philippines; and Viet Nam. The shares in Asia's two major financial centers—Hong Kong, China and Singapore—are much higher.

Yet despite the likely financial impact, as in the 2008–2009 crisis, the main channel of impact will be trade—financial linkages between the eurozone and the region are indeed substantial, but pale in comparison to the extensive trade linkages.[1] The eurozone is a major market for the region's exports, accounting for 12.0% of the total—about the same

1.2.1 Developing Asia's borrowings from eurozone banks, September 2011

Region/Economy	Amount ($ billion)	Share by each region/economy (%)	Share of borrowings from eurozone in total foreign bank borrowings	Borrowings from eurozone banks as share of domestic credit
Central Asia	13.3	3.0	49.2	-
East Asia	228.9	51.9	12.4	-
People's Rep. of China	96.4	21.9	14.1	0.9
Hong Kong, China	63.8	14.5	9.8	12.4
Korea, Rep. of	44.0	10.0	13.0	4.1
Taipei,China	24.7	5.6	14.2	4.1
South Asia	60.4	13.7	17.2	-
India	57.5	13.0	17.9	4.4
Southeast Asia	114.8	26.0	14.3	-
Indonesia	18.8	4.3	16.2	6.6
Malaysia	10.2	2.3	7.0	3.0
Philippines	8.2	1.9	20.7	7.7
Singapore	63.6	14.4	16.9	27.4
Thailand	7.1	1.6	7.5	1.5
Viet Nam	6.4	1.5	26.2	4.6
The Pacific	23.5	5.3	49.8	-
Developing Asia	440.9	100.0	14.3	2.9

- = data not available.

Note: Data cover nine eurozone countries (Austria, Belgium, France, Germany, Greece, Italy, Netherlands, Portugal, and Spain) with individual country data on developing Asia. Data for developing Asia in column 5 are based on the 11 economies with data.

Source: ADB calculations based on Table 9b (Consolidated foreign claims, immediate borrower basis), Bank for International Settlements and CEIC Data Company (both accessed 26 March 2012).

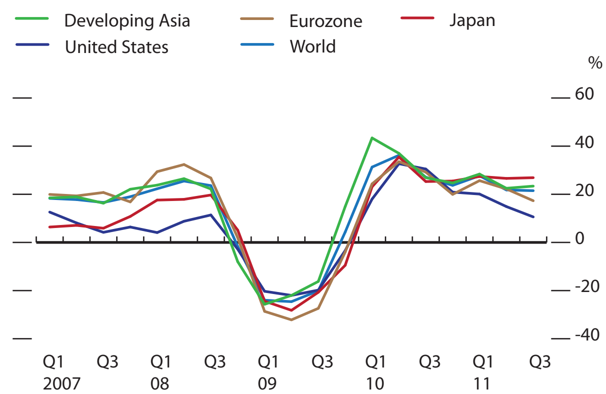
share as the US (12.5%). During the global downturn, the synchronized recession of the advanced economies had a pronounced effect on developing Asia's exports (Figure 1.2.6), pulling back growth (Figure 1.2.7).

Yes, the region is shifting its exports from the major industrial economies: since 2005, developing Asia's exports to the eurozone and US have declined from about 30% of the total to about 24% in 2011 (up to September). And it is strengthening trade ties with Latin America and Africa—but even combined they still only account for 7.1% of total exports. The contribution of regional demand to export growth, too, has increased, with intraregional trade rising from 39.5% to 42.1% between 2005 and 2011, but a good portion of this is still a reflection of the cross-border production networks rather than final goods. So while there has been a shift toward greater diversification in export destinations, the eurozone is still large enough to do damage to developing Asia.

The ratio of exports to the eurozone to GDP is another marker of developing Asia's exposure to a recession in the eurozone. The ratio varies greatly across subregions (Figure 1.2.8). Exposure is higher for East and Southeast Asia than it is for the other subregions, reflecting those two subregions' role as major exporters of manufactured goods. Export exposure to the eurozone (and the US) declined in 2005–2010, pointing to its diminishing vulnerability to a eurozone slowdown.

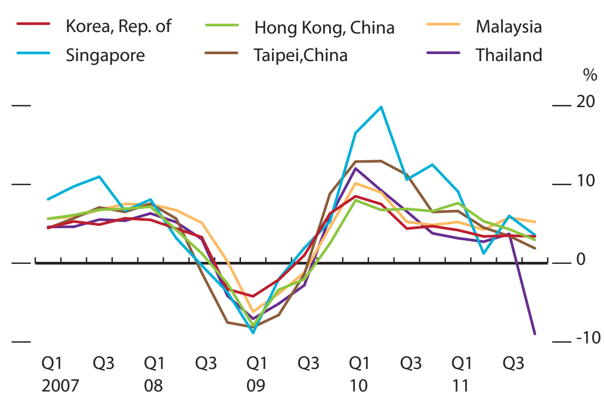
The industrial composition of exports is another important factor. For example, the exports of East and Southeast Asia, Asia's traditional manufacturing hubs, are heavily skewed

1.2.6 Growth of exports, developing Asia and major industrial economies



Source: ADB calculations based on International Monetary Fund, Direction of Trade Statistics online database (accessed 15 March 2012).

1.2.7 GDP growth, selected developing Asian economies



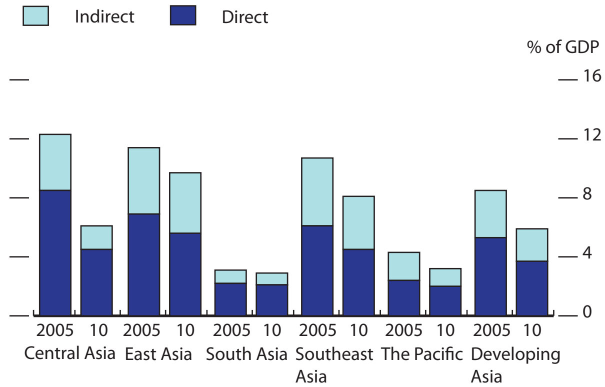
Source: CEIC Data Company (accessed 15 March 2012).

toward manufactured goods (97% and 82%, respectively) and hence more vulnerable to a eurozone recession (Figure 1.2.9). During the global crisis, highly open exporters of manufactured goods—such as the four newly industrialized economies, as well as Malaysia and Thailand—were hit harder than other groups of countries.

The above data show that the eurozone is a key export market for Asia, and will remain so for the near future despite its declining share in recent years. But they also suggest that, as long as the slowdown is confined to the eurozone—and does not become a synchronized advanced-country recession—developing Asia should be able to absorb the impact of lower export demand.

The risk, though, is that the current armistice in the eurozone sovereign debt crisis may be short-lived. If the shock to the eurozone periphery were to spread more broadly through financial markets there and push the eurozone further into recession, the global impacts would be much larger than the *Asian Development Outlook*'s global baseline assumptions. And if matters in the eurozone worsen to the extent of undermining global recovery, developing Asia's policy makers will need to be ready to act quickly. Recent history shows that two areas in particular—global value chains and trade finance—interact with an external trade shock to intensify its impact.

1.2.8 Export exposure to the eurozone (% of GDP), developing Asia



Notes: 1. Regional averages are simple averages. Total exposure includes potential reexports—e.g. Malaysia exports parts and components to the PRC, which reexports to the eurozone and US after assembling them. 2. Export exposure is the sum of direct and indirect export exposure of a country to the eurozone. Direct trade exposure is the country's exports to the eurozone as a share of GDP. Indirect trade exposure comprises the country's indirect export routes to the eurozone through trade between the eurozone and its trading partners.

