

World Economic and Financial Surveys

Regional Economic Outlook

Asia and Pacific

.....

OCT 10

World Economic and Financial Surveys

Regional Economic Outlook

Asia and Pacific

**Consolidating the Recovery and
Building Sustainable Growth**

.....

oCT 10

©2010 International Monetary Fund

Cataloging-in-Publication Data

Regional economic outlook : Asia and Pacific : consolidating the recovery and building sustainable growth. – Washington, D.C. : International Monetary Fund, 2010.
p. ; cm. – (World economic and financial surveys, 0258-7440)

“Oct. 10.”

Includes bibliographical references.

ISBN 978-1-58906-950-3

1. Economic forecasting – Asia. 2. Economic forecasting – Pacific Area.
3. Economic development – Asia. 4. Economic development – Pacific Area. 5. Inflation (Finance) – Asia. 6. Inflation (Finance) – Pacific Area. 7. Investments – Asia. 8. Investments – Pacific Area. I. International Monetary Fund. II. Series: World economic and financial surveys.

HC412.R445 2010

Please send orders to:
International Monetary Fund, Publication Services
PO Box 92780, Washington, DC 20090, U.S.A.
Tel.: (202) 623-7430 Fax: (202) 623-7201
E-mail: publications@imf.org
Internet: www.imfbookstore.org

Contents

Definitions	<u>vii</u>
Executive Summary	<u>x</u>
I. Moving to Sustainable Growth: Risks and Challenges	<u>1</u>
A. Recent Developments and Emerging Pressures	<u>1</u>
B. Economic Outlook	<u>12</u>
C. Risks	<u>26</u>
D. Policy Challenges	<u>30</u>
II. Inflation Dynamics in Asia	<u>41</u>
A. Introduction	<u>41</u>
B. Explaining Inflation Dynamics in Asia	<u>42</u>
C. A Closer Look at Inflation Dynamics in China and India	<u>46</u>
D. Conclusions and Policy Implications	<u>51</u>
Appendix 2.1. Global VAR	<u>54</u>
Appendix 2.2. Structural VAR (SVAR)	<u>54</u>
III. Investment and Rebalancing in Asia	<u>57</u>
A. Introduction	<u>57</u>
B. Investment Trends in Asia	<u>58</u>
C. What Drives Investment in Asia?	<u>60</u>
D. Policy Implications: How Can Asia Facilitate Rebalancing Through Investment?	<u>65</u>
E. Summary	<u>70</u>
Appendix 3.1. Firm-Level Analysis	<u>70</u>
IV. Low-Income Countries and the Pacific Islands	<u>75</u>
A. Introduction	<u>75</u>
B. Postcrisis Fiscal Adjustment in Asian Low-Income Countries	<u>75</u>
C. Sri Lanka: At a Crossroads	<u>78</u>
D. Mongolia: A Remarkable Turnaround	<u>79</u>
E. Fiscal Challenges for Compact Countries—Marshall Islands, Micronesia, and Palau	<u>80</u>
References	<u>85</u>
Boxes	
1.1 Global Volatility and Forex Returns in East Asia	<u>6</u>
1.2 The Yen's Appreciation and Its Implications for Japan's Outlook	<u>8</u>
1.3 A Financial Conditions Index for Asia	<u>11</u>
1.4 Are House Prices Rising Too Fast in China?	<u>13</u>
1.5 Capital Flows and Domestic Demand in Emerging Asia	<u>17</u>
1.6 Asia and Global Financial Reforms	<u>21</u>

REGIONAL ECONOMIC OUTLOOK: ASIA AND PACIFIC

1.7	Sovereign Spreads and the Risk of Contagion for Asia	29
1.8	Fiscal Policy in Commodity-Exporting Countries	34
1.9	Bank Funding and Liquidity Rules in Australia and New Zealand	38
2.1	Persistence of Food Price Inflation	52

