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Policy challenges for sustaining the dynamism of Asia-Pacific economies

Policy challenges for sustaining the dynamism of Asia-Pacific economies: growth outlook, emerging headwinds and policy agenda for inclusive and sustainable development

Note by the secretariat

Summary

The Asia-Pacific region is facing the challenge of coping with a sharp deterioration in the global environment. As forewarned by ESCAP, the developed economies of the world remain mired in the economic crisis which erupted in 2008. The impact on Asia-Pacific countries at this stage of the crisis will be on the financial markets through capital outflows due to risk aversion, and more fundamentally on growth due to shrinking demand for exports.

Many economies in the region also continue to grapple with the challenge of inflation, influenced in substantial part by factors such as global food and oil prices and foreign capital inflows buoyed by global liquidity. Many countries in the region are now confronted with the dilemma of maintaining price stability in the face of a deteriorating global economic environment.

Policymakers in the region should vigilantly monitor the development of spillovers from the problems of the developed world. Any global credit crunch would undoubtedly have an impact on financial markets in the region, as was the case in 2008. It is increasingly accepted that capital controls have to be strengthened to deal with such risks. Nevertheless, the region remains in a relatively favourable situation due to its strong macroeconomic fundamentals, which allow for the enactment of short-term stimulus. The medium-term challenge for the region is to sustain its development by continuing to rebalance growth through inclusive policies which boost domestic and regional demand.

Committee members may wish to share their experiences, and the Committee may wish to consider the issues analysed in the present document, and provide guidance regarding the future regional policy agenda for inclusive and sustainable development.

* The late submission of the present document is due to the non-availability of relevant national data by the submission deadline.

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I. Outlook and emerging headwinds for Asia and the Pacific

A. Coping with the deteriorating global environment

1. The Asia-Pacific region is facing the challenge of coping with a sharp deterioration in the global environment. As forewarned by ESCAP,¹ the developed economies of the world remain mired in the economic crisis which erupted in 2008. After showing welcome resilience during the initial months of the crisis in late 2008, which affected mainly the financial sector, the region was subsequently buffeted by the spill over of the crisis into the real economy and the resulting sharp reduction in demand in the developed economies in 2009. From 2010 onwards, the region showed impressive strength through export recovery due to fiscal stimulus-boosted export demand pickup in the developed economies and the growth of intraregional trade, as well as continued robust domestic demand in several Asia-Pacific economies. There are now indications, however, that the region will likely have to contend with a more challenging global environment in the coming months.

2. While there was an outbreak of premature optimism in early 2011, it has become increasingly clear that recovery of the developed economies has come to a halt. This has opened a second stage of the crisis where the United States of America and advanced economies in Europe need to tackle their public debt issues amid ailing growth in contrast to the first, initial stage of the crisis stemming from the financial sector. The stalled growth performance has even increased the likelihood of a double-dip recession in some economies and is likely to have an adverse impact on the Asia-Pacific region. The impact on Asia-Pacific countries at this stage of the crisis will be on the financial markets through heightened risk aversion and higher risk premiums that may spill over to the real economy in the form of higher capital costs for more risky firms. More fundamentally, slowing growth in developed economies will directly affect Asia and the Pacific through shrinking demand in the developed world for their exports.

3. Many economies in the region also continue to grapple with the challenge of inflation. Persistent inflation across countries is influenced in substantial part by global factors, particularly food and oil prices and foreign capital inflows. In addition, some countries with a high proportion of domestic demand have witnessed additional inflation due to local factors. In order to manage the impact of these factors on core inflation, authorities engaged in substantial monetary policy tightening during 2011. The impact of this tightening, in addition to a decrease in global commodity prices due to slowing global growth, has moderated the pace of inflation in many cases. Nevertheless, with the level of inflation remaining relatively high, countries are confronted with the dilemma of maintaining price stability in the face of slackening growth resulting from a deteriorating global environment.

4. The measures likely to be adopted by developed economies in order to foster growth will present further challenges for the region. With the limited scope for most developed economy governments to engage in much further fiscal stimulus, due to differences in views in the United States and the sovereign debt crisis in the euro zone, governments are likely to

¹ *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2).

maintain a loose monetary stance as their main stimulatory tool. In the United States, there is the possibility of a third round of quantitative easing, while, in the euro zone, low interest rates are likely to continue as long as inflationary pressures remain subdued. Injecting further liquidity to the financial markets as well as the interest rate differential with the Asia-Pacific region will result in the continuing attraction of asset markets and currencies in the region for foreign investors. As a result, there will continue to be the risk of a build-up of asset market bubbles, exchange rate appreciation and inflationary pressures for the region through this channel. On the other hand, asset markets and exchange rates are currently being destabilized due to sharp outflows of capital as a result of global risk aversion in the face of uncertainties regarding global financial stability. There is the risk of future periods of such reversals in response to further unexpected global economic events. One such event could be a sovereign debt default by economies in the euro zone, which may lead to fears of significant losses by developed economy banks, causing a credit crunch, a flight to safety and repatriation of funds from Asia-Pacific markets. Apart from the inflow of capital, inflationary pressure in the region may be caused by higher commodity prices that appear to be supported by the injection of global liquidity. One of the main causes of inflationary pressure across the region has been steep rises in food and oil prices. It is now relatively widely accepted, as highlighted previously by ESCAP,² that one of the driving forces behind these price rises since the outbreak of the crisis has been the financialization of commodity markets fuelled by liquidity resulting from monetary easing in developed economies.

5. In the face of so many rapidly evolving challenges, policymakers in the region should vigilantly monitor the early warning signs of blowback from the developed world. The region remains in a relatively favourable situation in terms of protecting its economic dynamism in the face of these challenges due to its strong macroeconomic fundamentals. If serious pressure on growth performance were to materialize, the strong budgetary positions of many countries would allow the enactment of short-term fiscal stimulus measures. Furthermore, if inflationary pressures were to decline substantially due to concerns about global growth, the relatively high interest rates in the region would provide space for monetary easing. In the banking sector, the region is not likely to be hit significantly by losses due to a sovereign debt default as most regional banks have limited direct exposure. Nevertheless, a credit crunch would have an impact in the region due to the reliance of some economies on borrowing from abroad, while sudden capital outflows could place asset markets and the currencies of some economies under strain, as was the case in 2008.

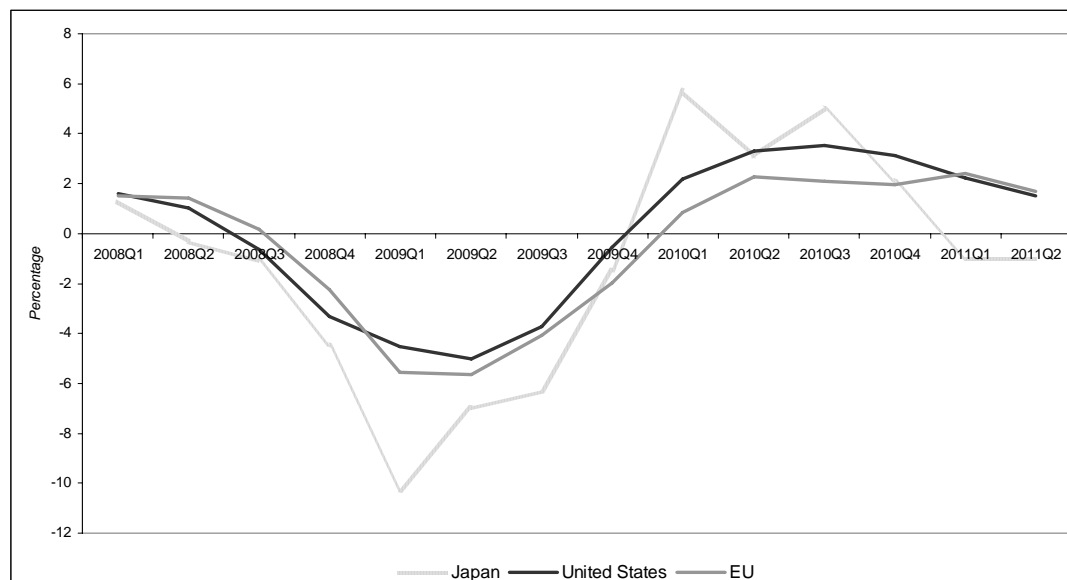
B. Second phase of the crisis in developed economies

6. The United States and the economies of the euro zone—the major developed economies and the region's key export markets—have been experiencing stalled growth due primarily to concerns about sovereign debt levels. Growth data over the past few quarters indicate a halt to the recovery process in these economies (see figure 1). Meanwhile, growth in Japan veered sharply downwards due to the after-effects from the tsunami and the nuclear incident of early 2011. Once normal economic activity resumes and the reconstruction of affected areas begins, growth is expected to increase, but, while this will be beneficial for the economy, it is not likely to

² *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2).

contribute significantly to growth in the rest of the region due to the diminishing importance of the economy as an export market.