Source: ADB calculations based on International Monetary Fund, Direction of Trade Statistics online database (accessed 15 March 2012).

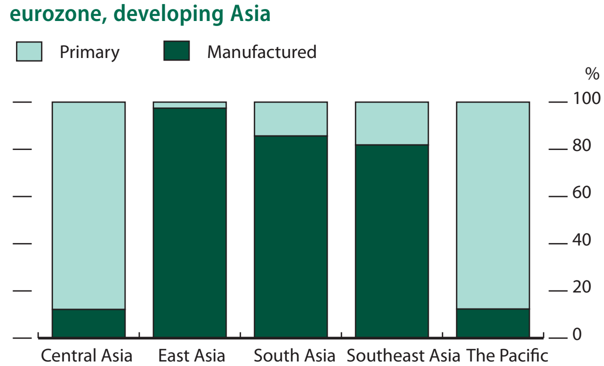
Factors intensifying external shocks

Global value chains

The integration of emerging East and Southeast Asian economies and Japan in global value chains (GVCs)—the division of production processes among multiple firms and countries—helps explain the region's vulnerability to external demand shocks (Box 1.2.2).[2] Under this type of production framework, which predominate the global manufacture of durable goods such as electronics and automobiles, the volume of exports is magnified as components move multiple times across national boundaries before becoming final goods.

Because the import content of durable goods is larger than for nondurable goods and services, the rise of GVCs gives durable goods greater weight as a share of trade than their weight in GDP. One estimate shows that durable goods before the 2008–2009 global crisis had grown to almost 40% of trade, but amounted to only 10% of final demand.[3] Since consumers tend to first cutback purchases of durables in a recession, the transmission of demand shocks along GVCs can induce a disproportionate drop in trade relative to GDP.

1.2.9 Share of primary and manufactured exports to the eurozone, developing Asia



Source: ADB calculations based on UN Comtrade online database (accessed 15 March 2012).

Trade finance

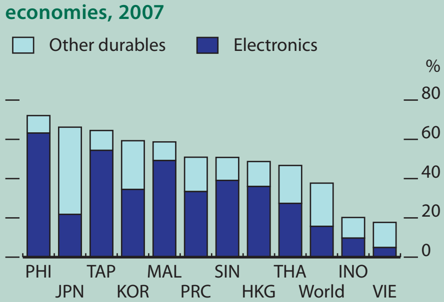
Trade finance, broadly speaking, includes various forms of short-term funding to facilitate international trade transactions. The majority of such finance involves transactions between

1.2.2 Asia and global value chains

An implication of the rise of global value chains (GVCs) in the past few decades is that international trade is increasingly dominated by trade in tasks, which are embodied in intermediate goods crossing borders multiple times for further processing within the GVCs. Currently, trade in intermediate inputs accounts for roughly two-thirds of international trade. GVCs have expanded asymmetrically across industries, predominantly emerging in durable goods such as electronics and automobiles.

East and Southeast Asian economies (including Japan) have taken on a key role in the GVCs of durable goods, effectively turning the region into the "factory of the world." From 2000 to 2007, their share in world durable goods exports grew from 35% to 42%. The exports of the economies along GVCs are more heavily concentrated in durable goods than those of the rest of the world (Box figure 1). This is largely due to these economies' key role in the electronics GVCs: electronics constituted more than half durable goods exports in 2007 for the region (except for Viet Nam, Indonesia, and Japan).

1 Share of durable goods and electronics products in total exports, selected Asian economies, 2007



HKG = Hong Kong, China; INO = Indonesia; JPN = Japan; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; PRC = People's Rep. of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.

Source: Ma and Van Assche (2012).

While durable goods trade has clustered in East and Southeast Asia, the final consumption of such goods remains concentrated in North America and Europe. In 2007, 61% of their intermediate durables were traded within the East and Southeast Asian GVCs, but 55% of its exports of final durable goods went to non-Asian OECD countries.

Economies play different roles in GVCs depending on their level of economic development. Box figure 2 plots countries according to their position in GVCs and their level of development. Upstream stages such as design, R&D and production of sophisticated components are generally located in developed countries, while manufacturing and especially final assembly activities are relocated to developing countries. Finally, the downstream activities marketing and consumption once again take place in developed countries.

Japan thus specializes in the upstream production and exports of sophisticated intermediate goods such as semiconductors.

The high-income newly industrialized economies economies (Hong Kong China; the Republic of Korea; Singapore; and Taipei,China) as well as Malaysia and the Philippines are located in the middle of the chain where they specialize in processing intermediate goods. While they disproportionately import intermediate durables, intermediate goods also make up a larger-than-average share of their durable goods exports.

The middle-income countries—the PRC and Thailand—specialize in the downstream assembly of final durable goods. They disproportionately import intermediate durables, and specialize in the export of final durable goods.

Finally, the high-income Western economies—mainly US and EU—serve as dominant markets for final goods, intensively importing durable goods.

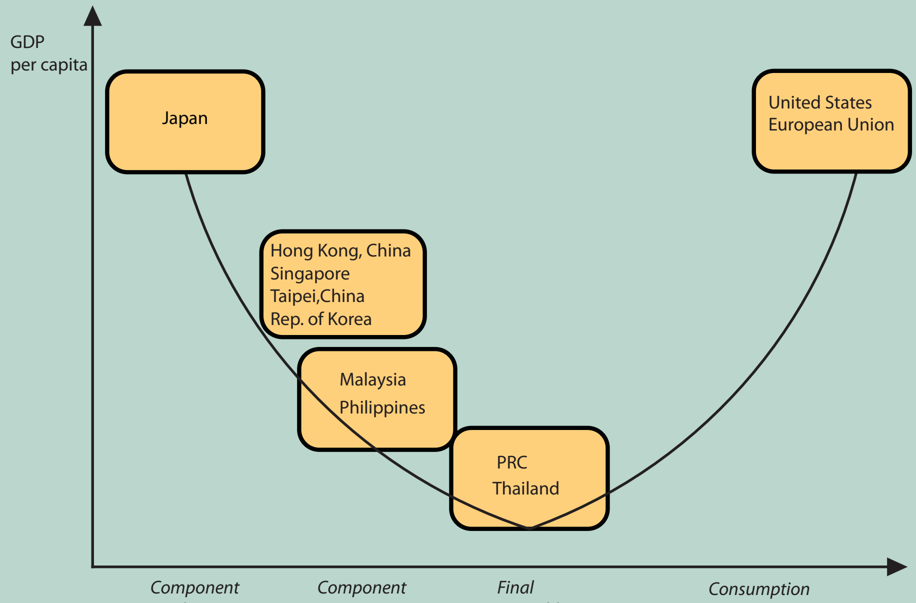
The transmission of external shocks is further amplified

firms, but an estimated 40% is intermediated by banks. The availability of such financing is critical for the region, given the important role that trade plays for many developing Asian economies. While the 2008–2009 trade collapse coincided with a tightening of global credit conditions, the extent that shrinking trade finance contributed to the fall in trade is not clear, in part because of incomplete data.

This is because most trade finance transactions are not reported. Interfirm transactions (involving open accounts and cash-in-advance trade finance, for example) are largely undisclosed, and the bank-intermediated portion of trade credits is notably an area of finance that mainly involves relationship banking and does not take place in organized markets.

1.2.2 *(continued)*

2 Stylized structure of GVCs in durable goods



Source: Ma and Van Assche (2012).

by the strongly synchronized, just-in-time nature of intermediate goods trade and the adjustment of inventories along supply chains. To see this, consider Box figure 2 and suppose that there is a sudden decline EU demand for final durable goods. This decreases the demand for imports from the final assembly platforms PRC and Thailand.

