Economic and Social Survey of Asia and the Pacific 2010: Year-end Update

Maintaining Growth Amid Global Uncertainty
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The Year-end Update 2010 takes a stock of the recovery of the region’s economies from the Great Recession of 2008/09 and emerging challenges since the publication of the Economic and Social Survey of Asia and the Pacific 2010 in May 2010 and provides recommendations on appropriate responses for policy-makers in the region. The Update finds that 2010 has seen an impressive recovery of the region’s economies led by the large economies of China and India. But the region is faced with a weakening of growth in the developed economies that affect the pace of recovery. Furthermore, as forewarned in the Survey 2010, some economies of the region are facing a deluge of short-term speculative capital flows causing their exchange rates to appreciate, asset bubbles to form and price pressures to build up especially of food. The Update then summarizes the short-term and medium term policy priorities for the region.

The Update has been prepared under the overall guidance of Dr. Noeleen Heyzer, Under-Secretary-General of the United Nations and Executive Secretary of the Economic and Social Commission for Asia and the Pacific (ESCAP) and substantive direction of the undersigned. The core team led by Aynul Hasan included Shuvojit Banerjee, Shahid Ahmed, Somchai Congtavinsutti, Woranut Sompitayanurak, Amornrut Supornsinchai and Sutinee Yeamkitpibul.

The report team benefited from insightful comments and views presented by a group of resource persons at the ESCAP-Club de Madrid Roundtable on the Global Economic Crisis and the Asia-Pacific Region: Sustaining Asian Dynamism in a Post-Crisis World held in Bangkok on 18 August 2010. A special mention is made of Amar Bhattacharya, Director, G24 Secretariat, Washington DC; Suthipand Chirathivat, Chairman, Chula Global Network, Chulalongkorn University, Bangkok; In Huh, Director, Department of International Macroeconomics and Finance, Korea Institute for International Economic Policy, Seoul; Sun Jie, Senior Fellow, Institute of World Economy and Politics, Chinese Academy of Social Sciences, Beijing; Pichit Patrawimolpon, Director, Office of the Governor, Bank of Thailand; Sanjay Peters, Director of the Center of Emerging Markets, IESE Business School, Barcelona; Kim Phalla, Director, Economic and Public Finance Policy Department, Ministry of Economy and Finance, Cambodia; Ramkishen Rajan, George Mason University and Institute of Southeast Asian Studies, Singapore; Y.V. Reddy, former Governor, Reserve Bank of India.

Orestes Plasencia and Sanoma Lee Kellogg of the Editorial Unit of ESCAP edited the manuscript. The layout and printing were provided by Advanced Printing Service.

Thawadi Pachariyangkun and Bentley Jenson of the United Nations Information Services coordinated the launch and dissemination of the report.

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Chief Economist and Director
Macroeconomic Policy and Development Division, UN-ESCAP
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<td>ABMI</td>
<td>Asian Bond Market Initiative</td>
</tr>
<tr>
<td>AMRO</td>
<td>ASEAN+3 Macroeconomic Research Office</td>
</tr>
<tr>
<td>APEC</td>
<td>Asia-Pacific Economic Cooperation</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<tr>
<td>CEPEA</td>
<td>Comprehensive Economic Partnership of East Asia</td>
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<tr>
<td>CMIM</td>
<td>Chiang Mai Initiative Multilateralization</td>
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<tr>
<td>CPI</td>
<td>consumer price index</td>
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<tr>
<td>EAFTA</td>
<td>East Asia Free Trade Agreement</td>
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<td>EAS</td>
<td>East Asia Summit</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>MDG</td>
<td>Millennium Development Goal</td>
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<tr>
<td>SAARC</td>
<td>South Asian Association for Regional Cooperation</td>
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INTRODUCTION

The Asia-Pacific region has recovered strongly from the depths of the severe 2008-2009 recession—the worst since the end of World War II. However, it is by no means out of the woods yet. After showing welcome resilience during the initial months of the crisis in 2008, which affected mainly the financial sector, the region was subsequently buffeted by the spillover of the crisis into the real economy and the resultant sharp reduction in demand in the developed economies in 2009. Thus far (up to the third quarter of 2010), the region has shown 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 economies in the region. There are now indications, however, that the region will likely have to contend with a more challenging global environment in 2011.

In the first place, as many leading developed countries are expecting to see growth dissipate over the coming quarters, the global environment in 2011 is likely to be less supportive than in 2010. The loss of momentum is being driven by uncertainty on the jobs front as fiscal consolidation takes centre stage in most developed countries and monetary policy is given pre-eminence in promoting growth. In view of this, the continuing dependence of many economies in the region on the markets of developed countries would mean that growth rates in the region are likely to be negatively affected to some extent, at least in the short term. On the other hand, an increase in intraregional trade due to the demand generated in the larger economies of the region should provide some cushioning to the slowdown of exports to developed countries. It is pertinent to note here that the juxtaposition of these phenomena in 2010 has provided renewed evidence of the ability of the Asia-Pacific region both to drive its own growth and to act as a vitally important contributor to the wider global recovery.

In the second place, other than slower growth in the developed countries, a major challenge for the region stems from the impact of the enormous liquidity injections being undertaken by developed economies as part of their efforts to boost recovery from the crisis. A consequence of this increase in liquidity, specifically in the face of more favourable growth prospects and of the higher returns available in many developing economies, is that huge foreign capital inflows have been attracted into different asset markets in many countries of the region. The capital inflows have originated, for the most part, in the cheap liquidity made available through the policy of quantitative easing and the resultant near-zero interest rates in the developed economies; they, in turn, have supported a burgeoning carry trade of investment in higher-yielding assets in the developing economies. These short-term capital inflows have already led to the creation of potential asset market bubbles in some countries; they have also boosted inflationary pressures in a number of economies by sharply increasing liquidity. Simultaneously, they have led to significant exchange rate appreciation in a number of countries.

Appreciating exchange rates are normally contractionary in impact. In the present circumstances, their immediate impact is likely to dampen the growth of exports from the region rather than reduce pressure on prices. Price pressures are being driven primarily by the huge flood of liquidity originating in the developed countries. Indeed, from a broader social perspective, the loose liquidity environment in the
developed countries has provided a significant fillip to global food price inflation leading to considerable hardships for the poor in the developing countries.

From an Asia-Pacific perspective, the responsibility to meet these challenges clearly lies with individual governments. There is nevertheless considerable merit in a collective regional approach to managing them through greater regional cooperation. At the present juncture, the solution lies in facilitating a sustained, broad-based recovery in the region as a whole by partly boosting domestic demand in the larger economies and partly boosting trade between them and between the different subregions. For such an approach to be effective, the time has come for the Asia-Pacific region to deepen the process of integration further and, to this end, to enhance the coordination and implementation of the policies of the leading regional economies. The region is home to a number of subregional economic and trade cooperation agreements. It is time to usher in a heightened level of cooperation by further deepening economic integration already agreed by the Association of Southeast Asian Nations (ASEAN), the South Asian Association for Regional Cooperation (SAARC) and move forward on the agenda of broader regionalism in Asia-Pacific for which a number of proposals now exist including the East Asia Free Trade Agreement (EAFTA) within the framework of ASEAN Plus Three, the Comprehensive Economic Partnership Arrangements of East Asia (CEPEA) within the framework of the East Asia Summit (EAS) or ASEAN Plus Six or a Free Trade Area of the Asia-Pacific (FTAAP) within the APEC framework. Four ASEAN Plus Working Groups had been set up at the East Asia Summit in Hua Hin in 2009 to take the proposals of EAFTA and CEPEA forward in a parallel manner. These Working Groups were directed to recommend specific targets and timelines within which to complete consolidation at the Fifth EAS in Hanoi in October 2010.¹

Regaining the pre-crisis momentum of growth is the principal short-term objective for the region. In this regard, it is worth noting that the growth of gross domestic product (GDP) in the export-oriented economies recovered and surpassed pre-crisis GDP during late 2009 (see figure 1), implying that the income shock for the public at the aggregate level had lasted for approximately one year. Notwithstanding this rapid recovery, unless growth during the current phase occurs at a faster rate than before the crisis, the public would still have suffered a lifetime loss in income due to this contraction. Furthermore, on account of the sluggish recovery in the developed economies, it now appears likely that the recovery of the region could be somewhat slower and that ground lost in 2008-2009 would take longer to make up than previously thought. Promoting greater economic cooperation and integration offers a way of avoiding such output losses in the future.