Figure 1
Real gross domestic product growth by quarter, year-on-year, of major developed economies, 2008-2011



Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from <http://ceicdata.com> (accessed 5 September 2011).

7. There are a number of time-specific reasons for the slowdown in the United States, the euro zone's high oil prices in early 2011 and the impact of the disaster in Japan on global supply chains. However, additional reasons for the slowdown are more fundamental in nature and lead to concern regarding the prospects for the economies in the year ahead because earlier fiscal stimulus measures have been increasingly phased out over a period that has seen slowing growth. Furthermore, the overriding importance being given to reducing debt through spending cuts in these economies means that there is not likely to be significant additional fiscal stimulus in the future.

8. There are differing reasons for the limited scope in providing further significant stimulus in the United States and the euro zone, although the implications are similar. In the case of the United States, the political parties in the legislature hold different views towards the country's debt situation, as was seen during the recent debt ceiling negotiations, which led Standard & Poor's to downgrade the country's debt status. For most of the euro zone, further fiscal stimulus is even more unlikely than in the United States given the pressure from the financial markets to engage in austerity measures in order to maintain acceptable yield spreads for new debt issuance. Another source of pressure comes from attempting to avoid the excessive deficit procedure established by the European Commission to discipline countries with insufficiently prudent fiscal policies. A key risk from the continuing euro zone debt crisis is the possible impact on major banks in Europe and other developed economies. There is the possibility that any defaults on euro zone sovereign debt held by the banks or stress tests which involve their sovereign debt assets being marked down to market value will result in the failure of some banks, thereby inducing a new banking crisis, which

would wreak havoc with global financial markets and entail a possible global credit crunch and the need for government bailouts.

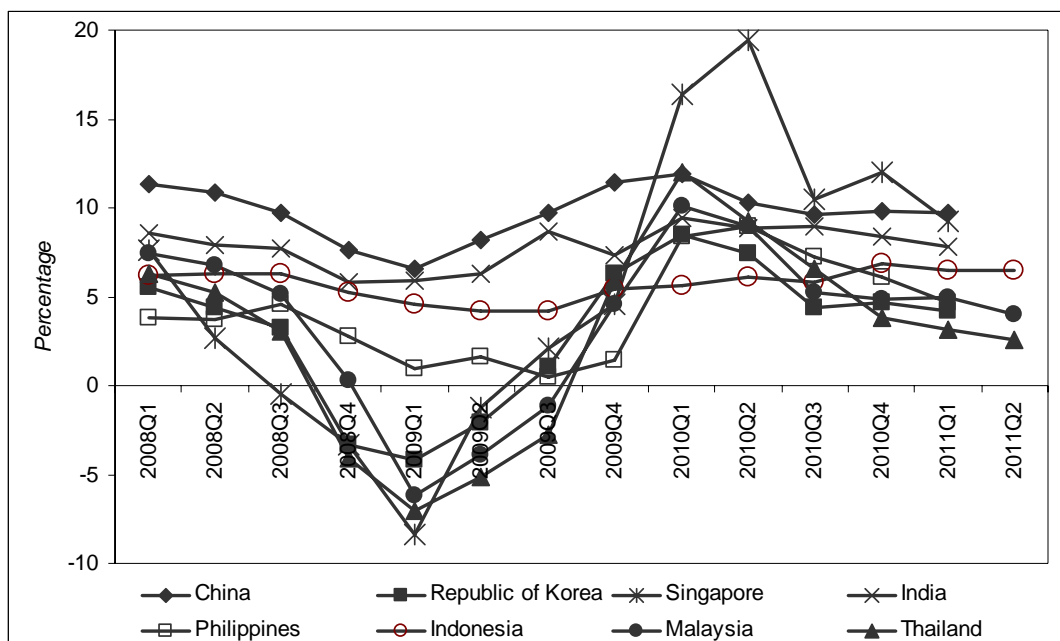
9. The other main option open to policymakers in the United States and the euro zone is a further loosening of monetary policy. In the United States, further reduction of interest rates is not possible given their current near-zero levels. Therefore, unconventional methods of loosening monetary policy are required. In August 2011, the United States Federal Reserve Bank took one such measure by pledging not to raise interest rates until mid-2013. The most potent tool that remains available to the United States, due to the large scale on which it can be implemented, is another round of quantitative easing. However, as the previous round did not prove to be very effective, there is little reason to believe that further quantitative easing would achieve significantly better results. Despite concerns about its efficacy, the potential benefits of a new round of quantitative easing may make the option attractive as one of the few viable alternatives to support growth in the absence of fiscal policy measures. In the euro zone, there remains some limited room to further reduce interest rates.

10. Emerging Asia-Pacific economies, along with other developing economies around the world, will have to manage the various negative impacts of the measures taken to revive growth in developed economies as well as the slowing growth itself. One result of increased global liquidity due to monetary stimulus will be more foreign capital which will head for the region's shores. Global liquidity may also be directed in part to commodity markets, such as food and oil, further spurring inflationary pressure for the region. With regard to slowing growth in developed economies, apart from the trade impact on the region, another risk is an increase in protectionist measures in those economies. As has been observed during most downturns, there is a tendency to protect domestic industries in affected economies by restricting competition from exports. This can lead to measures to depreciate the currencies of developed economies and to trade measures aimed at supporting exports while restricting imports. Consequently, there exists the possibility of a global currency war in which the region would be obliged to manage exchange rates in order to maintain export competitiveness.

C. Varied Asia-Pacific exposure to the slowdown in the developed world

11. Despite the perilous state of the developed economies, the growth impact on Asia and the Pacific will depend very much on country circumstances. The initial signs of slowing growth in some economies in the region can be seen in their performance in recent quarters (see figure 2). There are two key aspects driving the degree of exposure of economies in the region. One is the extent to which the export sector is important as opposed to domestic demand. In this respect, the region possesses prominent examples of both sets of economies. While many economies in the region are notable for their export dependence, other economies in the region are key players in driving global growth due to their large domestic demand. The other aspect, which provides an increasing avenue of support even to the exposed exporting economies, is the growing importance of intraregional exports flowing to economies with large domestic demand.