In turn, since these final assembly platforms heavily rely on imported components, they react to the negative demand shock by importing fewer components from countries like Malaysia or the Philippines. The latter react to the shock by importing fewer inputs from the next upstream stage, Japan. As a result, the negative demand shock leads to a sudden, synchronized regional trade decline.

The demand shock further amplifies as it moves up the GVC due to inventory adjustments. The logic for such a "bullwhip effect" is that businesses typically face forecast errors in their sales against which they try to shelter by building safety stocks of inventories. When a downstream firm is confronted with a drop in demand for its final products, its first reaction is then to run down its inventories, therefore more than proportionally reducing its orders of upstream components.

As this inventory adjustment process propagates upstream, the demand shock continues to amplify. East and Southeast Asia's heavy involvement in GVCs helps explain why some of its economies saw their trade drop up to 40% (year on year) in the trough of the global downturn in first quarter of 2009.

Lessons can thus be drawn for the region's vulnerability to global demand shocks, such a deepening recession among European countries. Although Asia's reliance on EU demand for its exports has declined in recent years, a European recession can yet again amplify along the GVCs, leading to a slowdown in regional trade. Such a demand shock would be further intensified if accompanied by a contraction in credit markets or spikes in protectionism.

Source: A. Ma and A. Van Assche "Is East Asia's Economic Faith Chained to the West?" (forthcoming). *ADB Economics Working Paper Series.*

Information about trade finance and the impact of global financial and economic developments comes primarily from surveys of commercial banks. The International Monetary Fund, for instance, has collaborated with the Bankers' Association for Finance and Trade and the International Chamber of Commerce to conduct surveys during 2008–2010, interviewing banks in supplier and buyer countries.

It found that data reported from banks generally show that the decline in trade finance during the crisis was not as severe as the decline in trade volumes. However, bank data may understate the impact of the crisis on trade finance for two reasons. Monetary stimulus and programs from international financial institutions targeting trade finance would have softened the blow. Moreover, bank surveys cannot show the impact on interfirm trade finance transactions since they do not cover this segment.

Other data on the importance of trade finance come from surveys of businesses, such as two World Bank surveys, also carried out in 2008–2010, in 14 developing countries (two in Asia). The surveys focused on firms' perceptions.

Firm perception survey results, in contrast to bank survey results, do suggest some important connections. Those interviewed felt that the driving factor behind lower trade levels was the drop in demand during the 2008–2009 global recession rather than an inability to secure financing. But there was an important shift from inter-firm transactions to bank intermediated trade finance as firms tried to shift counter-party risk during that period of heightened uncertainty. Banks themselves adopted stricter risk management and greater client differentiation, raising both collateral requirements and margins. Those firms that were able to get bank financing faced higher pricing margins. This hampered trade by raising transaction costs.

The effect of this squeeze was most pronounced in developing countries. The World Bank surveys found that developing countries' firms did suffer from constrained trade finance. Firms relying chiefly on inter-firm or self-financed trade credit were most strongly affected by the global drop in trade, the compression of export revenues, the cancellation of orders, as well as payment delays. Firms relying mainly on the banking sector for trade credit were affected by banks' risk aversion and discrimination. For example, in the Philippines, firms still felt as late of April 2010—when the second of the two surveys was conducted—that eligibility criteria imposed by banks continued to be overly stringent.

Small and medium-sized enterprises were affected more strongly than large ones by the strains to trade finance. These firms faced larger increases in the price of trade finance, due to their weaker capital base to stem against revenues compression, and their disadvantage in bargaining with the larger corporations and banks in the global markets.

Looking ahead, there are several factors that may tighten trade finance conditions in developing Asia. First is the ongoing bank deleveraging in advanced economies. The sharpening of the eurozone crisis in 2011 added pressure on banks to increase their capital, reducing capacity in the market. Consequently, many European banks, traditionally active in supporting trade in Asia, have retrenched, leaving a larger gap for trade finance. The potential impact of reduced lending by eurozone banks is significant, since they are estimated to provide about 30% of total trade finance in the region.

Second, the Basel III accord—as important as it is to help place the global financial system on a more sound footing—has unintended consequences. By treating the cost of capital the same for a high-risk high-margin activity, compared with a relatively low-risk lower-margin activity such as trade finance, Basel III encourages financial institutions toward higher return (and higher risk) lending away from trade finance. This is despite the strong evidence showing that trade finance carries a relatively low probability of default and loss because it is highly collateralized.

Finally, for developing economies, trade finance is not just about access to credit, but rather access to international liquidity. Advanced economies can use expansionary monetary policy to provide liquidity to markets in currencies accepted in international transactions. The analogy for developing Asian economies would be to draw down foreign reserves with central banks supplying dollars to local banks through repurchasing agreements, but this could put the exchange rate at risk.

The confluence of these factors may squeeze trade finance availability—especially if the situation in the eurozone were to worsen. Policy makers need to closely monitor trade finance availability, especially for small and medium-sized enterprises.

They need to be ready to act—on a wider field than trade finance—and have the capacity to do so.

Macro-policy directions for developing Asia

Enough policy space for a major external shock

Responding to the global economic downturn in 2008–2009, countries in developing Asia adopted policy stimulus measures, which though effective, absorbed some of the region's monetary and fiscal policy space (Box 1.3.1) that was earned through earlier prudent macroeconomic management. Many countries reduced their benchmark policy interest rates to record lows and saw their ratio of public debt to GDP spike as they expanded government spending substantially.

1.3.1 What is policy space?

Policy space refers to the scope for using fiscal and monetary policy to counter the effects of shocks to the economic environment. For example, relatively low public debt to GDP ratios allow governments to increase spending and cut taxes without triggering adverse reactions from financial markets about fiscal sustainability.

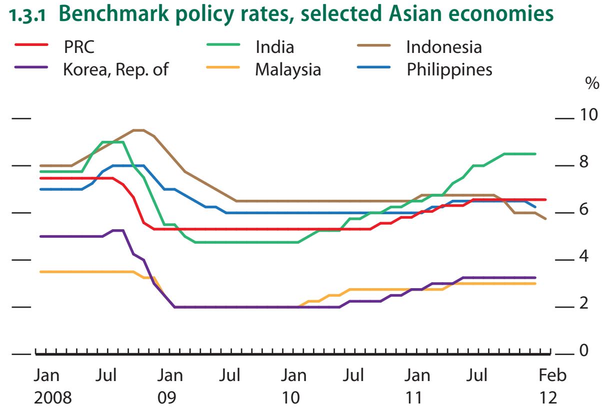
Likewise, a history of anti-inflationary policies builds credibility and expands the scope for interest rate cuts. Further, the presence of a clearly defined lender of last resort strengthens the effectiveness of monetary policy during a crisis.

As countries started to unwind the stimulus measures in 2010, they began to claw back some of this hard-earned policy space. But, given the global outlook, can developing Asia pursue another round of such measures if the downside risks materialize?

In an attempt to answer this question, it is useful to look in more detail at the earlier measures. Since the crisis eased, regional central banks have tightened their monetary policy stance to stem rising inflationary pressures, most of them due to food price increases. Benchmark policy rates in the region rose in the 2 years to around mid-2011 (Figure 1.3.1), as the crisis in the eurozone slowed global economic activity and inflation pressures moderated in developing Asia. Unlike the advanced economies (with near zero rates), developing Asia now has room to cut rates, although benchmark rates in most economies are still lower than before the downturn, suggesting less room to tighten.