¹ See Chairman’s Statement at the East Asia Summit, Hanoi, 30 October 2010. Also see Declarations of APEC Leaders at their Yokohama Summit in November 2010, available at www.apec.org/apec/leaders_declarations/2010.html (access 26 November 2010).
RECOVERY WITH HEADWINDS IN 2010

Asia-Pacific displays stellar performance in 2010

The region witnessed a dramatic recovery in growth in 2010 from the slowdown resulting from the severe 2008-2009 recession in the developed countries. The performance in 2010 was a continuation of the recovery seen from the first quarter of 2009 (see figure 1). While economies with a large domestic demand component weathered the crisis with only a moderate decrease in growth and performed robustly again in 2010, many export-oriented economies only moved into positive territory from around the third quarter of 2009 onwards. The key driver of the recovery for the most affected economies in the region in 2010 was renewed strength in the export sector following the initial critical support to growth through large fiscal stimulus packages. Export-driven economies began their recoveries in part through the growth of intraregional trade, particularly the robust demand generated by China and India. China’s economy benefited from the significant stimulus measures taken in 2009, which were buttressed by expanding exports to the developed economies where demand improved from late 2009 onwards in response to their own stimulus policies.

Figure 1. Real GDP growth by quarter, year-on-year, in selected developing economies, 2008-2010


The most affected economies in the region have recovered to pre-crisis income levels in 2010. Since year-on-year growth numbers in a crisis are influenced by the base effect of low growth in the previous period, absolute GDP numbers give a better picture of the recovery in the region and the real impact on the livelihood of the people (see figure 2).
Despite the headwinds affecting growth in 2010 due to the slowing recovery in the developed world, growth for the Asia-Pacific region as a whole has still remained impressive. As in 2009, the region is by far the fastest-growing region in the world, with close to double the growth rate of the next highest growth-performing regions of the world. This brings into stark relief the role of the region as an engine of growth for the global economy. The growth impact on other regions clearly emanates from the Asia-Pacific region serving as a source of demand for the commodities and goods of other regions. As the region itself is now the biggest producer of goods consumed within the region, the main impact of growth on other regions is being transmitted via demand for their raw materials and commodities. Thus, manufactured goods producers in other regions, such as in the developed economies, may not obtain a significant lift to their growth from demand in Asia and the Pacific, whereas developing regions where commodities are more important are likely to experience a greater impact.

The rising influence of the Asia-Pacific region has been noticeable during 2010, especially in Africa and Latin America, which have exhibited both increased trade and investment in the commodity-related sectors. Africa’s trade with Asia now takes up 27 per cent of Africa’s exports, as compared to 14 per cent in 2000, with the new figure being similar to the ratio of Africa’s exports to its traditional trading partners of the United States and Europe.\(^2\) Exports of primary commodities to Asia are one of the principal factors underlying the growth of 21.4 per cent forecast in

2010 for the exports of the Latin American and Caribbean region, with its exports to China specifically accounting for 44.8 per cent of its total exports.³

Coping with the slowdown in the developed economies

After an initial relatively strong recovery in the United States and the European Union, these economies suffered from a renewed period of weak output growth in 2010 (see figure 3) as mounting budget deficits led to pressure for fiscal consolidation. The ensuing lower public spending in the developed countries generated uncertainty about the future, which further affected overall household consumption in these countries and, more specifically, the demand for exports from the developing countries. The slowdown in the developed countries is of particular concern as it comes after a severe contraction in their growth in 2009, implying that these economies have suffered a permanent loss in output in excess of about 4-5 percentage points of GDP relative to trend on account of the 2008-2009 recession.

As mentioned above, the rather rapid winding down of fiscal stimulus has led to a growth slowdown in most developed economies, as recovery has failed to become self-sustaining. Indeed, the slowdown in 2010 has emanated from lower public spending combined with the impact of households working off their debt burdens, weaker house prices and higher unemployment, for which the initial fiscal and monetary stimuli have not been able to compensate. The ratio of household debt to income has fallen consistently from 130 per cent in the third quarter of 2007 to stand at 118 per cent in the second quarter of 2010,⁴ while in the United States, house prices have witnessed renewed falls in August 2010 after the expiry of support to the housing sector through the homebuyers’ tax credit.⁵ Overall, the unemployment rate in the United States, at 9.6 per cent in September 2010, has remained unchanged since early 2009.


On a similar note, growth in the European Union in the third quarter of 2010 slowed to 2.2 per cent on a year-on-year basis from 2.5 per cent in the previous quarter. The slowdown in the United States has negatively impacted previously strong export-related growth in Germany, with export growth falling in consecutive months from mid-2010 on a month-to-month basis. Growth in the other major economies of the European Union continues to be constrained by low consumption due to roughly the same factors as in the United States, compounded by reduced government spending to cut budget deficits. The emphasis on fiscal consolidation, if pursued vigorously, could adversely affect growth in the medium term in the European Union as the process gathers pace in 2011 and beyond. It is expected that the overall near-neutral fiscal stance in the more developed European countries in 2010 will turn contractionary in 2011 as a result of fiscal consolidation.

In the Asia-Pacific region, Japan, too, faces renewed difficulties in durably reviving growth. The export sector, which remains critical to the economy, has been beset by slowing United States demand for its high-end products, both as direct exports and, indirectly, as inputs for onward export from China. The rate of export growth has slowed consistently throughout most of 2010.

As mentioned earlier, the likelihood of further stimulus in the developed economies to support growth has been limited due to growing concerns about fiscal sustainability. Concern about the sustainability of budget deficits has prevented the administration in the United States from obtaining political support for further fiscal stimulus after the $785 billion injection in 2009. In this regard, the perceived pressure on developed country governments to cut public spending has been

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the greatest in the European Union as country after country has been forced to breach the conditions of the Stability and Growth Pact which accompanied the launch of the euro in 2000. Early 2010 saw the onset of a sovereign debt crisis (see section below on managing the blowback from the European debt crisis) through a sharp increase in debt financing costs in some European Union economies, due to the lack of confidence of international financial investors in the ability of these governments to service their large and growing debt burdens. This has persuaded the imperilled governments, as well as other economies under less immediate financial market pressure in the region, to introduce drastic programmes to reduce deficits through spending cuts and tax increases.