Figure 2
Real gross domestic product growth, year-on-year, in selected developing ESCAP economies, 2008-2011



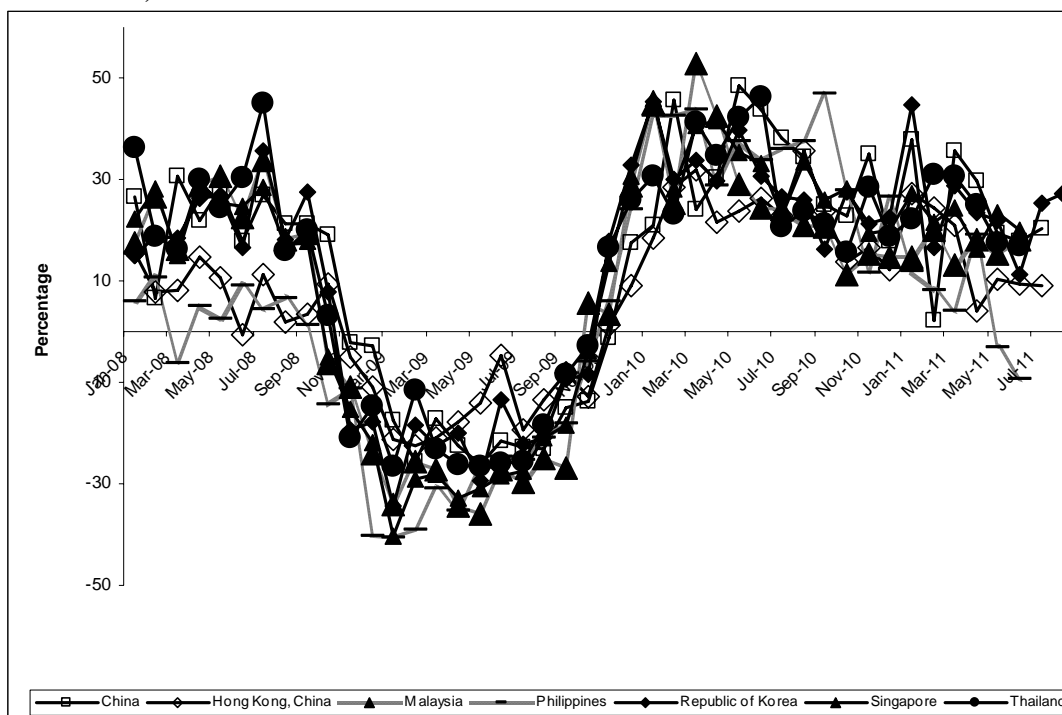
Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from <http://ceicdata.com> (accessed 5 September 2011).

12. The economies in the region which face the greatest growth pressure from the developed world slowdown are the manufacturing export-dependent economies of East and South-East Asia. These are the economies which have the highest share of their gross domestic product (GDP) accounted for by exports. The economies with the greatest exposure are Malaysia, the Philippines, the Republic of Korea, Singapore, Thailand, Taiwan Province of China and Hong Kong, China. The initial signs of such a slowdown can already be seen in the export growth performance of some of these economies in recent months (see figure 3). Other economies in the region which may also experience a slowdown in exports due to the global situation are commodity exporters. The impact on this group is less certain, as not all commodity prices, such as those of food, may move downwards in line with global growth. Therefore, certain commodity producers in the region may be more negatively affected than others, depending on the type of commodity produced.

13. On the other hand, the economies which will suffer the least from the above-mentioned slowdown are those with large and robust domestic sectors—the most prominent being India, Indonesia and China. While strong domestic demand in India and Indonesia are related to a high proportion of consumption in GDP, in the case of China the domestic demand is mainly through the investment channel. China is a special case in that exports are more important to the economy than other economies with large domestic demand, with a significant proportion of investment also related to the export sector. This implies that a continued decrease in demand from the developed world will exert a larger impact on growth. Furthermore, investment in China since the onset of the 2008 crisis has not always been based on fundamental factors, having been supported in some cases by policies engendering strong credit growth. It is also somewhat the case that consumption in India and Indonesia has been supported additionally by real interest rates which have been relatively

accommodating. With India and China concerned with relatively high inflation rates by their recent historical standards, their ongoing moves to tighten monetary policy over the past year may constrain previously robust domestic demand to some degree. Indeed, recent growth performance in these large economies indicates the impact of policy tightening, with GDP growth in India in the second quarter of 2011 down to its lowest level in 18 months, though still robust at 7.7 per cent.

Figure 3
Growth in exports, year-on-year, for selected developing ESCAP economies, 2008-2011



Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from <http://ceicdata.com> (accessed 15 August 2011).

14. High-frequency indicators provide some guidance as to possible slowdown of exports ahead for numerous countries. While growth has already slowed down in the developed markets over the past few quarters when compared to 2010, the impact on the region's exports is normally delayed by a number of months due to the time gap between orders and production. The low Purchasing Managers' Index (PMI) readings in a number of key exporting economies in recent months—for instance, the Republic of Korea and Taiwan Province of China in August 2011—indicate that exporters are expecting production to be affected in the near future. Export growth figures in the latter part of 2011 will need to be closely watched for direct confirmation of this potential export slowdown. The impact of the earthquake and tsunami in Japan on the regional supply chain resulted in exports being artificially depressed in some economies; this will make establishing a trend towards export growth somewhat complex. As production in Japan resumes over the course of 2011, export growth may benefit somewhat through this channel. Nevertheless, the deceleration of export growth in coming months can already start to be seen from the decline in month on month figures for new export orders in a number of key exporting economies. The August 2011 figures for China are an example of this.

15. The increasing importance of intraregional export demand is a factor which will help to alleviate the impact of the slowdown in the developed economies. However, caution is necessary, as the slowdown in overall manufacturing in many economies of the region, which can be seen from the declines in PMIs in recent months, is a clear indicator of the continued importance of the developed economies because it comes in tandem with the slowdown in those economies. Trade within the region is indeed growing faster than the region's trade with the rest of the world. While the region's exports to the rest of the world roughly doubled between 2000 and 2009, intraregional exports rose almost 2.5 times.³ However the importance of intraregional exports as a proportion of total exports has so far only increased marginally as a result of these trends. The share of intraregional exports in total Asia-Pacific exports increased from about 49 per cent in 2000 to about 52 per cent in 2009.⁴ Furthermore, the proportion of intraregional exports which supply final demand in the region is substantially lower, as a significant portion of exports of the medium-income and higher-income economies of the region are intermediates which are processed in another country and exported onward to the developed economies. China is the most prominent destination for intraregional intermediate inputs, with the country's large proportion of exports to the developed economies providing a somewhat better picture of the true importance of the developed economies to this set of economies in the region. If demand from developed economies were to slow down significantly and remain sluggish for some time, a ripple effect across the regional supply chain might eventually be reflected in intraregional exports.

16. Intraregional demand will not be as supportive for exporting economies as it was at the start of the crisis due to the lower likelihood of significant stimulus in the major economies with large domestic demand. The two largest developing economies in the region, China and India, are more concerned with taming price rises than with maintaining growth which, though slowing, remains at relatively robust levels. ESCAP analysis⁵ shows that the strong growth of China was a key factor in the export recovery of the region after the onset of the crisis and prior to the subsequent uptick in demand from the developed economies. Demand from India was also a factor supporting growth in the region, with India notable for its characteristics as an economy with large and growing domestic consumption which maintains trade deficits with most of the region. In 2010, for example, the economies of the Association of Southeast Asian Nations (ASEAN) had a trade surplus with India of \$13 billion, representing 17 per cent of the total trade surplus of ASEAN, and China had a trade surplus with India of \$21 billion.⁶ However, as opposed to the situation at the onset of the crisis, the policy regimes in both China and India have now moved from stimulus to monetary tightening in order to moderate the respective drivers of domestic demand in the areas of investment and consumption. It is this two-track nature of growth in the region, with inflation concerns being dominant for the domestic-demand oriented group, and growth concerns for the export-oriented group, which

³ *Asia-Pacific Trade and Investment Report 2011* (United Nations publication, Sales No. E.11.II.F.8.), Chap. 1, p. 9.

⁴ *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2), Chap. 3.

⁵ *Ibid.*, Chap. 1, p. 11.

⁶ *Economic and Social Survey of Asia and the Pacific 2010* (United Nations publication, Sales No. E.10.II.F.2), Chap. 1, p. 16.