Regional inflation—reflecting normalizing monetary policy and stabilizing global commodity prices—has come down since the last quarter of 2011 (Figure 1.3.2). As discussed much earlier, the risk of such prices, especially for oil, picking up again remains high, however, making possible a reversal of the recent downward trend in headline inflation in developing Asia.

1.3.1 Benchmark policy rates, selected Asian economies



PRC = People's Republic of China.

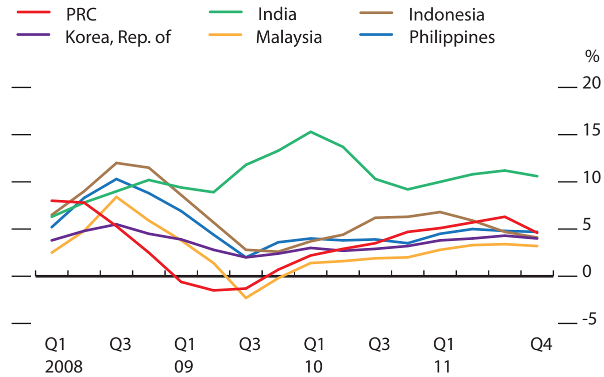
Source: CEIC Data Company (accessed 15 March 2012).

The region's monetary authorities have maintained enough foreign exchange reserves to overcome shortages of international liquidity if a major financial shock hits. This is costly as reserves are typically invested in low-interest assets at the same time as governments pay higher rates on their outstanding debt, but uncertainties in Europe and the lack of global financial safety nets have prompted most Asian economies to follow this practice, which also allows for exchange rate management.

Common management of pooled reserves under a regional coordination mechanism would be the best way to use these reserves in combating international liquidity shortages. Thus strengthening the Chiang Mai Initiative Multeralization (CMIM) mechanism as a regional platform—with support from the newly established AMRO for ASEAN+3 for harnessing regional macro and exchange rate policy coordination—could offer substantial returns (Box 1.3.2).

Developing Asia also has enough fiscal space for short-term stimulus if it is hit by a shock. Although fiscal deficits are still fairly high in, for example, India, Malaysia, and Pakistan, fiscal balances of many regional countries remain healthy as they are not likely to lead to increases in public debt to GDP ratios. In the PRC, India, the Republic of Korea, Philippines and Viet Nam, fiscal positions have also improved in 2011 from the previous 3 years as the stimulus put through during the global crisis was unwound (Figure 1.3.3). Public debt-to-GDP ratios are fairly low internationally and are projected to decline even further in the medium term (Box 1.3.3).

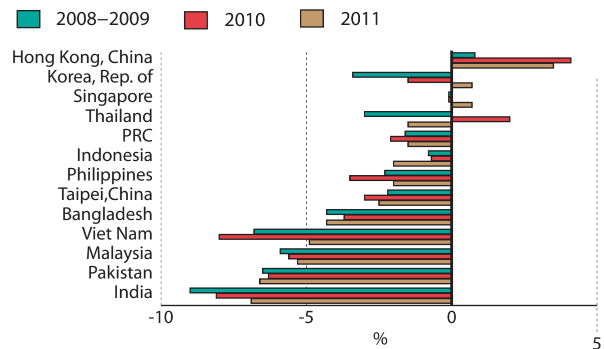
1.3.2 Inflation, selected Asian economies



PRC = People's Republic of China.

Source: CEIC Data Company (accessed 15 March 2012).

1.3.3 Fiscal balances, selected Asian economies



PRC = People's Republic of China.

Source: Asian Development Outlook database.

No clear case for short-term countercyclical policy

The agreements reached on an orderly workout of Greece's debt removed the immediate risk of a disorderly default that could lead to a new global liquidity crisis. As a result, investors' risk appetite and confidence toward the region has generally improved. Since escalating in October 2011 sovereign spreads have declined. This

1.3.2 Chiang Mai Initiative Multilateralization

The CMIM is an evolution of the framework for providing liquidity support for the ASEAN+3 countries (the 10 ASEAN member countries plus the PRC, Japan, and the Republic of Korea) conceived through the Chiang Mai initiative in 2000. CMIM, which took effect in March 2010, is a US$120 billion multilateral currency swap facility designed to address short-term liquidity difficulties in the region and supplement international financial arrangements.

As a reserve pooling arrangement, CMIM members committed their contribution to the facility but continue to manage their own reserves. Each member is eligible to access the facility up to a certain approved multiple of its contribution. When a member's request for a swap facility is approved, each of the contributing members extends its contribution prorated to its commitment.

To support CMIM operations, the ASEAN+3 Macroeconomic Research Office (AMRO) was established in April 2011 to act as the regional surveillance unit of CMIM. AMRO monitors and analyzes regional economies. It also contributes to early detection of risks and swift implementation of remedial actions to ensure for an effective decision-making of the CMIM.

1.3.3 Public debt in developing Asia after the global crisis

Fiscal intervention by governments in developing Asia to stem the 2008–2009 crisis raised regional public debt ratios by an average of 5% in 2009, thus breaking a trend of fiscal consolidation that most countries had followed since the late 1990s' Asian financial crisis. The 2009 spike in debt ratios was highest in Central and East Asia. All ratios resumed their downward trend in 2010 and 2011, as fiscal stimulus measures gradually faded and economic growth in the region returned.

The outlook on debt dynamics for the region is generally benign, and most public debt ratios are projected to decline in the medium term. This is shown in Box figure 1, which shows debt ratios averaged by subregion over a historical period (2000–2010) and projected period (2011–2016), as well as for seven major Asian economies.

Apart from the baseline projection—the lines in red—also shown is a historical scenario—the dashed lines in blue—that projects debt ratios with key variables kept at their 2000–2010 historical averages. A comparison between the two scenarios suggests that the macroeconomic and fiscal assumptions underlying the baseline are not overly optimistic when compared with historical track records.[1]

Favorable debt dynamics in the region in 2011–2016 are premised mainly on the assumption that low real interest rates and high growth rates will prevail, against the backdrop of a progressive strengthening of fiscal balances. In line with the historical pattern observed in large parts of the region during the past 2 decades or so, higher economic than interest-rate growth is expected to continue eroding debt ratios faster than they will rise because of primary deficits or other factors, such as exchange rate movements increasing the value of foreign currency–denominated public debt.

For example, in relation to the aggregate for the seven economies, Box figure 2 shows that strong economic growth of around 6% a year is expected to cause the debt ratio to shrink by roughly 2% each year between 2011 and 2016, which will more than outweigh the increase in debt due to the combined impact of narrowing primary deficits, a positive real interest rate, and slightly unfavorable exchange rate movements. As a result, the average debt ratio of the seven economies is expected to fall to about 34% in 2016, from nearly 40% in 2011.

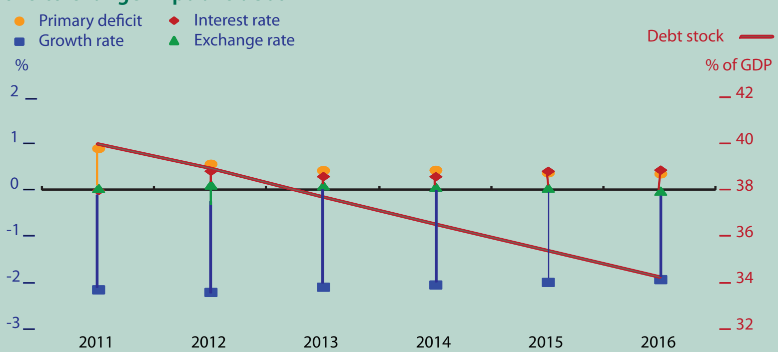
Premised on these assumptions, standard debt-

1 Public debt projections for developing Asia

Note: The seven Asian economies are the People's Republic of China, India, Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
Source: Ferrarini and Ramayandi (2012).