Tables

1.1	Asia: Real GDP Growth	24
1.2	Selected Asia: Medium-Term Fiscal Objectives	36
2.1	Selected Asia: Pass-Through from Output Gap to Core Inflation	43
2.2	China: NKPC—Baseline GMM Estimates with Nonfood Inflation	48
2.3	India: NKPC—Baseline GMM Estimates with Core Inflation	49
2.4	India: NKPC—Baseline GMM Estimates with Wholesale Price Inflation	50
2.5	India: NKPC—Open Economy GMM Estimates with Core Inflation	50
3.1	Determinants of Private Investment Spending	61
3.2	Effect of Infrastructure on Private Investment Spending	63
3.3	How Would an Improvement in Fundamentals Affect Investment in Asia?	64
3.4	NIEs and Japan: Changes in Fundamentals, 1990–97 versus 2000–07 by Firm	65
3.A1	Selected Financial Indicators for Firms	71
3.A2	Investment Equations, Full Sample (1991–2008)	72
3.A3	Asia: Investment Equations, Sub-Sample Analysis	73
4.1	Asian LICs: Planned and Ongoing Fiscal Reforms	77

Figures

1.1	Selected Asia: Contributions to GDP Growth	1
1.2	Export-Oriented Asia: Real GDP	1
1.3	China: Urban Real Fixed Asset Investment	2
1.4	Asia: Merchandise Exports	2
1.5	Asia: Industrial Production	3
1.6	Selected Asia: Manufacturing Inventories and Shipments	3
1.7	United States: Electronics Inventories-to-Sales Ratio	3
1.8	Asia: Direction of Exports	4
1.9	Asia: Retail Sales Volume	4
1.10	Asia: Net Capital Inflows	4
1.11	Selected Emerging Asia: Net Foreign Investment in Equity Markets	5
1.12	Emerging Asia: Foreign Currency Bond Issuance and Foreign Holdings of Government Bonds	5
1.13	Asia: Stock Markets	5
1.14	Selected Asia: Real Effective Exchange Rate	7
1.15	Asia: Real Policy Rates	7
1.16	Asia: Credit to Private Sector	10
1.17	Selected Asia: Bank Spreads	12
1.18	Asia: Contributions to Change in Financial Conditions Index (FCI) since 2009:Q4	12
1.19	Asia: Estimated Output Gap Closure Dates	15
1.20	Asia: Headline Consumer Prices	15

1.21	Selected Asia: Property Prices	15
1.22	Asia: Fiscal Impulse	16
1.23	Asia: Cyclically Adjusted General Government Balance	16
1.24	Selected Asia: Unemployment Rate	19
1.25	Selected Asia: Real Wage/Earnings	20
1.26	Selected Export-Oriented Emerging Asia: Link Between Exports and Employment	20
1.27	Emerging Asia: Contribution to Recovery of Private Investment (2009:Q1–2010:Q1)	20
1.28	Asia: Real Cost of Equity	23
1.29	Selected Asia: Manufacturing Capacity Utilization	23
1.30	Commercial Banks' Loan-to-Deposit Ratio	23
1.31	China and India: Contributions to Growth	24
1.32	NIEs and ASEAN-5: Contributions to Growth	24
1.33	Industrial Asia: Contributions to Growth	25
1.34	Asia: Consumer Prices	25
1.35	Asia: Current Account Balance	25
1.36	Asia: GDP Growth	26
1.37	Selected Asia: Share of Non-Asian Final Demand in Asian Value Added	27
1.38	Selected Asia: Impact of 1 Percentage Point Decline in G-2 Final Demand on GDP Growth	27
1.39	Outstanding Cross-Border Claims of Asian Banks, 2009	27
1.40	Outstanding Claims of BIS Reporting Banks on Asia, 2009	28
1.41	Foreign Currency Refinancing Need for Nonfinancial Private Corporations	28
1.42	Asia: Local Currency Refinancing Need for Nonfinancial Private Corporations	28
1.43	Gross Public Debt, 2009	30
1.44	Emerging Asia: Stock Market Movements and Global Risk Aversion	31
1.45	Asia: Monetary Tightening since 2009:Q3	31
1.46	Emerging Asia: Excess Liquidity	31
1.47	Asia: Policy Rates and Estimated Taylor-Rule Rates	32
1.48	Asia: Household Debt, 2009	32
1.49	Emerging Asia (excl. China): Exchange Market Pressure Index	32
1.50	Asia: Projected General Government Gross Debt (2010–15)	33
1.51	Equity and Debt Portfolio Inflows	36
1.52	Global Imbalances	37
2.1	Asia (excl. Japan): Headline Consumer Price Index	41
2.2	Asia (excl. Japan): Core Consumer Price Index	41
2.3	Emerging Asia: Food and Energy Weights in Consumer Price Index Baskets	43
2.4	Asia (excl. Japan): Headline Inflation and Global Commodity Price Inflation	43
2.5	United States and Emerging Asia: Oil Demand	44
2.6	Emerging Asia: Metal and Soy Demand	44
2.7	Selected Asia: Contribution of Supply Shocks to Inflation Variation	44
2.8	Selected Asia: Contribution of Commodity Price Shocks to Inflation Variation and Oil Intensity	45
2.9	Selected Asia: Contribution of Aggregate Demand Shocks to Inflation Variation	45
2.10	Asia (excl. Japan): Year-on-Year Inflation and Output Gap	45
2.11	Change in the Relative Contribution of Shocks Between 1986–99 and 2000–10	46