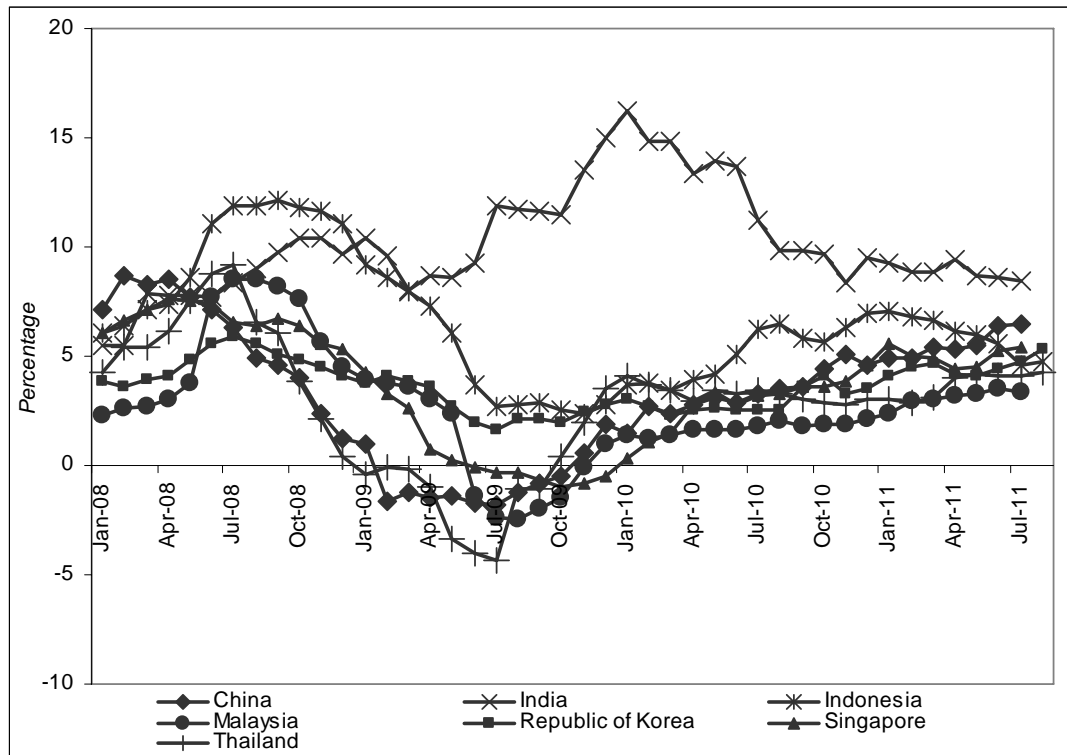
implies that intraregional demand may well prove less supportive for growth in the short term than in previous years.

D. Continuing inflationary pressure from abroad

17. The rising pace of inflation during the earlier part of 2011 has been moderated by global developments as well as monetary policy tightening across much of the region. While much of the pressure behind the price rises was supply-led and came from abroad due to high global food and oil prices, strong growth in economies due to robust exports and strong domestic demand contributed in some measure to demand-led inflation. The drivers of inflation also differ across the region, with domestic-demand-led economies experiencing consumption or investment booms having more concerns about demand-side inflation, whereas exporting economies have been more influenced by imported inflation. For such exporting economies, with demand-led pressure receding in many countries due to the less supportive global environment for exports in recent months, the main inflationary spur is now concentrated on the outlook for global food and oil prices. It is not certain if lower global growth will necessarily result in significant reductions in such prices, with a number of countervailing price drivers at work. For domestic demand-led economies, managing the domestic drivers of inflation will continue to be a policy challenge. In some of these economies, however, growth has also been slowing down due to the strong monetary policy measures taken to bring prices under check. Managing the different drivers of inflation across the region will be a challenge for policymakers in an environment of imperilled growth performance, as any and all monetary policy decisions will also have an impact on that performance.

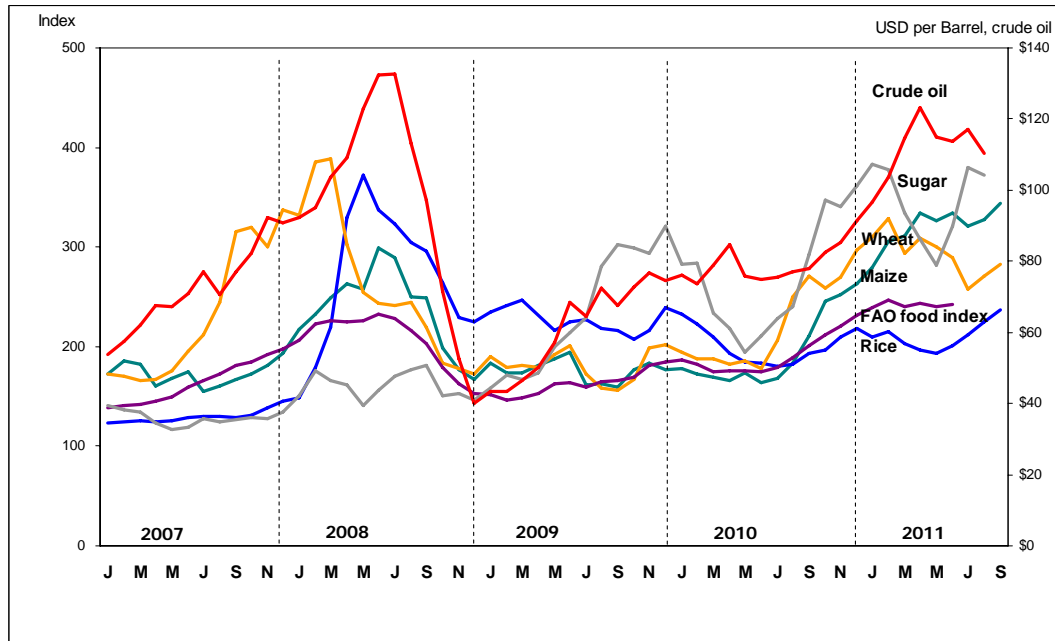
18. During the course of 2010, inflation emerged as a pressing concern across much of the region (see figure 4), though it was driven by differentiated factors for particular groups of economies. In the more globalized exporting economies of South-East Asia and East Asia, price rises were spurred by high global food and oil prices (see figure 5), along with capital inflows to the relatively open financial markets of those economies. High food and oil prices were supported by a combination of concerns about oil producing economies in the Middle East due to political upheaval, weather-related supply disruptions in key food producing countries, redirection of food crops to produce biofuels, and liquidity-driven speculation on commodity markets. Price rises were also supported by strong capital inflows into many of these economies as a result of high global liquidity, interest rate differentials within the developed economies, and relatively healthy growth prospects. These capital inflows contributed to substantial rises in the prices of assets such as equities and property. For a number of economies in which domestic demand plays a major role, price rises due to global food and oil prices were supplemented by significant demand-side pressures. Many economies in South Asia, such as India, were especially affected by consumption-demand related price increases. China, on the other hand, was particularly impacted by investment demand-led price increases, with prices increasing beyond the target level of policymakers as investment was spurred by strong credit growth stemming from stimulus measures enacted during the crisis.

Figure 4
Consumer price inflation, year-on-year, in selected developing ESCAP economies, 2008-2011



Source: ESCAP, based on data extracted from CEIC Data Company Limited (as of 6 September 2011).

Figure 5
Oil price, FAO Food Price Index and selected food prices (index 1998-2000 = 100), 2007-2011

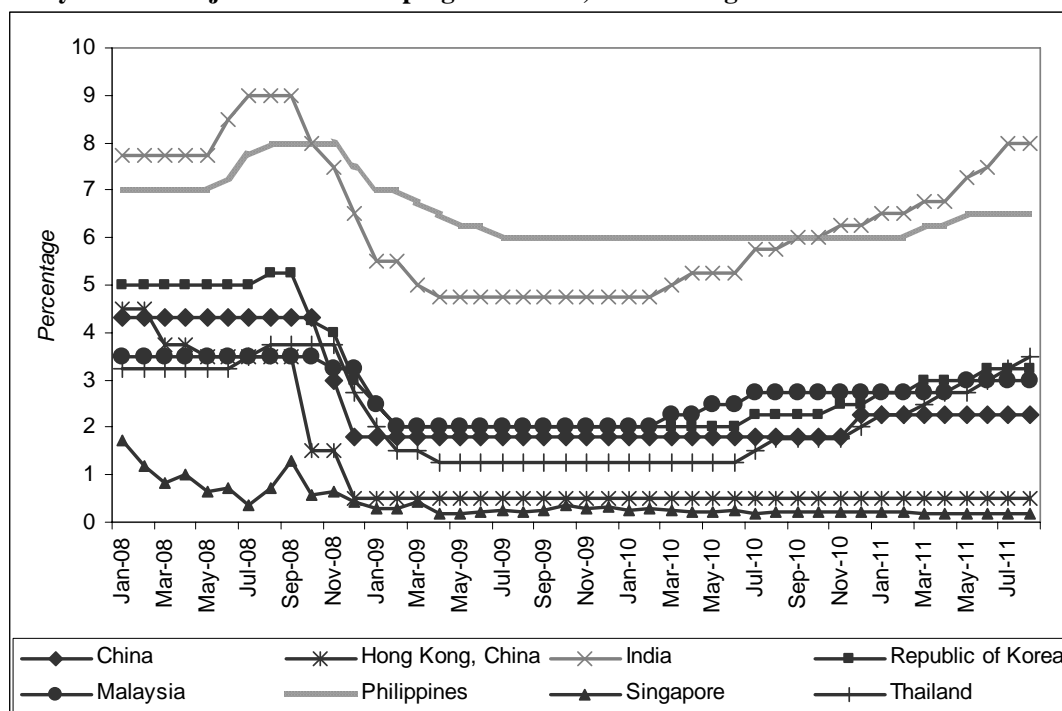


Sources: Food and Agriculture Organization of the United Nations, <http://www.fao.org/es/esc/prices/PricesServlet.jsp?lang=en>; United States Energy Information Administration, http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm; and International Monetary Fund Primary Commodities Price.