1.3.3 *(continued)*

2 Contributions to change in public debt



Source: Ferrarini and Ramayandi (forthcoming).

sustainability analysis finds public debt in the region to be broadly sustainable, in that expected future macroeconomic and fiscal performances are likely to enable governments to smoothly finance their budgets and service debt without generating explosive increases in public debt ratios. Moreover, falling debt ratios are associated with a gradual expansion of the fiscal policy space that was temporarily compressed by the global crisis. To some extent, this would enable governments in the region to intervene again, if necessary.

By contrast, fiscal space—and with it the feasibility of heavy government intervention—would quickly shrink in the event of a particularly severe or prolonged deterioration in the region's macroeconomic environment. An example is another major global crisis, such as triggered by an international financial crisis that would spike interest rates, dry up international capital markets, and derail economic growth in the region.

Put differently, in terms of Box figure 2, any large internal or external shock that would largely invalidate the key assumption as regards the continuing presence of a higher than interest rate growth favoring debt dynamics in the region would inevitably complicate debt management and, if sufficiently severe, could jeopardize debt sustainability in many countries of the region.

Risks to public debt sustainability also arise out of the intrinsic vulnerabilities to macroeconomic stability, in some countries particularly. Stochastic debt-sustainability analyses[2] discussed in Ferrarini, Jha, and Ramayandi (forthcoming) show that, when the frequency and entity of historical shocks as well as co-movements of the variables affecting the debt ratio are fully accounted for, debt projections for the more vulnerable Asian economies display a broad range of likely outcomes, some of which have the potential to undermine public debt sustainability.

Furthermore, the study emphasizes the issue of local as opposed to central government debt, as well as contingent liabilities, the full extent of which typically eludes standard debt-sustainability analysis. Finally, the medium-term focus of this analysis abstracts from structural factors that are likely to introduce a significant upward pressure on the regions' fiscal budgets and debt ratios in the longer term. For example, health care, pension spending, and social safety nets are likely to expand. The related fiscal outlays will add significant pressure on general government budgets across the region, shifting debt ratios upward.

In sum, assessing public debt sustainability in Asia and the Pacific involves more rigorous analysis that goes beyond simple debt-sustainability analysis projections. Nevertheless, even a more attentive analysis of the debt and risk profiles for selected countries in the region suggests that, by and large, public debt in these countries is sustainable and governments do have a degree of policy space to count on for the case that fiscal intervention to support their economies should be required.

[1] With the main exception of East Asia (including the PRC, the Republic of Korea, and Mongolia), where the historical scenario is affected by a debt crisis in Mongolia, which saw the country's debt ratio spike to about 100% in the early 2000s before falling steeply in the rest of the decade.

[2] VAR-based Monte Carlo simulations.

Reference

B. Ferrarini, and A. Ramayandi (forthcoming). "Public Debt Sustainability Assessments for Developing Asia." In B. Ferrarini, R. Jha, and A. Ramayandi, eds. (forthcoming). *Public debt sustainability in developing Asia*. Abingdon, UK: Routledge.

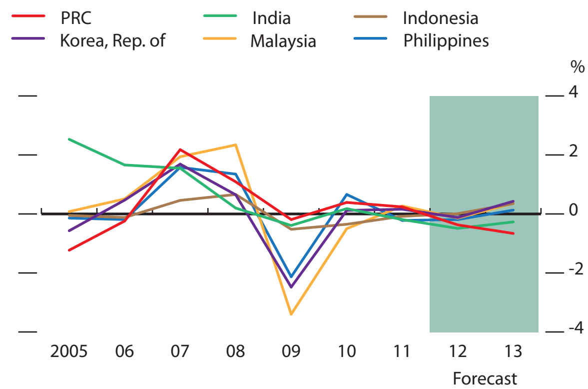
improvement in investor sentiment could soon be followed by another stream of volatile capital inflows to the region, which was one of the factors behind the rise in inflation during the recovery, as it flooded the region with additional liquidity.

While the slowdown in Europe is putting a brake on economic growth in Asian economies, the extent seems to be manageable. Except for Thailand, which is still recovering after the floods late last year, actual output levels in the region do not appear to be substantially below trend (Figure 1.3.4). This suggests that the region's economies are still operating around their potential output levels and are expected to continue doing so in the medium run—unlike the major industrial economies (Figure 1.3.5).

Although there is no clear case for developing Asia to deploy aggressive countercyclical policy, there may still be a need for policy intervention. The region accounts for a large and growing share of the world's economic activity, thus such intervention may help to ensure the continuation of strong domestic demand, which in turn will also contribute positively to the global economic recovery.

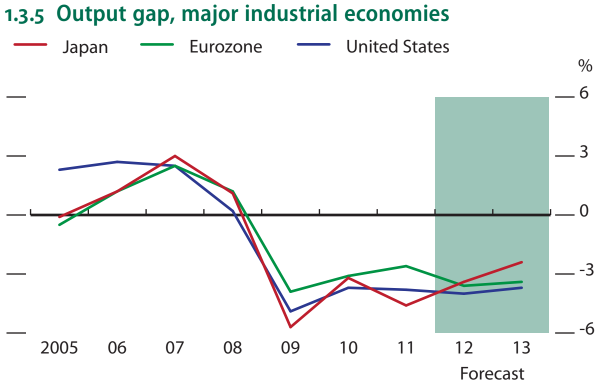
The role of monetary policy for maintaining the growth momentum seems to be more limited than that of fiscal policy. The overall stance of monetary policy in the region is still fairly accommodative. Real interest rates are still very low—slightly below zero in most cases or even highly negative (Viet Nam) (Figure 1.3.6). The slowdown in food price inflation has helped cool the headline rate, but core inflation has not slowed as much, suggesting that price pressures remain. Finally, credit in the region, although moderating slightly, continues to grow strongly, at a two-digit rate in most cases.

1.3.4 Output gap, selected Asian economies



Source: Staff estimates

1.3.5 Output gap, major industrial economies



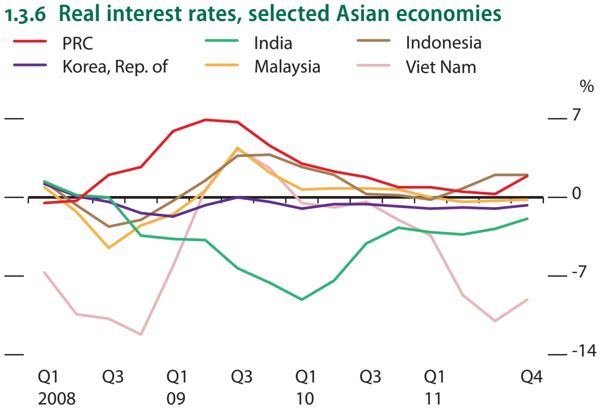
Source: OECD Economic Outlook November 2011.

Looking to the longer term

The smaller GDP gaps, relatively low real interest rates and high credit expansion, as well as persistent core inflation in Asia suggest that pressures for inflation originating from aggregate demand are still persistent. Recent improvement in the investor sentiment also entails the potential for another stream of capital inflows to the region, which in turn adds pressure for aggregate demand to increase. In tandem with the risk of elevating price of oil in the international markets, and the absence of further shock to the global environment, there may be resumption for inflationary pressures to the region.

If inflationary pressures build again and capital inflows resume, there may be a need to readjust monetary policy to maintain price stability. But until that happens (if indeed it does), the region's monetary authorities should fine tune their policy stance while keeping focused on stabilizing inflation expectations.