Among the developed countries, Japan is the only major economy still engaged in fiscal stimulus measures. The Government of Japan approved a new stimulus package in August 2010. Concerns about the size of the budget deficit, however, have also restricted the amount to around $60 billion which is not likely to be large enough to have a significant impact on economic recovery. Whether the fears of the financial markets should drive policy with wide-ranging social repercussions is a complex political judgement whose true costs will only become apparent with the passage of time.

Given that new fiscal stimulus measures have been eschewed for the time being, the consequent focus on monetary policy may not be as effective as expected by some. For instance, there are growing concerns about the ability of quantitative easing—the monetary policy of choice—to substantially increase domestic demand. Quantitative easing seeks to do this primarily by increasing liquidity in the economy. This, in turn, is expected to lower long-term interest rates, encourage borrowing and boost household consumption and wealth. In practice, however, each of these avenues may not be as effective as is generally assumed. The household wealth effect of increasing asset prices such as equities may not increase consumer spending when the public is still contending with the major impact on their wealth of the housing downturn and as the increase in asset prices may be viewed as being temporary. Quantitative easing also may not be able to stimulate lending by reducing interest rates significantly as they are already at very low levels even with the inclusion of the risk premium involved in lending to individuals and companies.

Indeed, the evidence is that such easing is not increasing the flow of credit from banks to the private sector. Banks already have substantial funds available from previous bouts of quantitative easing which they have chosen not to onlend to the public due to concerns about their own balance sheets and the risks involving such lending as compared to alternative uses of such funds, such as purchases of government bonds.

The United States is nevertheless expected to continue the quantitative easing policy by the Federal Reserve, to attempt to offer some support to the economy in the absence of the ability to undertake new fiscal support measures. It is noteworthy that, apart from the United States, Japan has continued to undertake monetary stimulus through quantitative easing, with various moves during the course of 2010 to inject funds into the banking sector, a process that actually has a long history in that country. In common with the United States, however, there is a concern that

banks will remain unwilling to increase credit to the private sector. In the European Union, on the other hand, monetary policy is not likely to be used to as great a degree as a stimulus measure as in the United States and Japan. Monetary policy, which is set by the European Central Bank for the euro area countries, is still viewed through an anti-inflationary prism both in the Central Bank and in many of the euro economies. Inflation continues to be viewed as a major threat to long-term financial and economic stability and the Central Bank’s focus on it means that monetary stimulus is not available even for those economies suffering low growth and a lack of inflation concerns.

On balance, the experience of the last 18 months indicates that there remains a degree of latitude in deciding on the turning point at which fiscal stimulus should be withdrawn and monetary policy given pre-eminence. Such decisions are, of course, the purview of individual countries, but centralized approaches, such as that of the European Central Bank due to its views on the threat of inflation, reduce such latitude. Ideally, the fiscal stimulus should first create sustainable growth before dealing with the long-term challenge of fiscal consolidation. In deciding on this turning point, for a number of economies not immediately pressured by the financial markets to undertake fiscal consolidation, it might appear preferable to err on the side of stimulating growth while adding to still-sustainable levels of debt. It may be the case that the growth thereby created may actually be more favourable in the attempt to balance budgets in the future than fiscal consolidation, due to increased tax receipts from businesses and consumers and reduced social support outlays.

Indeed, attempting to reduce deficits without first ensuring sufficient growth may result in perverse consequences, with the budgetary gains from budget cuts and tax rate increases being exceeded by the reduction in the quantum of tax receipts and increased mandatory social sector payments. It is possible, therefore, that the financial markets themselves may accept the difficulty of reducing debt as growth falters and may actually penalize countries that embark on fiscal consolidation without having credible policies to drive growth in the interim. Arguably, this has been the case with a number of European economies, such as Ireland, which have found their bond yields increasing in recent months despite their stringent debt reduction programmes, the precise opposite of the key intended effect of such plans to reduce interest rates for the public and private sectors.

On the part of Asia-Pacific economies policymakers should cope with the growth impact of the sluggish recovery in developed economies by adopting a cautious approach to exit from fiscal stimulus packages in the year ahead.

Asia-Pacific economies should cope with the growth impact of the sluggish recovery in developed economies by adopting a cautious approach to exit from fiscal stimulus packages in the year ahead.
Managing the blowback from the European debt crisis

The Asia-Pacific economies have to absorb the probable impact on the region of the still largely unresolved public debt crisis in a number of European economies. In recent months, the scale of public debt in Greece, in particular, but also in Ireland, Portugal and Spain, has led to credit down-grades and increased the debt servicing costs of those countries. In response, their governments have pledged to sharply reduce their fiscal deficits and contain their levels of debt in the coming years through stringent programmes of budget cuts, as affirmed recently by the G20. In the medium term, further compounding the immediate fiscal gap are ageing societies and weak economic growth, which would entail substantial additional resources for health and pensions as tax proceeds come under pressure. In this regard, the worst-case scenario of one or more simultaneous sovereign debt defaults in Europe in the near term cannot be ruled out. They would almost certainly generate wide-ranging repercussions that would not bypass the region.

A major challenge in the region is the possibility that a sovereign debt crisis might spill over from a relatively small number of countries to the rest of the European Union and to the global economy through the financial channel. The impact of a new debt crisis has the potential to affect the financial sector in parts of Asia and the Pacific. As Asia-Pacific banks are not believed to have significant holdings of European sovereign debt products, they are not considered to be at immediate risk from a new debt crisis. Such is the interconnectedness of major financial institutions in the global economy, however, that the financial sector of the region remains at risk indirectly from exposure to any global credit withdrawal. While the banking sector over much of the region is healthy at the domestic level, in some economies it is exposed to potential shocks due to its involvement in the interbank market. In a number of economies, banks are carrying loans that exceed domestic deposits (see figure 4), necessitating recourse to funding from international banks. As with the subprime crisis, banking operations in such cases have the potential to be disrupted by an international credit crunch through which affected banks in other regions are unwilling or unable to engage in interbank lending. The external public debt of countries could be affected by such developments, although such debt does not represent a large share of total public debt for most economies in the region.

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8 For further details, see ibid.
9 In the Toronto Summit Declaration of 27 June 2010, the G20 state that “...recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, properly phased and growth-friendly plans to deliver fiscal sustainability, differentiated for and tailored to national circumstances”. Available online at www.g20.org/Documents/g20_declaration_en.pdf.
There may also be an impact on asset markets in the region, as affected financial institutions in developed countries withdraw from portfolio investments in Asia and the Pacific in a “flight to safety”. Similarly, there could be an impact on foreign direct investment to the region if European companies act to counter losses in their home markets by shelving investment plans in Asia and the Pacific.

While the Asia-Pacific region at present has not been affected to a significant degree by the spillover from the European debt crisis, as the crisis has the potential to worsen in the coming months, there remains cause for considerable concern. In this climate of uncertainty, policymakers in the region would need to consider measures to protect themselves against contagion from a more severe European debt crisis. These measures would be most applicable not only to those economies that are exposed through foreign trade or external financing needs, but also those that experience an excessive level of interest by the international investment community in the form of large inflows of speculative capital. Governments that are at risk of sudden withdrawals of external financing and a credit crunch need to make credible arrangements for rapid liquidity support to their financial sectors in the case of a financial shock from abroad. Such arrangements, which were established in the wake of the subprime crisis, are currently being wound up in response to the region’s apparent rapid recovery in recent months. There is a case for keeping these arrangements intact for the time being.
Growth of exports to the developed countries to falter

The impact of a slowdown in the developed economies on exports from the region has already begun to be reflected in monthly export growth numbers in 2010 (see figure 5), which have weakened during the latter part of 2010. Trade slowdown is traditionally a leading indicator of a wider slowdown in the region and this trend predicts a growth slowdown in the Asia-Pacific region in 2011.