Last updated: 13 September 2011.

19. Economies across the region reacted to rising prices by enacting monetary policy tightening progressively starting in 2010 (see figure 6). As growth prospects for exporting economies have moved downwards in line with the global environment, the trade-off of inflation-related monetary tightening with growth has assumed increasing importance. The impact of tightening over recent months along with lower commodity prices have also led to some stabilization of inflation rates in some economies of the region (see figure 4). Concerns regarding growth prospects as well as the somewhat more positive outlook for inflation have led some economies to hold off on further monetary policy tightening of late (see figure 6). In contrast, economies whose growth is primarily due to domestic factors have continued to use monetary policy to dampen demand-side price pressures. Monetary policy and other controls on lending have been tightened throughout 2011 in a number of South Asian economies and China. The negative impact of such measures on growth in these economies has been accepted as necessary in order to manage the threat of overheating. Nevertheless, the situation of China is somewhat unique in that both exports and investment exert a significant impact on growth through various channels. Therefore, measures to dampen demand-side inflation due to excessive investment at a time of slowing exports would introduce an additional source of pressure on growth in the economy, raising some concerns about an inevitable “hard landing” for the economy.

Figure 6
Policy rates in major Asian developing economies, 2008 to August 2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 6 September 2011).

Notes: China: Policy rate (rediscount rate); Hong Kong, China: Policy rate (Discount Window base rate); India: Policy rate (Repo rates (Reserve Bank of India)); Republic of Korea: Policy rate (base rate (Bank of Korea)); Malaysia: Policy rate (overnight policy rate); Philippines: Policy rate (repurchase rate); Singapore: Overnight Repo rate; Thailand: Policy rate (end month).

20. The outlook for inflation in coming months has become less certain due to a number of countervailing forces pressing on the region. It would normally be expected that slowing global growth would reduce demand for commodities and therefore substantially lower food and, especially, oil prices. However, these prices are dependent on a number of factors apart from global demand. On the supply side, there are ever present risks of supply disruptions stemming from weather conditions for food and continuing instability in the Middle East for oil. On the demand side, the interaction of food and oil through biofuels and high global liquidity spurring speculation in commodity markets may continue to exert upward pressure on prices. This would present the problem that the prices of these key commodities would be rising, remaining stable or at least not falling significantly at a time of slowing growth. For non-commodity-producing economies in the region, such a scenario would imply the need to support growth at a time when price pressures through the commodities channel have not completely abated.

E. Increased volatility in financial markets

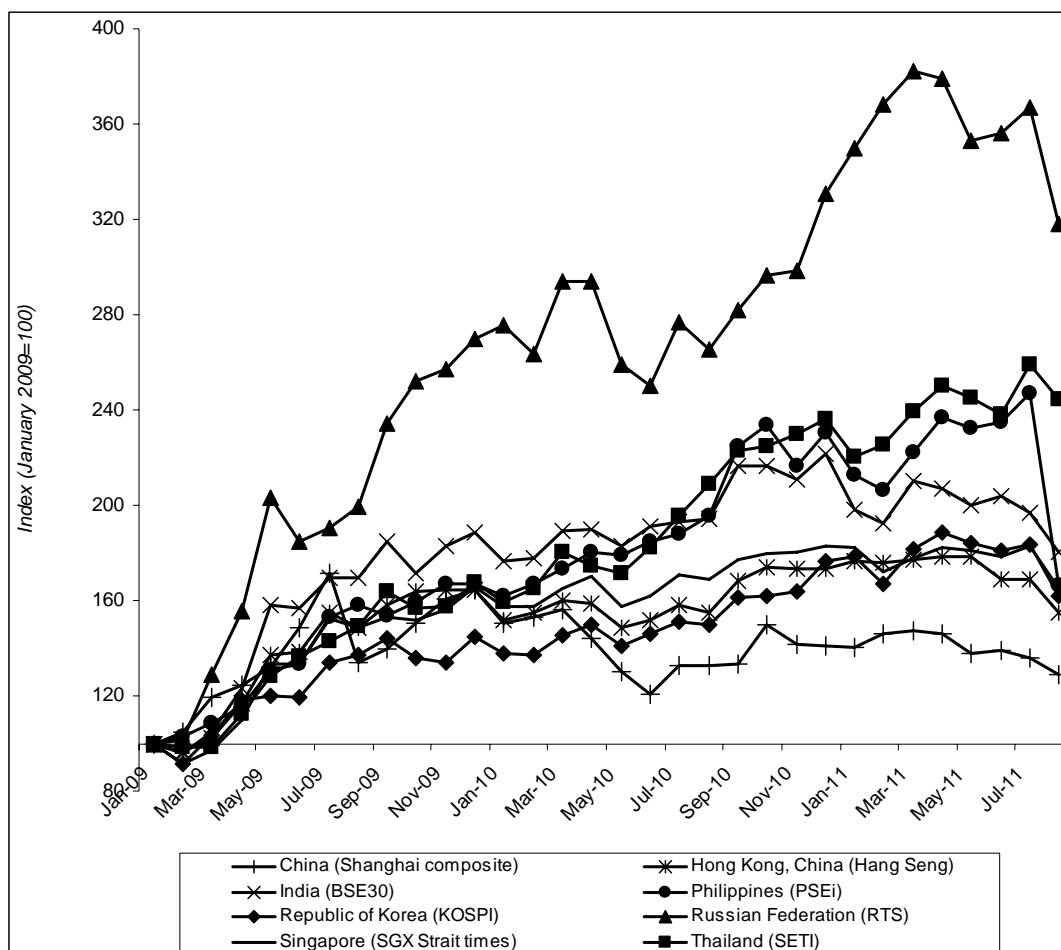
21. Financial markets in the region are faced with a period of considerable volatility as investors attempt to insulate themselves against perceived increase in the risks facing the global economy as well as Asia and the Pacific. Asset prices and exchange rates in the region are likely to face periods of both capital outflows and inflows as a result of global liquidity, financial conditions and major news events. What is therefore clear is that policymakers will have to be prepared for the consequences of periodic bouts of volatility which will complicate their macroeconomic planning.

22. The Asia-Pacific region has recently experienced capital outflows as investors have come to realize that slowing growth in the global economy will inevitably affect the export-led growth model of many economies in the region. Consequently, growth projections for enterprises have been scaled downwards, thereby affecting equity markets (see figure 7). Furthermore, the belief that monetary policy tightening is less likely for economies in an environment of constrained growth has mollified assumptions of interest rate movements, thereby affecting bond markets. More generally, at times of perceived global economic uncertainty, the region is also affected by the standard reaction of a “flight to safety”—a retreat to assets that are perceived to be safe. Thus, despite sovereign debt concerns in the United States, investors have retreated once again to United States Treasury bills in large numbers.