REGIONAL ECONOMIC OUTLOOK: ASIA AND PACIFIC

2.12	Selected Asia: Relative Contributions of Domestic, Regional, and Global Factors to Inflation Variation	46
2.13	Selected Asia: Contribution of Domestic Demand Shocks to Inflation and Openness	46
2.14	Contribution of Regional Demand Factor to Fuel and Food Price Inflation	47
2.15	China: Consumer Price Inflation	47
2.16	India: Headline Inflation (WPI) and Inflation Volatility	47
2.17	China: Impact of Foreign Output Gap	48
2.18	China: Impact of Monetary Policy	48
2.19	China: Variance Decomposition of Inflation	49
2.20	India: Inflation and Output Gap	49
2.21	India: Actual and Simulated Inflation	51
3.1	Asia: Gross Fixed Capital Formation (GFCF) and Gross Saving	58
3.2	Export-Oriented Asia: Contribution to Change in Average Share of GFCF in GDP	58
3.3	Selected Asia: Change in Investment by Type	58
3.4	Phone Connections	59
3.5	Electricity Generation	59
3.6	Firm-Level Investment Rate, 2000–07	59
3.7	Composition of Investment by Sector	60
3.8	NIEs: Firm-Level Investment Rate, by Size and by Sector	61
3.9	Export-Oriented Asia: GFCF—Change in Share versus Change in Relative Prices	61
3.10	Corporate Sector Leverage: 2000–08	64
3.11	Uncertainty: 2000–08	64
3.12	Effective Corporate Tax Rates in OECD	67
3.13	Selected Asia: Size of the Corporate Bond Market, 2009	67
3.14	Selected Advanced Economies: Venture Capital Investment	67
4.1	Asia: Changes in Fiscal Balance Relative to Precrisis Level	76
4.2	Asian LICs: Expenditure versus Revenue	76
4.3	Asian LICs: Public Debt	76
4.4	Sri Lanka: Gross Official Reserves	78
4.5	Sri Lanka: Inflation and GDP Growth	78
4.6	Mongolia: Real GDP	79
4.7	Mongolia: Mineral Exports	80
4.8	Compact Countries: Share of Grants in Overall Revenue, FY2008	81
4.9	Compact Countries: Fiscal Balance, FY2008	81
4.10	Pacific Island Economies: Public Wage Expenditure, 2007	81
4.11	Pacific Island Economies: Tax Revenue, 2007	82
4.12	Compact Trust Fund Balance	82