Figure 5. Index of exports from selected developing Asian economies to world total, 2008-2010 (July)

![Graph showing index of exports from selected developing Asian economies to world total, 2008-2010 (July)](image)


Countering the slowdown, however, there are some encouraging initial trends of export redirection to within the region. The initial post-crisis recovery of exports starting from early 2009 preceded growth in the developed economies, influenced by exports to China and other resilient economies in the region. Intra-regional exports accounted for over 50 per cent of the exports of economies in 2009, by far the largest share of total exports (see figure 6). Some of these exports remain linked to demand in the developed countries, as they reflect intra-regional exports as part of inter-country production networks supplying final demand in the European Union and the United States. Even accounting for such exports, though, intra-regional exports supplying final demand in Asia and the Pacific are still a very large proportion of total exports. Discounting exports to China, which is the major recipient of inputs from the region for processing and onward export to supply final demand in developed countries, intra-regional exports still account for over 28 per cent of total exports. Furthermore, this figure may be taken as a lower bound as an estimate of true regional final demand, as a substantial proportion of exports to China now also supply the sizeable and growing final demand of the domestic economy of China.

There are some encouraging initial trends of export redirection to within the region
Figure 6. Share of exports from developing countries in the ESCAP region to main trading partners, as a percentage of total exports from developing countries in the region.

Source: ESCAP analysis, based on data from the International Monetary Fund, Direction of Trade Statistics. Available from http://www2.imfstatistics.org/DOT/.

Note: The scale on the left-hand side shows the percentages for exports of developing ESCAP countries to China (the dark-coloured bars) and other developing ESCAP countries (shown by the light-coloured bars). The scale on right-hand side shows percentages for exports from developing ESCAP countries to the United States and the EU-15.

At this stage, the redirection of exports to economies within the Asia-Pacific region is unlikely to fully replace the demand from the developed economies. There is considerable potential for such an outcome in the medium term, however, with the increasing wealth of the larger, more rapidly-growing economies of the region. In this regard, other than China, India is likely to play a more important role in the coming years due to its high proportion of consumption in GDP, rapidly increasing household incomes and the fact that it is running a trade deficit with most economies of the region. Fostering the process of export redirection will, however, require further regional trade, transport and financial integration. While tariff barriers have been reduced in many cases, non-tariff barriers to doing business remain high. For example, transportation costs for exports remain higher within the region than to developed economies. There is an urgent need for such barriers to be removed, perhaps as a time-bound regional initiative.

Fostering the process of export redirection will require further regional trade, transport and financial integration.
Rising prices accompanying growth recovery

Despite the contractionary effects of appreciating exchange rates, inflation has started to increase across the region in tandem with the growth recovery. Given its deleterious social consequences, inflation remains an issue of particular concern in a number of economies (see figure 7).

Figure 7. Consumer price inflation, year-on-year, in major Asian developing economies, 2008-2010

Overall, the rise in global commodity prices (see section below on rising food prices affecting the poor) is beginning to put upward pressure on general prices and is disproportionately affecting the poor in many countries. Stronger currencies are having a tempering effect but overall price pressures are a matter of growing concern. Furthermore, there are significant risks that excess liquidity resulting from continued monetary easing in developed economies is spilling over into general inflation due to incomplete sterilization of capital flows (see section below on managing capital inflows) and speculative asset price bubbles.

For much of the region, although headline inflation has been increasing, it has remained moderate, particularly in the export-oriented economies, which saw sharp declines in economic activity and inflationary pressures during the crisis. The domestic demand-led economies, which were less affected by the slowdown during the crisis, are also now experiencing increasing inflationary pressure. For instance, inflation in a number of South Asian economies in 2010 is expected to remain in double digits or close to it. Contributory factors have been increases in utility and petroleum prices, which have caused the prices of other consumer goods and services to rise as well. High budget deficits in most South Asian economies have also been contributing to high inflation. In South-East Asia, traditionally a subregion of low inflation, Viet Nam has seen inflation reach almost 9 per cent this year due to price increases in food and foodstuffs, as well as housing and construction materials.

Exchange rates appreciating under pressure from capital flows

The region is being buffeted by the nature of the expansionary monetary policies undertaken by developed economies as part of their efforts to recover from the crisis. Developed countries are seeing their currencies weaken, while developing countries are seeing their currencies strengthen. The measures that economies around the globe are taking to moderate the impact on their currencies are leading to trade tensions as economies attempt to protect their exports against those of their competitors. There is a fear that economies may eventually move from relatively benign supportive measures to other more serious efforts to protect exports, such as subsidies, or resort to more generalized protectionism.

As mentioned elsewhere, the low interest rates in the developed economies are pushing investors towards the developing economies, including those in the Asia-Pacific region. These developing economies are attractive because of the better yields offered by their currencies due to the higher returns available in the region and potential capital gains from asset investments due to the better growth prospects in many of the economies. The scale of potential pressure for regional economies can be seen, for example, in the disproportionate size of the global fund management industry as compared to the size of most regional economies. The quantum of total global funds under management was estimated at $61.6 trillion in 2008.\(^\text{11}\)

Other than the reallocation of existing funds by financial institutions, there is once again the burgeoning of the carry trade using borrowed funds. Investors are taking advantage of low interest rates in developed economies to borrow and invest in the currencies and financial assets of major developing economies in the region. The confluence of circumstances in the developed economies and developing economies in the region has led to a situation similar in nature to that which existed before the crisis when the yen and, to a lesser extent, the dollar were borrowed to invest in higher-yielding currencies in both the developed and developing worlds. In the initial months of the crisis, risk aversion led to a reversal of the carry trade as investors reverted to so-called safe havens such as the dollar and yen, despite the low yields of these currencies. However, with a perception among investors of greater stability in global financial markets, the search for high yields and growth has led to a resumption of the pre-crisis carry trade, with the destination of choice

now being developing country markets, mainly in the Asia-Pacific region. While the size of the present carry trade is difficult to measure with certainty, estimates put it at around $750 billion, approaching the size of the previous carry trade at its peak between 2004 and 2007.12

The immediate impact on the economies in the region of the deluge in foreign capital flows has been steep rises in currency values. Many economies in the region have current account surpluses, which would put upward pressure on exchange rates in any event, but economies are experiencing additional currency appreciation pressure due to the large capital inflows. Most major currencies in the region have risen significantly since 2009 (see figure 8). For example, from January 2009 to November 2010, Indonesia, the Republic of Korea, Thailand and Malaysia have seen their currencies appreciate by 22.7 per cent, 17.4 per cent, 16.5 per cent and 12.4 per cent respectively. A number of countries, such as Indonesia, Malaysia and Singapore, are witnessing exchange rates against the dollar that have already exceeded their pre-crisis values.

Figure 8. Exchange rate movements in major developing economies, 2008-2010

Note: A positive trend represents appreciation and vice versa.