23. There are reasons to believe, however, that fundamental factors will result in periods of continued financial inflows to the region. Despite the growth slowdown in the region, economies in the region continue to experience far more robust growth than developed economies, thereby supporting the performance of equity and property markets. Interest rates, while less likely to rise in many economies, remain at far higher levels than the near-zero levels of the developed economies, thus maintaining foreign interest in the region’s bonds and other assets. It may also be argued that investors have developed a more nuanced view of risk, with a gradual altering of the perception that, in times of uncertainty, one should withdraw from emerging markets. While, in the short term, Treasury bills, for instance, continue to remain popular, in the long term, such bills may come to be regarded as more risky assets as the willingness and ability of the United States to continue to finance such debt is increasingly called into

question following the difficulties in the debt ceiling negotiations witnessed in recent months.

Figure 7
Equity market performance in major Asian developing economies, 2009 to August 2011

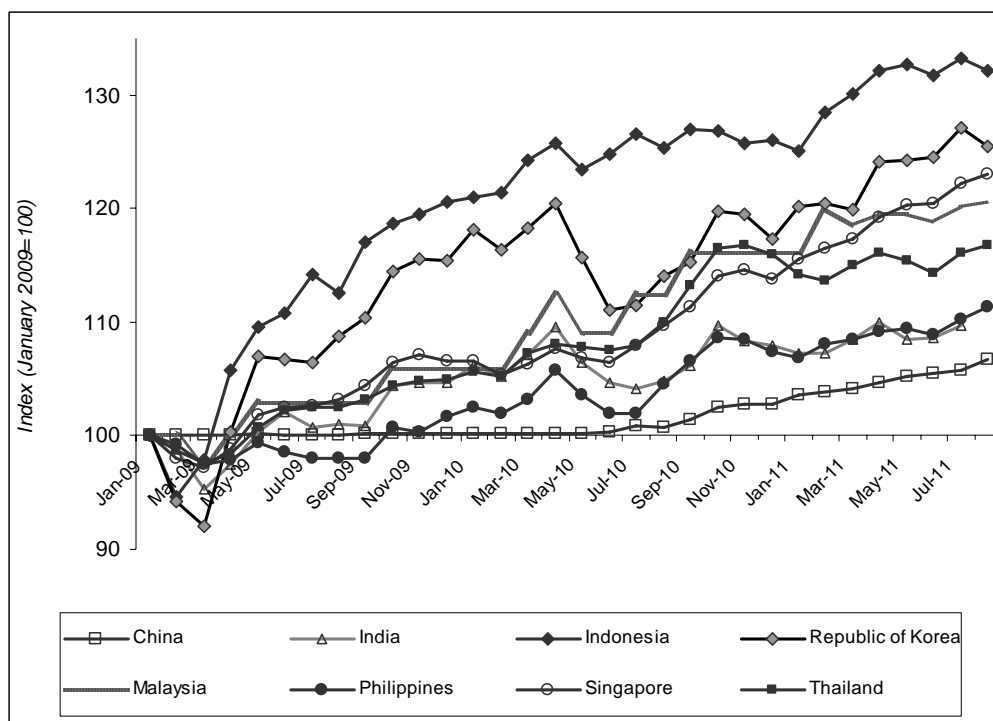


Source: ESCAP calculations based on data from CEIC Data Company Limited, available from <http://ceicdata.com> (accessed September 2011).

Note: The equity market of each country is noted in parentheses in the legend.

24. In such an environment, where both positive and negative factors influence capital flows to the region, economies should be prepared for volatility in such flows. There is a risk, therefore, that macroeconomic stability will be impacted through substantial movements in exchange rates and asset values. Exchange rate movements (see figure 8) would affect inflation, export performance, and domestic financial sector stability. Asset value changes create the risk of further build-up of potential asset price bubbles and the possible bursting of such bubbles. Economies in the region have traditionally managed the risk of exchange rate volatility by building up foreign exchange reserves, both to protect currencies in case of sudden capital outflow and to maintain export competitiveness.

Figure 8
Exchange rate movement in major developing economies, 2009-2011



Source: Based on data from CEIC Data Company Limited, available from <http://ceicdata.com> (accessed September 2011).

Note: A positive trend represents appreciation and vice versa.

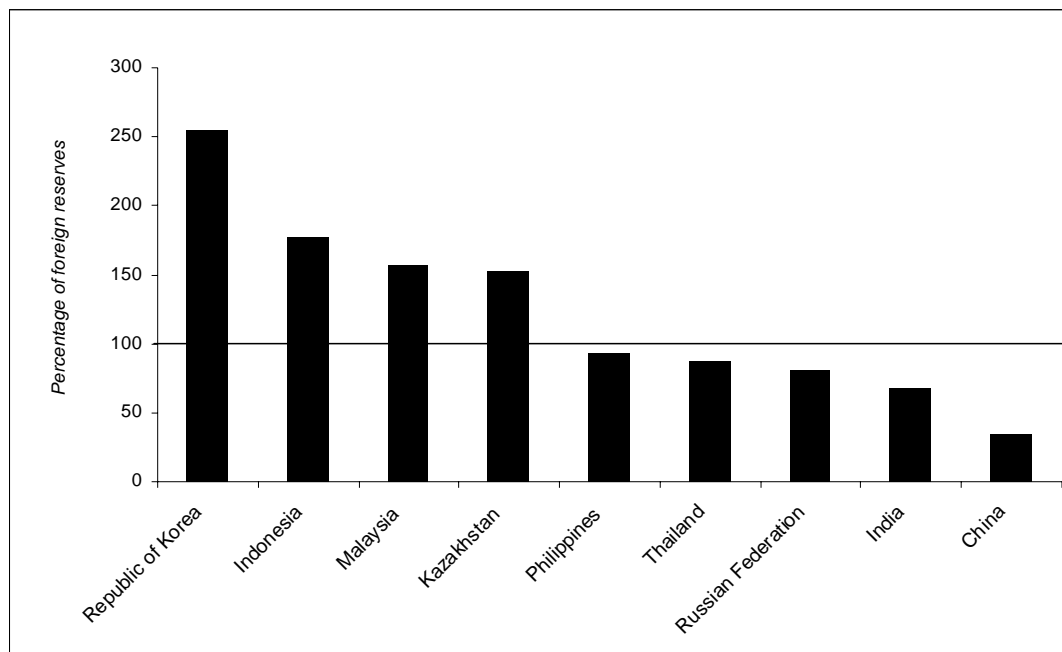
25. The ESCAP foreign reserves vulnerability index however indicates that, in a number of cases, it is not evident that reserves are adequate to protect exchange rates, and in turn, macroeconomic stability in the case of substantial capital outflows (see figure 9). If the worst-case scenario results in the global economy of a renewed banking crisis, sparked for instance by sovereign debt defaults and bank collapses in the euro zone, then a number of economies in the region could be at significant risk of exchange rate pressure. The mechanism may be a flight to safe assets by investors sparking a sudden loss of short-term capital flows. The economies which would be most at risk would be those that have deep, highly open and relatively sophisticated financial markets and have seen substantial inflows over the past few years, where there is thus the possibility that reserves do not fully take into account the scale of possible portfolio capital outflows.

26. Even if reserves were adequate, the use of such reserves does not assist in dealing with the issue of asset price declines in the case of outflows. Similarly, in the case of capital inflows, the use of reserves does not prevent excessive increases in domestic asset values. It is also the case that interest rate rises, the standard tool for dealing with the inflationary consequences of capital inflows, are self-defeating to some degree as they in turn attract more capital. If one expects capital inflows to the region to be a long-term trend, then the continued use of foreign exchange reserves as the primary tool for managing the consequences presents a host of difficulties. Other than the efficacy of using reserves, an ever present and increasingly important issue is the cost of holding them. Declines in the value of the United States dollar and the euro have reduced the value of holdings in local currencies substantially and it may very well be that these currencies will depreciate further in the medium term. An additional cost is

the interest rate differential between holding European or United States bonds at close to zero interest rates, as compared to the relatively high interest rates which have to be paid on domestic bonds issued to mop up the inflation created by the injection of local currency.

Figure 9

Vulnerability yardstick as a percentage of foreign reserves in selected developing economies, latest data available



Sources: ESCAP calculations based on data from International Monetary Fund, International Financial Statistics CD-ROM, July 2011; World Bank, Quarterly External Debt Statistics databases, accessed September 2011; and CEIC Data Company Limited (accessed on September 2011).