1.3.6 Real interest rates, selected Asian economies



Source: Staff estimates

To shield against the highly volatile nature of capital flows, Asia needs to be ready with measures to fend off large and rapid fluctuations in cross-border capital movements. Strengthening domestic financial systems by improving their supervision and regulatory rules should help enhance domestic financial stability. More flexible exchange rate regimes are also useful for filtering speculative short-term capital inflows. If large swings of capital flows to the region reoccur, various measures of capital flow management can also be deployed, but they require regional coordination to be effective.

Given the limited room for monetary policy maneuver, authorities can also use fiscal policy. They can compensate for the slowdown in external demand by boosting domestic demand to keep the growth momentum, but have to do this without undermining their fiscal position. So although debt-to-GDP ratios in the region have now generally resumed their downward path, governments have no room for complacency. Sustaining these improving debt ratios depends on continued favorable growth and interest rates, which—as seen repeatedly over the years—can suddenly reverse. Moreover, the region faces further sources of fiscal strain in the years ahead, such as adjusting to aging populations and building adequate social safety nets.

Fiscal policy should thus strike a balance between the pursuit of long-term fiscal stability and support to growth. Fiscal authorities can do this with budget-neutral measures through expenditure-switching policies that support domestic economic rebalancing, such as increasing the share of spending on education, health, and social safety nets, within given deficit levels. They may though at some stage need to raise tax revenue as a share of GDP to finance the needed social spending, by broadening tax bases and improving tax administration.

Such fiscal shifts will be increasingly important as the region confronts rising income inequality while fostering continued economic expansion—an issue further analyzed in the theme chapter.

Endnotes

1 A recent empirical study of the relative importance of finance and trade links between the eurozone and developing Asia as channels of contagion comes to the same conclusion—financial sector repercussions will be felt, but trade impacts are potentially larger (M. Lee et al. Forthcoming. "Economic Impact of Eurozone Sovereign Debt Crisis on Developing Asia." *ADB Economics Working Paper Series*. Manila: Asian Development Bank.).

2 This section is based on a background paper for this report, by A. Ma and A. Van Assche. "Is East Asia's Economic Faith Chained to the West?" Forthcoming. *ADB Economics Working Paper Series*.

3 R. Bems, S. Johnson, and K.-M. Yi. 2010. Demand Spillovers and the Collapse of Trade in the Global Recession. *IMF Economic Review* 58(2). pp. 295-326.

Annex: The external environment

Continuing the pattern of 2011, developments in the major industrial economies of the United States (US), eurozone, and Japan will hold back global economic activity over the next 2 years. In particular, the eurozone is expected to see renewed recession in 2012. Under the baseline assumptions, growth of the industrial economies is expected to edge even lower from its already slow 2011 rate of 1.2% to 1.1% in 2012 before picking up a shade to 1.7% in 2013. Against this dim global economic backdrop, world merchandise export growth is expected to slow to 3.8% in 2012 before recovering in 2013 (see Table 1.1.1 at the start of the main text).

Recent developments in major industrial countries

United States

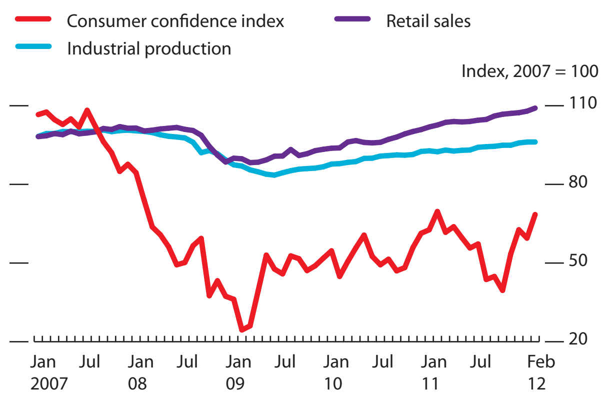
Data for the first half of 2011 disappointed and spurred speculation about a double-dip recession and additional policy stimulus. Uncertainty about the course of the economy reached its climax in August when long-term US sovereign credit was downgraded by a major rating agency. In part owing to the situation in the eurozone, however, yields on US treasuries fell and the dollar appreciated.

GDP growth—at a quarter-on-quarter, seasonally adjusted annualized rate (qoq saar)—was barely positive in the first quarter of 2011, but picked up in the second half with a strong performance in the last quarter when growth reached 3.0% qoq saar, taking it to 1.7% for the year. Industrial production and retail sales rose only gradually (Figure A1.1.1) from the trough in May 2009.

The unsteady climb in consumer confidence ended in March 2011, but has recovered since December last year. The values of the PMI compiled by the Institute for Supply Management lie above 50 for the first 2 months of 2012, 54.1 for January and 52.4 for February. Values above 50 indicate that the manufacturing economy is generally expanding.

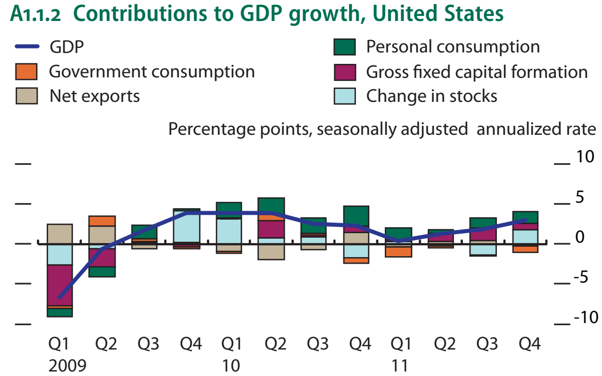
Moderate gains in private consumption and fixed investment accompanied the GDP growth pickup in 2011 (Figure A1.1.2). Cuts in government consumption have slowed the recovery and are expected to continue doing so, such that in 2012 and 2013 the economy will extend its recovery, but at a moderate pace only. Absent large negative spillovers from Europe and with an accommodative monetary policy, growth is likely to reach 2.0% in 2012 and 2.3% in 2013.

A1.1.1 Business activities and consumer confidence indicators, United States



Source: CEIC Data Company (accessed 27 March 2012).

A1.1.2 Contributions to GDP growth, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 28 March 2012).

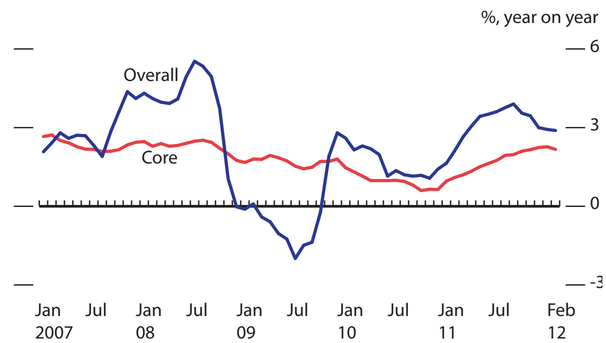
As with consumption, recent data for private investment and inventories suggest that businesses are still hesitant to expand production facilities and that the economy is far from reaching capacity constraints. Fixed investment has been growing over the last 6 quarters (to Q4 2011), but without conviction. Inventories are still adjusting after a large decline toward end-2010. External demand for US goods continued expanding through 2011. Facilitated by a weaker dollar, net exports made a modest positive contribution to GDP growth in 2011.

Beyond the uncertainty originating from outside the country, the state of public finances and the high unemployment rate pose major challenges. But whether immediate progress can be made on these policy fronts is questionable as the country enters another presidential election season. When and how policymakers will move on improving future fiscal space by deciding on medium- and long-term fiscal reform also affects the forecast for 2012 and 2013. Postponing fiscal consolidation until the economy has stabilized appears to be desirable, but may not turn out to be politically feasible.