Definitions

In this *Regional Economic Outlook: Asia and Pacific*, the following groupings are employed:

- “Emerging Asia” refers to China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, Thailand, and Vietnam.
- “Industrial Asia” refers to Australia, Japan, and New Zealand.
- “Asia” refers to emerging Asia plus industrial Asia.¹
- “Newly industrialized economies” (NIEs) refers to Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.
- “ASEAN-4” refers to Indonesia, Malaysia, the Philippines, and Thailand
- “ASEAN-5” refers to Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.
- “EU-15” refers to Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.
- “G-2” refers to the euro area and the United States.
- “G-7” refers to Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
- “G-20” refers to Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

The following abbreviations are used:

AER	average effective rate
APRA	Australian Prudential Regulation Authority
AsDB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BoJ	Bank of Japan
BVAR	Bayesian variance autoregression
CFR	core-funding ratio
CPI	consumer price index
EM	emerging markets
FDI	foreign direct investment
FY	fiscal year
GARCH	generalized autoregressive conditional heteroscedasticity
GDP	gross domestic product

¹ This definition of Asia differs from the *World Economic Outlook*.

REGIONAL ECONOMIC OUTLOOK: ASIA AND PACIFIC

GMM	generalized method of moments
GVAR	global vector autoregression
IRD	inland revenue department
IT	information technology
LAR	largest autoregressive root
LIC	low-income countries
MER	marginal effective rate
NIE	newly industrialized economy
NKPC	New Keynesian Phillips Curve
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
PFM	public financial management
PICs	Pacific Island countries
PPP	purchasing power parity
REER	real effective exchange rate
RBNZ	Reserve Bank of New Zealand
REO	<i>Regional Economic Outlook</i>
SAAR	seasonally adjusted at an annual rate
SARC	sum of autoregressive coefficients
SIFI	systemically important financial institutions
SMEs	small and medium-sized enterprises
SOEs	state-owned enterprises
SVAR	structural vector autoregression
VAR	vector autoregression
VAT	value-added tax
WEO	<i>World Economic Outlook</i>
WPI	wholesale price index

The following conventions are used:

- In tables, a blank cell indicates “not applicable,” ellipsis points (. . .) indicate “not available,” and 0 or 0.0 indicates “zero” or “negligible.” Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2007–08 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2007/08) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2010).
- An em dash (—) indicates the figure is zero or less than half the final digit shown.
- “Billion” means a thousand million; “trillion” means a thousand billion.
- “Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percentage point).

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

This *Regional Economic Outlook: Asia and Pacific* was prepared by a team coordinated by Vivek Arora and Roberto Cardarelli of the IMF's Asia and Pacific Department, under the overall direction of Anoop Singh. Contributors included Ashvin Ahuja, Brian Aitken, Steve Barnett, Pelin Berkmen, Julia Bersch, Ran Bi, Carlos Caceres, Stephan Danninger, Leif Lybecker Eskesen, Roberto Guimaraes, Byung Kyoon Jang, Sanjay Kalra, Svitlana Maslova, Malhar Nabar, Carolina Osorio Buitron, Runchana Pongsaparn, Nathan Porter, Yasuhisa Ojima, Mousa Shamouilian, Murtaza Syed, Kiichi Tokuoka, Patrizia Tumbarello, D. Filiz Unsal, Olaf Unterberdoerster, Shengzu Wang, and James Walsh. Souvik Gupta, Adil Mohommad, and Yiqun Wu provided research assistance; Antoinette Kanyabutembo and Lesa Yee provided production assistance. Martha Bonilla and Joanne Blake of the IMF's External Relations Department edited the volume and coordinated its publication and release. This report includes comments from other departments and some Executive Directors.

Executive Summary

Asia has entered the second year of the global economic expansion still firmly in the lead of the recovery. Growth in the first half of 2010 proceeded well above trend in almost all regional economies, as global manufacturing continued to rebound and fueled exports and investment in the region. Private consumption also remained strong, as labor conditions continued to improve and confidence remained high despite greater market volatility as a result of global financial turbulence.