Notes: Vulnerability yardstick is the sum of short-term debt, imports of the last quarter of the year and stock of equity and debt portfolio capital.

27. Given the disadvantages of using reserves as the main instrument for dealing with capital inflows, economies in the region have turned to the option of capital controls as an additional measure, as previously recommended by ESCAP. Over the past year, Indonesia, the Republic of Korea, Thailand and Taiwan Province of China have imposed various controls. Measures have included limits on foreign exchange and external debt exposure of domestic banks, limits on foreign holdings of domestic assets, restrictions on maturity of foreign holdings of assets (Indonesia, Republic of Korea, Taiwan Province of China), and taxes on foreign holdings of assets (Republic of Korea, Thailand).

II. Policy challenges and options

A. Navigating the growth and inflation balance

28. While growth in many countries in the region will come under pressure given the difficult global climate, there is considerable scope for supporting growth through government policy. Most countries in the region retain substantial fiscal space to increase government spending, while interest rates can be kept on hold or even decreased should inflation concerns permit, as their relatively high levels mean that a cut in rates could

stimulate lending. While fiscal balances have moved downwards due to the stimulus policies enacted at the start of the financial crisis, subsequent strong growth performance boosted government finances in 2010 compared to the previous year (see table). However, there are high disparities in the fiscal policy performance of Asia-Pacific countries, with South Asian countries recording relatively high fiscal deficits, and East Asian and South-East Asian countries showing strong fiscal consolidations in 2010.

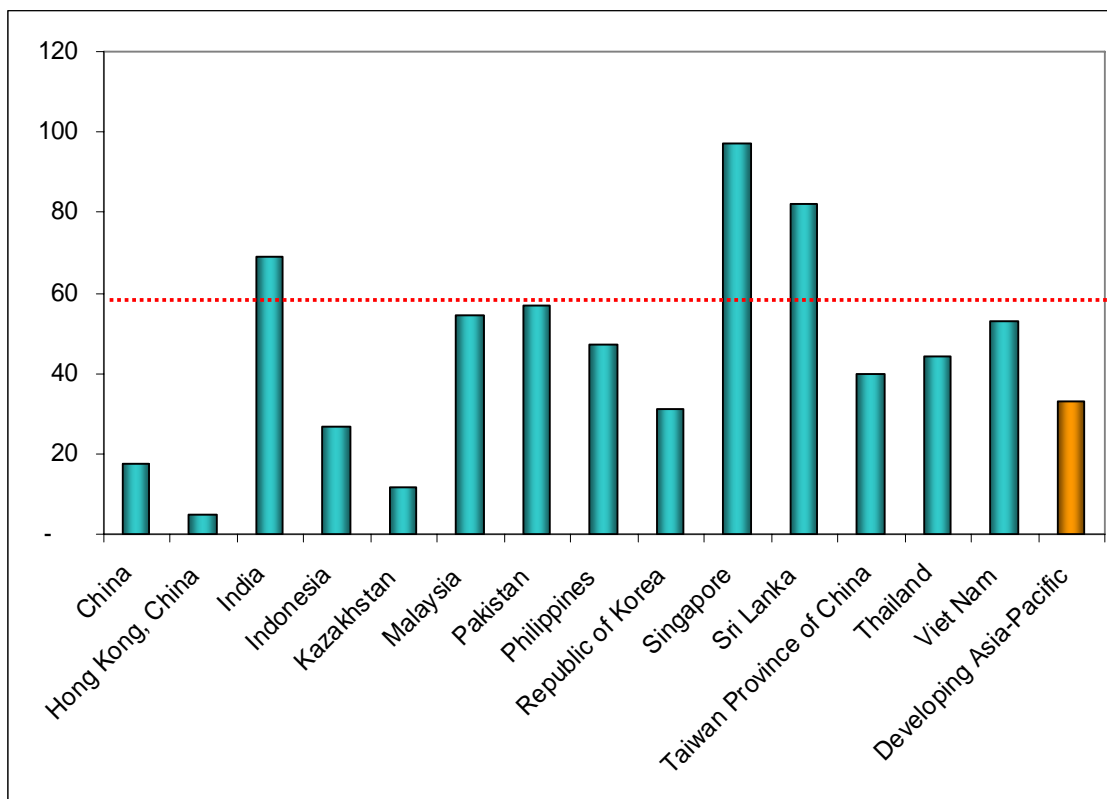
Table
Fiscal balance for selected Asia-Pacific developing economies
(Percentage of gross domestic product)

	2006	2007	2008	2009	2010
Bangladesh	-3.2	-3.2	-4.7	-3.9	-4.5
China	-0.8	0.6	-0.4	-2.9	-2.1
Fiji	-2.9	-1.8	-1.5	-3.0	-3.6
Hong Kong, China	4.0	7.7	0.1	1.6	4.1
India	-5.3	-4.1	-8.5	-9.58	-8.1
Indonesia	-0.9	-1.3	-0.1	-1.6	-0.6
Kazakhstan	0.8	-1.7	-2.1	-2.9	-2.5
Malaysia	-3.3	-3.2	-4.8	-7	-5.6
Pakistan	-4.3	-4.4	-7.6	-5.3	-6.3
Papua New Guinea	5.1	6.4	2.5	-14.3	-0.5
Philippines	-1.1	-0.2	-0.9	-3.9	-3.7
Republic of Korea	-2.6	0.4	-2	-5.1	-2.3
Samoa	0.3	1.2	-1.9	-4.0	-8.1
Singapore	0.0	2.9	0.1	-0.36	-0.1
Sri Lanka	-7.0	-6.9	-7	-9.9	-8.0
Taiwan Province of China	-0.7	-0.1	-0.9	-3.5	-3.2
Thailand	0.1	-1.1	-0.3	-4.8	-2.1
Viet Nam	-1.2	-4.6	-3.1	-10.6	-8.0
Developing Asia and the Pacific	-1.6	-0.2	-2.0	-4.2	-3.0

Source: ESCAP, based on national sources, and Asian Development Bank, *Asian Development Outlook 2011* (Manila, 2011).

29. There is scope for fiscal stimulus in most of the economies which may be most affected by a growth downturn. Fiscal deficits and levels of public debt (see figure 9) are relatively low in many export-oriented economies of the region, though they are somewhat high in a few, such as Malaysia. In terms of overall fiscal sustainability in the region, developing Asia-Pacific economies have a relatively low public debt level at an average of 33 per cent of GDP as of 2010. This is well-below the prudential public debt threshold of 60 per cent. Therefore, enacting further stimulus policies, if required, would not impose excessive burdens on budgets, nor would it increase public debt to unsustainable levels in the economies most likely to be hit by a slowdown in exports. Public debt levels are high in a number of economies, such as those of South Asia (see figure 10), but these economies are largely domestic-demand-led and hence less affected by shrinking global demand. Therefore, they are not likely to need further stimulus. The options for fiscal policy in particular economies include tax reduction, cash assistance for low-income households and increases in infrastructure spending. Other methods may include one-off subsidies, such as consumption vouchers and cash handouts.

Figure 10
Gross public debt as a percentage of GDP in selected Asia-Pacific developing economies, 2010



Source: ESCAP, based on CEIC Data Company Limited (September 2011) and International Monetary Fund, *World Economic Outlook Database*, April 2011.

Note: The high public debt to GDP ratio in Singapore should be considered as an exceptional case as most of the public debt is intra-government holdings by the Central Provident Fund and not to finance a government deficit.

30. The concern with renewed stimulus measures in the region is the impact that such measures have on inflation, which, despite having moderated in recent months, remains high in many economies. It is possible that external causes of inflation will continue to be less pressing in coming months, with the downturn in the global economy reducing commodities prices by reducing their demand. Furthermore, capital inflows to the region, which have also stoked inflation, may be curtailed in a risk-averse global environment. Nevertheless, the global price drivers for food, which is a key element of inflation in the region, may be less influenced by the difficult global environment. Food demand does not move as greatly in response to global growth, and weather-related factors and financial speculation remain more important causes of short-term volatility.