While steep, the exchange rate appreciations do not, in fact, reveal the full extent of the latent pressure experienced by governments, which in many cases have moderated the degree of increase with substantial foreign currency purchases. This is reflected in the significant increase in foreign exchange reserves of many countries since 2009, mirroring the period of exchange rate appreciation (see figure 9). The countries that have seen the steepest appreciations have also witnessed the most rapid build-up of foreign exchange reserves, implying that currency appreciation for these economies would have been still higher without such a reserve build-up. The degree of differentiation in the approach to exchange rate management among economies in the region is declining, as economies which did not previously intervene are now doing so. Japan, for example, intervened for the first time in six years in September 2010 to reduce the appreciation of the yen. On the other hand, economies such as Singapore and Hong Kong, China, which have engaged in de facto pegging to depreciating developed economy currencies, are increasingly concerned about the impact of such a policy. The low interest rates, which have to be maintained to allow their currencies to remain cheap, are leading to asset price increases fuelled by borrowing.

Figure 9. Foreign reserves (excluding gold) in major Asian developing economies, December 2007-October 2010

The perception that currency fluctuations can be moderated or even countered by economies through intervention and other methods has given rise to fears of a possible currency war in which countries seek to maintain their competitive advantage by letting their currencies weaken relative to their competitors. Developed economies that perceive other economies deriving an unfair advantage from managing currency movements may feel compelled to take protectionist measures. Since the onset of the crisis, the European Union and the United States, for example, have already implemented 299 and 240 protectionist measures, respectively.13

One notable aspect of protectionism in this crisis has been the role played by subsidies to financial institutions and manufacturing companies. Subsidy programmes and other forms of preferential treatment given as part of national bailout packages could significantly alter competitive conditions of trade for some time to come by skewing the playing field against Asian and Pacific enterprises that do not benefit from such subsidies. The concern is that developed economies may build on such protectionist measures in the coming months in reaction to a perceived currency war. In 2010, for example, draft legislation against countries that engaged in currency intervention was introduced in the United States Congress.14 While this particular measure is unlikely to become law, it may be a harbinger of measures to come. As fiscal consolidation proceeds in many developed economies, there may be an additional temptation to replace subsidies and preferential treatments granted in bailout programmes with new trade barriers. Such a scenario of heightened global protectionism would be a fundamental concern for the region as it would significantly jeopardize its export recovery and growth.

GROWTH OUTLOOK FOR 2011

All the current indications are that 2011 will see a slowdown in growth in the region as a result of the slowing pace of recovery in the developed economies of the world. This is partially reflected in the broadly parallel movements of growth forecasts for the developed economies and those of developing economies in the region (see figure 10). Whereas growth in the developed economies is forecast to stagnate at 2.2 per cent in 2011 (down from 2.7 per cent in 2010), growth in the developing economies of the region is forecast to fall from 8.3 per cent in 2010 to 7.0 per cent in 2011. The fall in exports driving the growth slowdown in developing economies began to become evident during the course of 2010 and this trend is expected to continue during 2011, with the impact spreading to other components of GDP growth over time, thereby driving the overall slowdown in growth in exporting economies.

Figure 10. Economic growth rates for Asian and Pacific developing economies and developed economies of the world, 2003-2011

Sources: ESCAP calculations based on national sources; International Monetary Fund, International Financial Statistics online (Washington, D.C., August 2010); Asian Development Bank, Key Indicators for Asia and the Pacific 2010 (Manila, 2010); and ESCAP estimates. Figures for developed economies of the world are extracted from International Monetary Fund, World Economic Outlook: Recovery, Risk, and Rebalancing (Washington, D.C., October 2010).

Note: Economic growth rates for 2010 and 2011 are estimates and forecasts, respectively.

Despite the slowdown in growth in 2011, the Asia-Pacific region will remain, by far, the region with the most dynamic growth in the world. As in 2010, the region will remain the principal contributor to global growth, with nearly double the rate of growth of any other region of the world (see figure 11).
Economies that have a large domestic demand component will continue to grow strongly in 2011. The highest growth economies in the region in 2011 will be the two largest economies, China and India, with a forecast growth of 9.0 per cent and 8.7 per cent, respectively, followed by Indonesia, with growth forecast at 6.5 per cent (see table 1). These economies were little hit by the sharp recession of 2008-2009. In addition, they engaged in fiscal stimulus, therefore maintaining fairly steady growth throughout the crisis. Factors that should continue to contribute to their steady performance in 2011 include ongoing consumption and investment in India and Indonesia, with growth increasing the spending power of the population and widening employment and business opportunities. In China, continuing strong infrastructure spending and net exports are expected to be supported by increased household consumption as the government puts in place measures to reorient the economy towards greater domestic consumption in the areas of health and education spending.

Sources: ESCAP calculations based on data from the United Nations regional commissions.

a Only developing economies in the ESCAP region (excluding countries of the Commonwealth of Independent States);
b Developed and developing member countries of the European Economic Commission.
Table 1. Rates of economic growth in selected developing Asian economies, 2009-2011

<table>
<thead>
<tr>
<th>Country or area</th>
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<th>Current forecast</th>
<th>Forecast</th>
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<td>9.8</td>
<td>9.0</td>
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<td>8.3</td>
<td>8.7</td>
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<td>2.0</td>
<td>5.8</td>
<td>5.5</td>
</tr>
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<td>5.0</td>
<td>6.8</td>
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<tr>
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<td>3.2</td>
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</tr>
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<td>Thailand</td>
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<td>Hong Kong, China</td>
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<td>6.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Developing ESCAP economies</td>
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<td>7.0</td>
<td>8.3</td>
<td>7.0</td>
</tr>
</tbody>
</table>

Sources: ESCAP, based on national sources; International Monetary Fund, International Financial Statistics online, available from www.imfstatistics.org/imf/ (accessed 19 October 2010); Asian Development Bank, Key Indicators for Asia and the Pacific 2010 (Manila, 2010); CEIC Data Company Limited; ESCAP estimates; and ESCAP, Economic and Social Survey of Asia and the Pacific 2010 (United Nations publication, Sales No. E.10.II.F.2).

Notes: Rates of real GDP growth for 2010 are estimates and those for 2011 are forecasts. Developing ESCAP economies comprise 37 economies (excluding the Central Asian countries) and the calculations are based on the weighted average of GDP figures in United States dollars in 2009 (at 2000 prices).

The dependence on exports to developed economies may lead to a reduction in the trend growth rate for exporting economies in the medium term.

It would appear that export-dependent economies are likely to be affected in 2011 by the global trade slowdown as a result of the sluggish growth in the developed economies. Exporting economies in the region had experienced a strong recovery in growth driven by net exports aided by their own fiscal stimulus programmes. Growth for many such economies, however, is expected to fall from the high levels of 2010 by about 2-2.5 per cent in 2011. Some deceleration in 2011 would be inevitable given the especially high growth rates seen in 2010, due to the base effect of low to negative comparator values of growth in 2009. Indications are that, even compared to the pre-crisis growth average between 2004 and 2007, growth in 2011 is forecast to be substantially lower in a number of export-dependent economies, such as Singapore (down 3.2 per cent), Malaysia (down 1 per cent), Thailand (down 0.8 per cent) and the Republic of Korea (down 0.5 per cent). This indicates the danger that the dependence on exports to developed economies may lead to a reduction in the trend growth rate for exporting economies in the medium term. To replace this possible loss, there is a compelling need to increase intraregional exports to benefit from growth in the large domestic demand-led economies and to increase domestic demand in the exporting economies through enhanced investment expenditures, which have substantially decreased in many of these economies since the 1997 crisis.