During the second half of 2010, economic activity has moderated toward a more sustainable pace, although it remains robust. In particular, industrial production and export growth rates have started to moderate. This in part reflects the maturing of the global and regional inventory cycle, particularly for the information technology products that are important for production and exports in many Asian economies.

The short-term baseline outlook for Asia remains positive, with growth expected to settle at more sustainable but still high levels. Growth is likely to remain particularly strong in the large, domestic-demand-driven economies of China, India, and Indonesia. The continuing, albeit sluggish, recovery in advanced economies during 2010–11 that is envisaged in the October 2010 *World Economic Outlook* should support firm growth in Asia's exports, although below the very high rates of 2009 and early 2010. A gradual pace of withdrawal of policy stimulus, sustained improvements in labor market conditions, and still accommodative financial conditions are expected to sustain private domestic demand. Ample global liquidity on the one hand, and the relatively robust growth and low public debt in Asia on the other hand, should continue to fuel capital flows to the region. Reflecting the slowing of export growth and strong domestic demand, Asia's current account surplus is projected to decrease to about 3 percent of regional GDP in 2010 and 2011, from about 5 percent in 2007, making a modest contribution to the narrowing of global imbalances.

The main risk to the outlook is the external environment. As discussed in the *World Economic Outlook*, while global financial conditions have improved since June 2010, underlying sovereign and banking vulnerabilities in advanced economies remain a significant challenge, and concerns linger over the strength of the global recovery. Despite Asia's strong economic and policy fundamentals, important trade and financial linkages with advanced economies suggest that a further deterioration in global financial conditions and a slowing of the global recovery would have important repercussions for the region.

In view of the strong economic expansion that is under way, and emerging signs of inflationary pressure in some economies, Asia has reached the threshold to normalize policy stances across the region. Many economies have started to take steps in this direction. But monetary and fiscal policies are still generally accommodative and, with output gaps closing rapidly, inflation pressures could intensify next year with the risk that policies are becoming more procyclical. In particular, tight capacity constraints could exacerbate the effect of supply shocks on inflation, as discussed in Chapter II. Continued capital inflows may also pose risks to financial stability if they are associated with excessively easy domestic financial conditions. Macroprudential measures have appropriately been taken in many regional economies to minimize these risks, but a further tightening of monetary policy conditions may be needed, including through greater exchange rate appreciation. A faster withdrawal of fiscal stimulus would also help guard against the risks of overheating and a buildup of financial imbalances. Should global conditions worsen, however, the region has the room to delay the normalization of policy stances.

Over the medium term, sustaining robust growth in Asia will require continued progress with rebalancing growth toward domestic demand. For Asia as a whole, only limited progress has been made toward reducing external imbalances. In 2009, while China's current account surplus narrowed as a percent of GDP, those of many other Asian economies, such as NIEs and ASEAN, increased. With external demand from advanced economies unlikely to return to precrisis trends in the foreseeable future, Asia will need stronger domestic demand to maintain robust growth. The normalization of policy conditions in Asia would, therefore, need to be accompanied by continued measures to reinforce private domestic consumption and investment. The challenge of raising private consumption was discussed in some detail in the April 2010 Asia and Pacific *Regional Economic Outlook*. In the present Asia and Pacific *Regional Economic Outlook*, Chapter III focuses on the challenge of raising investment and stresses the importance of measures to facilitate access to credit, particularly for smaller, domestically oriented, and service sector firms. The chapter also highlights the importance of reviving investment in infrastructure, which will contribute to rebalancing both directly and indirectly, by improving the environment for private sector investment.

In Asian low-income and Pacific Island countries, policy stimulus and rising global demand for commodities and garments have driven a strong recovery in recent quarters. But these economies face significant challenges in the near and medium term, including the need for fiscal consolidation to strengthen fiscal positions and create more policy space, and the need for structural reforms to raise potential growth and reduce vulnerabilities. Chapter IV discusses these issues.

This page intentionally left blank