Inflation remains well under control (Figure A1.1.3). As the global economy recovers slowly, slow-moving food and energy prices are expected to buttress the recovery. Given low and stable price inflation (not exceeding 2.0% over the forecast horizon), monetary policy is also expected to continue supporting the recovery, with the target for the Federal Funds rates unchanged within 0–0.25% at least until mid-2013, and slowly tightened after that.

Policy efforts are still very much geared to easing the impact of the previous downturn. In February 2012, the US Congress voted to extend the payroll tax cut of 2011 and unemployment insurance benefits through the whole year of 2012.

A1.1.3 Inflation, United States



Source: CEIC Data Company (accessed 27 March 2012).

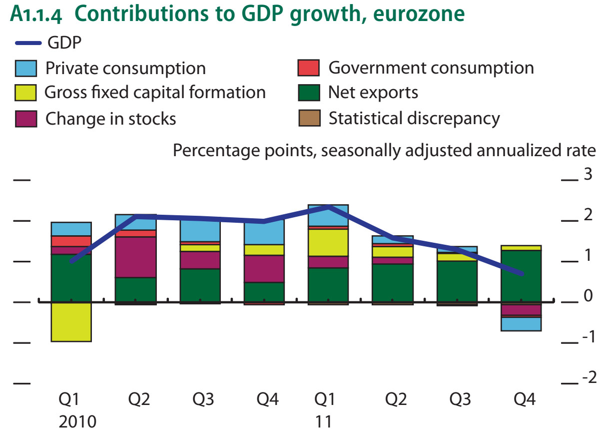
Eurozone

The core eurozone countries had a strong beginning to 2011—despite tensions in segments of the sovereign debt market—feeding hopes that the eurozone could escape a second recession after the first recession in 2009. Over the course of the year, however, a raft of new policy measures failed to prevent the sovereign debt crisis from engulfing Spanish and Italian government debt. Market players often viewed the timing of these measures as too late and kept testing the commitment of all member countries to the common currency. By year-end, growth for 2011 is estimated to have reached 1.4% year on year, with a negative outlook.

This negative trend is expected to carry over into 2012, and most forecasters see the eurozone falling back into recession for the year of 0.5%, heavily reflecting the impact of fiscal austerity measures. The year 2013 may bring better news with GDP growth reaching 1% year on year.

However, developments across countries differ substantially. Germany and many other core members of the eurozone are expected to grow slowly in 2012, whereas those countries directly affected by the European debt crisis will experience

A1.1.4 Contributions to GDP growth, eurozone



Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 4 March 2012).

more pronounced downturns. For example, German GDP growth will fall to 0.5% in 2012 after 3.0% in 2011.

Throughout 2011, net exports stayed a main contributor to GDP growth (Figure A1.1.4). The EU's trade with the rest of the world continued recovering from the 2009 contraction—the most rapid growth with developing Asia (Figure A1.1.5 and A1.1.6).

Fixed capital formation added 0.7 percentage points to GDP growth (saar) in the first quarter, marking an important turnaround after persistently negative investment growth during the postcrisis recovery (apart from the second quarter of 2010). After mid-2011, industrial production slowed and then declined (Figure A1.1.7).

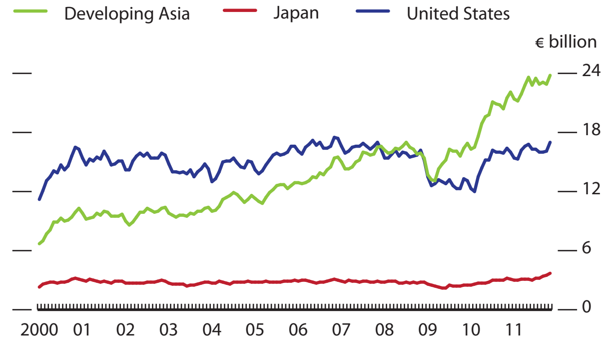
Private consumption made a positive—albeit small—contribution to the first 3 quarters of GDP growth, turning negative in the last quarter of 2011. Retail trade growth averaged 2.4% from January to April, but declined later in the year.

Unemployment stood at 10.7% in January 2012, thus slightly higher than at the start of the previous year, but this aggregate masks considerable disparity among member states. Spain's unemployment rate, for example, stood at 23.3% in January 2012, about five times the rate in the Netherlands or Austria and more than three times Germany's (Figure A1.1.8).

Consumer price inflation was 2.7% in February 2012, down from its peak of 3.0% in April 2011 (Figure A1.1.9). This reflects declining oil prices in the second quarter of 2011, as well as changes in measuring seasonal goods in computing the index. Food price inflation was higher than nonfood price inflation in the first half of the year, peaking at 4.0% in October–November 2011. Energy and commodity prices are likely to exert upward pressure on inflation in the second half of 2012.

Stress in segments of the European sovereign debt markets intensified in July and August when the political debate about

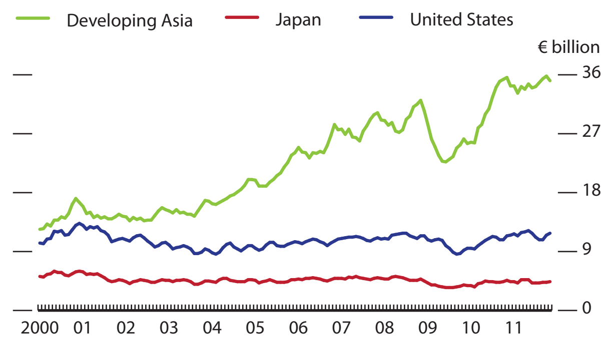
A1.1.5 Exports, 3-month moving average, extra-eurozone 17



Notes: Extra-eurozone refers to the exports and imports of eurozone to non-eurozone countries. Data refer to merchandise trade.

Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 8 March 2012).

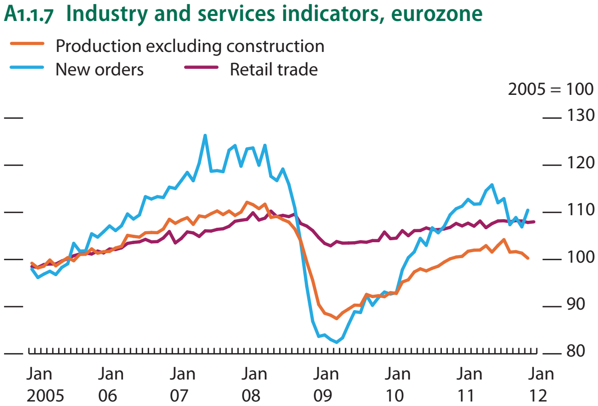
A1.1.6 Imports, 3-month moving average, extra-eurozone 17



Notes: Extra-eurozone refers to the exports and imports of eurozone to non-eurozone countries. Data refer to merchandise trade.

Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 8 March 2012).

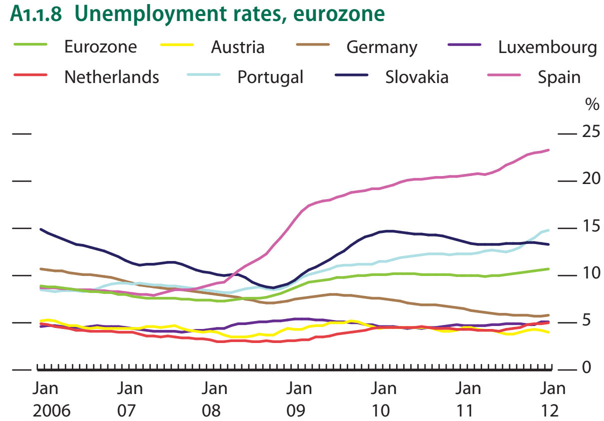
A1.1.7 Industry and services indicators, eurozone



Note: Since May 2010 business surveys data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev2) causing a potential break in series at this date.

Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 23 March 2012).

A1.1.8 Unemployment rates, eurozone



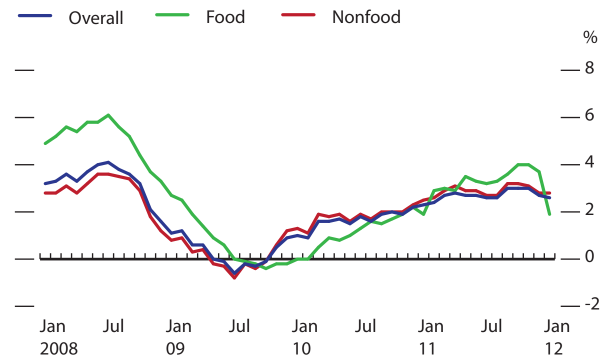
Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 8 March 2012).

a second rescue package for Greece confirmed again deep disagreement among eurozone members on how to resolve the crisis. Although a disorderly Greek default was prevented and additional measures to prevent further spreading of the crisis were agreed in March, July, and October 2011, sovereign interest rate spreads relative to German interest rates rose sharply in vulnerable economies, most importantly Spain and Italy. Tensions eased only as the European Central Bank (ECB) intervened in secondary sovereign debt markets.

During the October 2011 fall, the crisis intensified and new measures were taken to calm the situation. Although public attention is often directed to the European Financial Stability Facility (EFSF) as the prime mechanism to resolve the Greek debt crisis, the ECB has played a key role in stabilizing financial markets. After carefully extending its mandate beyond guaranteeing price stability to allow for direct purchases of government debt, it has emerged as a true lender of last resort.

In two longer-term refinancing operations in November 2011 and February 2012 offering three year loans at historically low interest rates, the ECB allocated about 1 trillion euros to the European banking sector. With the ECB turning to quantitative easing, sufficient liquidity is in the system to allow for smooth debt roll-over of most European economies.

A1.1.9 Harmonized indexes of consumer prices, eurozone



Note: Starting January 2011, a new methodology defines how seasonal products are to be treated in HICP affecting all-items index in the euroarea by a reduction of 0.1 percentage points for January 2011.

Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 5 March 2012).

Japan

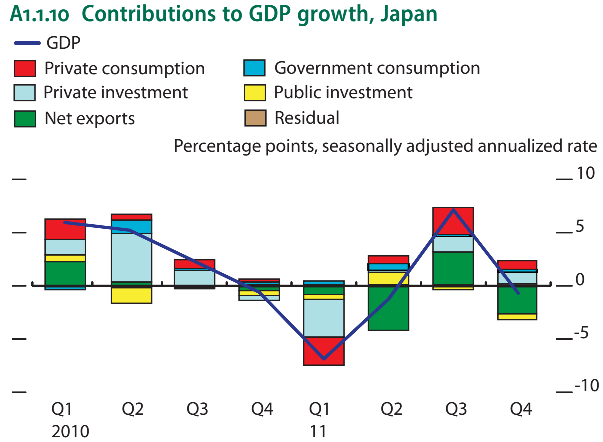
GDP contracted in the first half of 2011 by 2.9% (qoq saar) (Figure A1.1.10), although the 1.2% second-quarter GDP decline was smaller than expected given the earthquake in March, and may be a sign of recovery from the disaster. The contraction mostly occurred in exports of automobiles and electronic parts and stemmed from supply chain disruptions and weak private demand. Equally important was continued deflationary pressure.

Although reconstruction efforts started to be felt in the second half of 2011 (annualized quarterly GDP rose by 7.1% in the third quarter), supply-chain disruptions after the flooding in Thailand during August–November 2011, a persistently strong yen, and faltering foreign demand caused the GDP to contract by 0.7% in the last quarter of 2011 (qoq saar). GDP fell by 0.7% over the whole of 2011.

The recovery is expected to regain momentum in 2012, touching 1.9% GDP growth before receding to 1.5% in 2013, reflecting the dynamics of expected government expenditure: a sharp increase in 2012 will wear off and slow in 2013. Reconstruction will be driven by higher government spending and private residential investment; private consumption growth, by contrast, will remain weak.

The March disaster boosted imports in 2011, and will continue to do so this year, such that net exports will not contribute to GDP growth either this year or next. Consumer sentiment and business confidence have suffered amid fears relating to the nuclear crisis and deteriorating external environment. Sluggish wage growth and public expectations of a rise in the

A1.1.10 Contributions to GDP growth, Japan



Source: Economics and Social Research Institute, Cabinet Office, Government of Japan. http://www.esri.cao.go.jp/en (accessed 23 March 2012).

consumption tax will depress consumer sentiment in the coming years, with private consumption forecast to see almost no increase. Government consumption growth will be sustained throughout 2012–2013 by relief and reconstruction work, but it will fall back after that. Investment growth will also be boosted in 2012 by reconstruction.

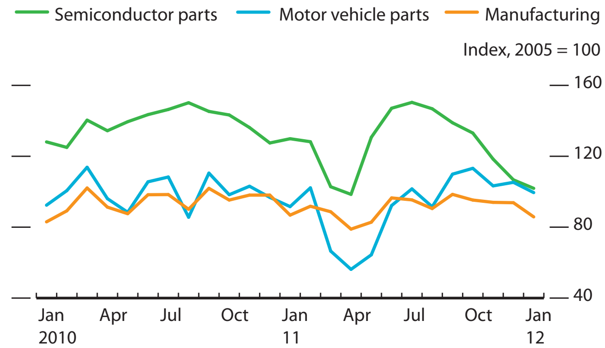
Industrial production recovered from its lows after the earthquake at first, but has been slow since (Figure A1.1.11). The floods in Thailand severely affected activity in the semiconductor industry.

Average consumer price inflation is estimated to have been above zero—0.3%—in 2011 (Figure A1.1.12) owing to supply-side factors, including a loss of agricultural land. Nonetheless, Japan's fundamentally deflationary environment remains in place, and the monetary authority is expected to preserve its expansionary stance while this is the case.

The Bank of Japan increased its Asset Purchase Program to ¥65 trillion in February 2012. In addition, the Bank of Japan introduced an explicit inflation target of 1% in the same month, suggesting more activity on the monetary policy front in the months to come.

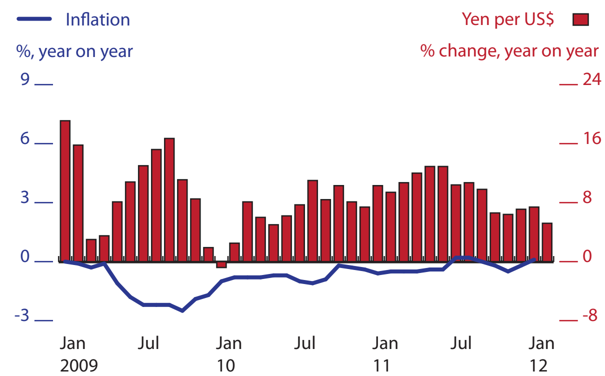
In the next 2 years, moderate economic growth and the consequent narrowing of the output gap will keep inflation in positive territory.

A1.1.11 Industrial production index, selected components, Japan



Source: Ministry of Economy, Trade and Industry. http://www.meti.go.jp (accessed 15 March 2012).

A1.1.12 Consumer price inflation and exchange rate, Japan



Source: CEIC Data Company (accessed 15 March 2012).