Inflationary pressures are likely to increase in some economies in 2011 but they should not, by and large, warrant measures that impede the process of recovery. A number of economies in the region are forecast to see an increase in inflation in 2011 (see figure 12). The inflationary pressures would, in fact, imply a normalization.
in economic activity as recovery continues after the recession. However, trends in overall inflation do not fully reflect the impact on the poor of rising prices, as they are more affected by particular elements of the inflation basket, especially food. Food prices have been increasing and volatile and any continuation of the high prices in this sector will have strong negative impacts on the livelihood of the poor (see section below on rising food prices affecting the poor).

Figure 12. Consumer price inflation\textsuperscript{a} of selected developing economies in the ESCAP region, 2009-2011

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tbody>
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<td>Kazakhstan</td>
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<td>Pakistan</td>
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<td>Philippines</td>
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<td>Republic of Korea</td>
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<td>Singapore</td>
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<td>Thailand</td>
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<td>Viet Nam</td>
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<tr>
<td>Hong Kong, China</td>
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</tbody>
</table>

\textsuperscript{a} Changes in the consumer price index.

Sources: ESCAP, based on national sources; International Monetary Fund, International Financial Statistics online (Washington, D.C., September 2010); Asian Development Bank, Key Indicators for Asia and the Pacific 2010 (Manila, 2010); CEIC Data Company Limited; and ESCAP estimates.

Notes: Rates of real GDP growth for 2010 are estimates and those for 2011 are forecasts. Developing economies of the region comprise 37 economies (excluding the Central Asian countries) and the calculations are based on GDP figures at market prices in United States dollars in 2009 (at 2000 prices) used as weights to calculate the regional growth rates.
KEY DOWNSIDE RISKS IN 2011

Managing capital inflows

The major economies in the region are having to deal with the destabilizing impact of short-term capital inflows. The problem with these inflows is that they are essentially of a speculative nature, seeking high rates of return on existing assets over the short term rather than leading to new capital formation, as in the case of foreign direct investment. They are also characterized by herding behaviour, which means they tend to crowd in the well-performing emerging markets and avoid the poorer or least developed countries, which need foreign capital the most. The veritable deluge of capital inflows has led to potential asset market bubbles in some countries and boosted inflationary pressures through the risk of incomplete sterilization of capital inflows.

Equity markets in many economies of the region, for example in India, the Republic of Korea, the Philippines and Thailand, are already at their pre-crisis peaks (see figure 13). Foreign investor interest in the equity markets of the region is reflected in booming inflows to non-Japan Asia equity funds, which stood at $45 billion for the year to September 2010, with the greatest interest being in China and India. While price-earnings ratios remain relatively low in the region by historical standards, the steep rise in equity prices for a number of economies indicates the possibility of a bubble where equity prices are driven to very high levels not so much on the basis of reasonable expectations of earnings growth of companies but on the basis of potential capital gains.

Another rising asset class is property, both in China and in high-income economies such as Singapore and Hong Kong, China. The Asia-Pacific region as a whole has seen the highest rises in property prices of all regions and a number of economies have led the world in property price increases until the second quarter of 2010, with Singapore seeing the highest rise globally (37.0 per cent as compared to a year earlier), followed by China (36.8 per cent) and Hong Kong, China (24.9 per cent).\(^{16}\)

There can be little doubt that economies will have to be vigilant, not only with regard to the impact of capital inflows on their economy but also with regard to the risk of a sudden reversal of capital inflows into outflows. Economies have attempted to

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\(^{16}\) Knight Frank, “Asia continues to lead global housing market growth”, *News Release*, 22 October 2010.
The developing economies in the region should be encouraged to coordinate and utilize various forms of capital controls as required to manage the influx of destabilizing flows.

Economies in the region are becoming receptive to the view that another solution to managing the deluge of inflows lies in various forms of capital controls, as recommended by ESCAP, which both alerted policymakers to the incipient flood of capital heading for the region’s shores and recommended the application of capital controls. It is increasingly accepted that a completely open capital account may not be appropriate from a cost-benefit viewpoint, particularly since research has suggested that the benefits of such openness are ambiguous. A number of developing economies, both within and outside the region, have now realized the value of such controls and have imposed various forms of capital restrictions in recent months. Indonesia recently implemented controls, including a one-month minimum holding period for certain securities. In the Republic of Korea, limits have been placed on currency forward positions and a tax has been imposed on foreign buying of government bonds, while Thailand has imposed a 15 per cent withholding tax on foreign holders of bonds. Meanwhile, China requires banks to hold more foreign exchange reserves and to strengthen the auditing of overseas fund-raising.

Against this background, the developing economies in the region should be encouraged to coordinate and utilize various forms of capital controls as required to manage the influx of destabilizing flows. Such measures should ideally be implemented at the regional level, as no one economy can engage in such a policy without a likely exit of capital to comparable economies that do not institute such controls. There is also a need for developed economies to support the imposition of such controls when required by developing economies, especially as these controls have become necessary primarily because of the measures adopted by developed economies during their recoveries. In this regard, the G20 should support the use of capital controls as an additional policy tool at the disposal of developing countries dealing with this problem. In addition, the G20 could call

17 ESCAP, Economic and Social Survey of Asia and the Pacific 2010 (United Nations publication, Sales No E.10.II.F.2).
20 “Chairperson’s Summary of the High-level Consultation on Perspectives from Asia and the Pacific on the G20 Seoul Summit” (ESCAP document MPDD/2010/G20/1).
on the International Monetary Fund (IMF) to provide these countries with technical assistance to help them devise appropriate forms of such controls.21

Rising food prices affecting the poor

Increases in food prices are emerging as a major issue of concern across much of the region. Economies in various parts of the region have seen food prices increase by between 10 and 35 per cent since 2009 (see figure 14). Food prices influence general inflation numbers upwards, particularly in lower-income economies where such prices account for a higher proportion of the inflation basket. For example, China, India, Indonesia and Thailand have consumer price index (CPI) weightings of between 33 and 46 per cent for food. Rising food prices have exceeded headline CPI numbers in many economies in 2010, representing a key factor in the rise in overall CPI (see figure 15). Beyond the impact on CPI, rising food prices are of major concern because they represent a higher proportion of spending for the poorest citizens than for the general population, especially in the lower-income economies.

Figure 14. Food consumer price inflation movements in selected Asian developing economies, 2009-2010

Increases in food prices are emerging as a major issue of concern across much of the region.


Figure 15. Comparison between overall and food consumer price inflation (annualized) in selected developing economies, 2010 (to date), year-on-year

![Graph showing Comparison between overall and food consumer price inflation in selected developing economies]


Food price increases across the region have largely been driven by external factors, primarily weather-related developments and the increasing incidence of financial speculation in commodity markets. Key crop harvests have been affected by adverse weather events. The wheat production of major exporters such as Canada, Kazakhstan, the Russian Federation and Ukraine has been especially affected. Wheat prices were further affected by the announcement of an export ban by the Russian Federation in August 2010. While wheat is not a major staple for most countries in the region, the impact of wheat prices on prices of other staples due to increased demand for substitutes is of increasing concern. Rice prices rose about 10 per cent in August 2010 due to the wheat substitution effect, as well as weather-related shocks in China and Pakistan.²²

Furthermore, a significant portion of the increase in food prices and their growing volatility can only be explained by the emergence of a speculative bubble.²³ The massive liquidity expansion resulting from easy money policies in the advanced countries in the aftermath of the crisis is fuelling speculation in food markets and driving up food prices. Against this background, regulation of commodity markets should, therefore, be stepped up to prevent speculation. In particular, it is important that previously unregulated over the counter derivative trades be

²³ Olivier de Schutter, “Food commodities speculation and food price crises - Regulation to reduce the risks of price volatility”, United Nations Special Rapporteur on the Right to Food, Briefing Note No. 2, September 2010.
carried out in public exchanges and that speculative position limits (total number and value of contracts for a given commodity) be established and applied equally to all investors.24

The importance of non-demand-pull factors in explaining food price increases leads to concerns about utilizing monetary policy as the main tool to combat such increases. Monetary policy is considered by authorities to be more efficacious for tackling inflation of the demand-pull variety. In the absence of clear signs of excess demand pressures, however, such a policy would not be able to deal with the root cause of food price inflation because of concerns about the pass-through of food price inflation to other product prices due to higher costs from commodity inputs and higher food price-related wage demands. Dampening the general level of demand in the economy through monetary policy would actually be inimical to maintaining growth, which is critical for poverty reduction. Specifically, increased interest rates would reduce investment, which is critical for infrastructure spending and private sector development. Furthermore, monetary policy is a blunt tool which may have other undesirable macroeconomic consequences. A concern is the resulting pressure on the exchange rate due to additional global capital inflows, which would be attracted by increased interest rates.