31. The region must therefore be prepared for the risk that external price pressures, primarily through food and possibly oil, will remain high despite slowing domestic growth. While many of the causes of inflation are external, due to a global rise in food and oil prices and inflows of foreign capital, price increases in these items have fed through to core inflation through rising input prices and the second-round effects of higher wage demands. Therefore, restricting demand through monetary policy would have some effect on controlling prices. Monetary policy is a blunt tool, however, as it implies restricting demand to control price increases which are external or supply-led and not due to overheating domestic demand.

Demand in the economy which is already under pressure due to slowing exports would be further impacted by contractionary monetary policy. Measures such as tax and tariff policies to directly impact the high price of commodities should be an integral part of inflation-fighting, as should capital controls to restrict the inflow of foreign capital to local asset markets. However, in cases of substantial price increases in the general economy that feed into heightened inflationary expectations, monetary policy may remain the most effective tool, albeit accompanied by significant growth implications. The question then becomes: what level of inflation should be regarded as acceptable in the short term at a time when growth concerns have newly come to the fore?

32. It may be argued that the overriding importance given to keeping inflation at relatively low levels in economies facing external and supply-led inflation is excessive since, oftentimes, doing so may cause hardship to the population through loss of jobs or income. Consideration to both the growth and inflation impact of monetary policy may be more appropriate, with a rethinking of the need to meet the current level of short-term inflation targets at any given moment despite the worsening outlook for growth. A number of economies in the region have inflation targeting regimes for setting monetary policy enacted after the 1997 Asian crisis, including the Republic of Korea, Thailand, the Philippines and Indonesia. One option is for inflation targets to be revised upwards or considered over a longer time frame. Another is for precise targets to be removed, and for monetary policy decisions to be constantly re-thought and updated through a considered ongoing appraisal of the overall economic environment and the impact of monetary policy on all areas rather than only inflation.

33. For a number of more domestic-demand-led economies which are experiencing high inflation, the course of action is clearer. Since, in these cases, robust domestic demand has been one of the factors driving price increases, monetary policy measures which dampen demand will still have to be considered. This will have the effect of reducing growth to more sustainable levels. India, for instance, is likely to see somewhat slower growth as policymakers continue to tighten interest rates in the face of price rises that are still at near double digit levels.

34. China is in a somewhat special category among economies in the region as it has the distinction of being both export-oriented while having substantial demand-led inflation. However, the approach of China to any further stimulus in the event of a substantial slowdown in growth will be key to the performance of the exporting economies of the region. Any substantial support to growth in the economy will help cushion the export blow from the developed economies. China will require a different set of measures to sustain growth and manage inflation as compared to the economies which are led primarily by exports or by domestic demand. The economy is substantially impacted by the global slowdown; yet, it is experiencing inflation influenced by robust domestic demand, primarily through investment supported by the creation of credit. While dampening domestic investment through monetary policy is a rational measure to reduce inflation, enacting such measures at a time of weakness in other growth drivers will be a difficult balancing act if an excessive slowdown or “hard landing” is to be avoided. Excessive tightening of monetary policy may no longer be required as demand-side pressures should see a reduction through a slowdown in the export channel. It will be important to carefully monitor short-term developments in growth and price performance in the

economy to ensure the correct timing and proper scale of any measures taken.

B. Coping with capital flows

35. The region is still striving to determine which policies are appropriate for dealing with the pressing issue of exposure to excessive short-term capital flows. The current policy mix of currency intervention, foreign exchange reserves accumulation and limited capital controls have not proven sufficient to remove the impact of such inflows or the risks associated with sudden outflows. As discussed above, intervention as the primary method of reducing the risks associated with capital inflows and outflows comes with its own set of disadvantages. The increasingly accepted supplementary option across the region is to impose capital controls that attempt to deal with the problem of capital inflows proactively at the source rather than taking reactive measures, such as intervention, after inflows have taken place. However, capital controls in the region so far have been limited and may not be sufficient in their current guise to deal effectively with the challenge; therefore, further modifications may be required.

36. In the future, economies may have to design controls which deal with the possible challenge of a “new normal” of long-term pressure for the entry of foreign capital into the region. One of the criticisms traditionally offered regarding capital controls is that periods of short-term capital inflows are temporary and therefore the long-term efficiency costs of imposing controls outweigh the benefits of dealing with a transient issue. However, it may be argued that the new global environment presents a sea change in the behaviour of portfolio capital, with funds being attracted to the region for an extended period due to the inherent attractiveness of the region as seen from medium-term projections of growth and interest rate differentials with the developed world.

37. The next steps that may therefore be required by economies seeking to avoid the adverse impacts of volatile capital inflows will be to impose more widespread quantitative restrictions on foreign portfolio investments and bank non-productive investment lending. While a strong measure, it may be justified due to the long-term pressure some developing economies face vis-à-vis the developed world. The guiding principle may be to have free entry of foreign investment in the areas which would provide funding for foreign direct investment, corporate and bank project lending and new issuances of corporate equity and bonds, while carefully managing the entry of capital for existing portfolio and other assets. Such discrimination between uses of capital would by its nature be difficult to optimize, and there would be leakages or a reduction in the potential amount of foreign funds available for real investment. However, in practice, this consideration may not be critical as most developing economies which are being impacted by the inflow of capital are arguably not in significant need of foreign funds for their investment or else present such attractive investment stories that foreign capital will not be deterred by any restrictions.

C. Rebalancing amid external pressures

38. The medium-term need for the region in order to maintain its growth momentum continues to be the redirection of its growth drivers from extraregional to intraregional and domestic demand. However, this challenge is complicated in the short-term by the slowdown in extraregional

demand due to the global environment. Some of the possible measures used to aid in this redirection may have a negative impact on growth in the short term, which would add to current growth difficulties. Economies in the region differ in their rebalancing needs, with one set of economies, principally China, needing more consumption and another set of economies, especially in South-East Asia, more investment. Furthermore, export-led economies with upward pressure on their exchange rates could implement a coordinated exchange rate appreciation against developed economy currencies, which would both support domestic investment and consumption, while not affecting intraregional exports. While assisting in making imported goods cheaper for investment and consumption in economies as well as reducing imported inflation, such a policy would further damage export competitiveness in extraregional markets, risk unemployment and exert a downward pressure on wage levels in the export sector. In times of external difficulty, government policies which impinge on existing growth drivers may prove unpalatable.

39. A more acceptable range of policies to continue the medium-term task of rebalancing economies towards domestic and regional demand is to implement a set of measures which support future growth drivers while not unduly impacting the growth drivers of the present. One set of such policies is to continue the process of establishing social protection systems, such as the public provision of health and unemployment insurance, as well as pensions and enhanced public spending on health and education. These procedures increase the purchasing power of consumers by reducing the need for precautionary savings without having an undue downward impact on other components of growth. In terms of aiding investment in those economies where it remains relatively low, spending on infrastructure is a clear area of opportunity. Governments have ample room to boost investment in their own infrastructure and that of their neighbours with less fiscal ability, as such investments can offer both good returns and substantial indirect benefits by increasing intraregional integration and trade. Such investment can be supported by the creation of regional financial architecture for development financing, which would include a system of intermediation between its large savings and its unmet investment needs, as analysed by ESCAP.⁷

40. Another means of fostering a rebalancing is to support the development of the agricultural sector in the region. In Asia and the Pacific, the majority of poor people live in rural areas and derive most of their income from agriculture. Apart from the imperative to improve their lives and reduce poverty, increasing agricultural growth and therefore rural incomes will increase domestic and regional consumption. As the region aims for more balanced economic growth, it needs a second, more knowledge-intensive, green revolution that will reverse the relative neglect of the agricultural sector in public policy and overseas aid priorities over recent decades. Promoting higher agricultural productivity is the key policy response, and public resources therefore need to be shifted from subsidizing consumption to boosting agricultural productivity. This requires a sustained programme of agricultural research, public education and better-designed rural extension programmes. International partnerships and South-South cooperation can help foster such a green revolution while also addressing concerns regarding food security.

⁷ *Economic and Social Survey of Asia and the Pacific 2011* (United Nations publication, Sales No. E.11.II.F.2), Chap. 3.