A more appropriate approach for policymakers to deal with rising food prices might be to address explicit supply-side causes. First, financial speculation in international commodity prices should be addressed through international cooperation, as outlined above. Second, buffer stocks of food should be established and utilized, and price controls on essential items should be used to reduce prices for the poor; social protection should also be offered to minimize the poverty impact due to higher expenditures on food. Third, greater emphasis should be placed in the medium term on agricultural productivity through continued support for crop and rural development, instituting a new, knowledge-intensive green revolution which would also make agriculture more environmentally resilient.25

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24 “Chairperson’s Summary of the High-level Consultation on Perspectives from Asia and the Pacific on the G20 Seoul Summit” (ESCAP document MPDD/2010/G20/1).

25 For further details, see ESCAP, Economic and Social Survey of Asia and the Pacific 2010 (United Nations publication, Sales No. E.10.II.F.2).
FOSTERING ALTERNATIVE SOURCES OF DEMAND

In the medium term, the fundamental challenge for the Asia-Pacific economies would be to significantly bolster alternative local sources of demand to complement the constrained demand from developed economies. At the national level, this will mean increasing the role of domestic demand in the larger domestic demand-led economies. The areas of domestic demand which need to be boosted, however, vary across the region. For instance, in East Asia and, most importantly, in China, the main shortfall is in consumption (see figure 16). On the other hand, in South-East Asia, the key drawback is in investment (see figure 17). Intraregional trade and integration will also need to be boosted for the smaller exporting economies in the region to benefit from the domestic demand of their neighbours. The centrality of growth has been recognized by the G20 in its adoption of the Framework for Strong, Sustainable and Balanced Growth.26 At the Seoul G20 Summit in November 2010, leaders once again reiterated the need for countries to formulate and implement clear, credible, ambitious, growth-friendly medium-term fiscal consolidation plans, differentiated according to national circumstances.27

Figure 16. Share of household and government consumption in 10-year GDP growth

![Graph showing share of household and government consumption in 10-year GDP growth for United States, South-East Asia, South Asia, and East Asia.]


Notes: 2010 estimates; 2011 forecasts; see list of countries in table 7 of the Survey 2010 for country groupings.

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The Asia-Pacific region could significantly contribute to this framework by exploiting opportunities to generate additions to the global aggregate demand, while also addressing its most urgent development needs. In this respect, the region’s wide development and infrastructure gaps and its huge number of poor people can provide headroom for generating substantial additional impulses to aggregate demand, contributing to more sustained economic growth while making it more balanced and inclusive.

Figure 17. Share of gross capital formation in 10-year GDP growth


Notes: 2010 estimates; 2011 forecasts; see list of countries in table 7 of the Survey 2010 for country groupings.

Boosting consumption by reducing poverty and Millennium Development Goal gaps

Despite its impressive growth and development, the Asia-Pacific region is still home to some 947 million people living under $1.25 a day, roughly two thirds of the global poor. With inclusive development policies, those below the poverty line could, over time, be enabled to join mainstream consumers, potentially adding hundreds of millions of new consumers to the region’s aggregate demand. On a similar note, Asia-Pacific countries have been making slow progress on a number of Millennium Development Goals other than poverty reduction (see figure 18), implying that millions of people suffer from various forms of deprivation. For instance, 1.873 billion people are without basic sanitation (over 70 per cent of such people in the world) and 469 million are without access to safe drinking water, while nearly 70
per cent of the under-five underweight children reside in the region. Reducing these gaps so that the region can achieve the Millennium Development Goals by 2015 should be given the highest policy priority, not only for the intrinsic value of reducing human suffering and deprivation but also as a key anti-poverty strategy that would also contribute to sustaining aggregate demand and growth.

Figure 18. Progress towards achieving the Millennium Development Goals in the Asia-Pacific region

Studies have helped to attain a better understanding of the role of growth in poverty reduction and efforts to meet the other Millennium Development Goals. Recent research has found that the rate of poverty reduction can be accelerated significantly by ensuring that inequalities do not worsen with growth and that household consumption increases faster than it has done in the region. To illustrate the point, at its current rates of growth, Bangladesh will be able to achieve the poverty target by 2021. It can achieve the target by 2015, however, if it can be ensured that income inequalities do not rise with growth and that per capita

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29 ESCAP, Financing an Inclusive and Green Future: A supportive financial system and green growth for achieving the Millennium Development Goals in Asia and the Pacific (United Nations publication, Sales No. E.10.II.F.4).
household consumption can be increased by an additional 1 per cent.\textsuperscript{30} Thus, the need to foster policies that make growth more equitably distributed and enhance the consumption of the poor is self-evident. Some of these policies include promoting agriculture and rural development, strengthening social protection, enhancing financial inclusion and job creation, in general with a focus on women.

The Millennium Development Goal Summit held at the United Nations in September 2010 re-emphasized these objectives. In addition, it placed renewed stress on not turning inwards in times of economic and financial uncertainty. It called for the strengthening of regional integration and the promotion of trade, as they were crucial elements in strengthening development and generating resources to sustain the wider objectives enshrined in the Millennium Development Goals.\textsuperscript{31}

\section*{Boosting investment by removing infrastructure gaps}

The other aspect of development gaps which has received little attention is the existence of infrastructure gaps in the region. This is partially due to the lack of a single indicator that captures different aspects of infrastructure, such as roads, railways, communications infrastructure and energy supplies, which makes comparisons across countries difficult. ESCAP constructed a composite measure capturing aspects of transport infrastructure (roads, railways and air transport density), information and communications technology infrastructure (telephone and Internet density), energy availability (intensity of energy use) and banking infrastructure (density of bank branches).\textsuperscript{32}

The patterns that emerge from the composite indicator, as plotted in figure 19, suggest that high-income and upper middle-income countries and areas—namely Australia, Brunei Darussalam, Japan, New Zealand, the Republic of Korea, Singapore, Hong Kong, China and Macao, China—have reached a very high level of infrastructure development, occupying the top eight positions. At the other end of the spectrum, the least developed countries, small island economies and landlocked developing countries, such as Bhutan, Cambodia, the Lao People’s Democratic Republic, Mongolia, Nepal, Papua New Guinea, Solomon Islands and Vanuatu, have very wide gaps in the levels of infrastructure development remaining to be closed. Other developing countries occupy the middle positions, with significant gaps remaining to be closed.

\textsuperscript{30} Ibid.


\textsuperscript{32} ESCAP, Economic and Social Survey of Asia and the Pacific 2010 (United Nations publication, Sales No. E.10.II.F.2).
Integrating to benefit from the region’s domestic demand

A central component of policies for building sustained long-term growth and resilience in the Asia-Pacific region is the fostering of regional economic integration so that smaller exporting economies can benefit from the impact of increased domestic consumption and investment, especially in the larger economies, as discussed in the preceding sections. Some of the priority actions that can leverage complementarities across the region and lay the foundations for a more inclusive and sustainable development path include institutional arrangements for market integration and improved connectivity and the facilitation of cross-border movements of goods and services.

Towards a broader seamless market

The time has come to move towards combining the complex network of subregional groupings and numerous bilateral trade agreements into a broader arrangement.
and provisions of these arrangements. The time has come to move towards combining these agreements into a broader arrangement. For this purpose, progress can be accelerated on two current overlapping proposals: the East Asia Free Trade Agreement (EAFTA), that brings together the ASEAN+3 grouping, and the Comprehensive Economic Partnership of East Asia (CEPEA) of the East Asia Summit (EAS) members, which includes, in addition to the ASEAN+3 grouping, Australia, India and New Zealand (or ASEAN+6) as a stepping stone to an even broader unified market for the Asia-Pacific region and an economic community. The East Asia Summit in Hanoi in October 2010 underlined the importance of regional efforts in restoring financial stability and generating sustainable economic growth and development by enhancing regional financial cooperation and coordination.

**Integrated trade and transport policies for improved connectivity**

The region has improved its highway and railway networks, but it cannot use this infrastructure effectively without the legal and regulatory basis for vehicles, goods and people to move across borders and transit countries. Currently, many international movements are hindered by slow and costly processes, formalities and procedures. In the future, the region will need an integrated, multimodal transport system, which could be created, for example, by building intermodal transfer points, also known as dry ports, where goods, containers or vehicles can be trans-shipped using the most efficient mode of transport, and which also contain facilities for product grading, packaging, inspections and the processing of trade documentation. The areas surrounding dry ports can then emerge as growth poles, bringing new investment and employment opportunities to impoverished hinterlands while reducing pressure on coastal areas. Building on its Asian Highway and Trans-Asian Railway networks, the ESCAP secretariat is now assisting the region in developing a network of dry ports, in addition to improving trade and transport facilitation. ESCAP, along with other regional organizations, collaborated with ASEAN in developing the connectivity master plan that was adopted by the leaders at their Summit in Hanoi in October 2010.

**Creating a regional financial architecture to support economic integration**

It is now increasingly realized that a necessary pillar for greater economic integration in the region is the development of a regional financial architecture. The Asia-Pacific region is gradually moving towards the development of some elements of the regional financial architecture with the Chiang Mai Initiative and regional bond market development. With combined foreign exchange reserves of $5 trillion, however, the region now has the ability to develop a far more ambitious regional financial architecture, which will protect its growth from recurrent crises and provide the resources to bridge its development gaps.

**Crisis prevention and response**

The economic crisis highlighted the importance of a regional response to complement IMF facilities. If governments had access to a well-endowed regional crisis response and prevention facility, they would feel less need to build up large foreign exchange reserves to protect their economies against speculative attacks and liquidity crises and could thus free up reserves for more productive investments. So far, the cooperation in the area has been largely limited to the
Chiang Mai Initiative, which has now become multilateral and is known as the Chiang Mai Initiative Multilateralization (CMIM)\(^{33}\) with a reserve pool of $120 billion to meet the temporary liquidity needs of ASEAN+3 economies. The economies are also in the process of evolving their own surveillance facility, known as the ASEAN+3 Macroeconomic Research Office (AMRO). There is a need to extend the scope and coverage of the CMIM to create a real and effective regional crisis prevention and management facility. Enhanced regional cooperation for crisis response and management should not, however, be regarded as an alternative to full participation in global economic relations. Rather, it should be seen as a complement to it, filling in the gaps and establishing the building blocks for global multilateral cooperation.

**Development finance and the integration of capital markets**

The region needs to further develop its financial architecture for development financing, which would include systems of intermediation between its large savings and its unmet investment needs. One option would be to create an infrastructure development fund managed by a regional institution. If it utilized just 5 per cent of the region’s reserves of nearly $5 trillion, it could provide start-up capital of $250 billion, in addition to being able to borrow from the central banks. This pooling of reserves could assist the region in meeting some of its investment needs, estimated to be of the order of more than $800 billion per annum in transport, energy, water and telecommunications. The development of regional bond markets and the integration of the region’s capital markets would also facilitate investment flows within the region. The Asian Bond Market Initiative (ABMI) aims to develop local currency bond markets and to encourage making private savings available for regional investment needs. Efforts are being made to promote the demand for and issuance of such bonds. The relevant infrastructure and regulatory frameworks also need to be put in place. In this connection, ASEAN+3 has recently endorsed the establishment of a $700 million credit guarantee and investment facility, which will provide guarantees on local currency denominated bonds issued by companies in the region. It is expected that such initiatives will help channel money into regional investment needs and also reduce the currency and maturity mismatches that made the region vulnerable to external shocks in the past.

The ESCAP Commission at its 66th Session held in Incheon, Republic of Korea, in May 2010, adopted a resolution seeking a task force to elaborate the elements of a regional financial architecture that could assist the Asia-Pacific region with increased capital availability for infrastructure development.\(^{34}\)

**Exchange rate cooperation**

Another area where a regional financial architecture could make a positive contribution is in exchange rate coordination. As economies of the region increasingly trade with each other, they will need a currency management system that facilitates trade and macroeconomic stability and discourages beggar-thy-neighbour currency competition. One option worthy of consideration is a basket parity relative to a number of reserve currencies instead of the dollar alone, and a common set of weights determined on the basis of regional trade share.

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Regional cooperation for the reform of the international financial architecture

The development of a regional financial architecture would also increase the region’s capacity in the area of policy coordination and in developing a regional perspective on the reform of the international financial architecture. Issues of importance include various proposals, such as establishing a special-depository-receipt-based global reserve currency that includes major developed and developing economy currencies as well as other stores of value, such as gold, which could be issued counter-cyclically, supporting a global tax on financial transactions to moderate short-term capital flows and instituting international regulations to curb excessive risk-taking by the financial sector, as well as other issues concerning the reform of the international financial architecture that are emerging in the G20, the United Nations and other forums. The Asia-Pacific region has eight members in the G20—Australia, China, India, Indonesia, Japan, the Republic of Korea, the Russian Federation and Turkey—more than any other region, signifying the systemic importance of Asia and the Pacific in the global economy. The effective coordination of the positions of Asia-Pacific G20 economies would give them greater influence in shaping the direction, content and pace of reform of the international financial architecture so that the reform is best attuned to their developmental needs. In these areas, as well as many others, the Asia-Pacific region has the opportunity to further integrate and coordinate its actions, thus not only ensuring its current recovery and future dynamism but also supporting and contributing to the global economy to the greatest extent possible.

35 “Chairperson’s Summary of the High-level Consultation on Perspectives from Asia and the Pacific on the G20 Seoul Summit” (ESCAP document MPDD/2010/G20/1).

2010 has seen an impressive recovery of the Asia-Pacific region from the Great Recession of 2008/09. Led by the large economies of China and India, output growth in the region rebounded in 2009 and gathered further strength in 2010. But the region is faced with a weakening of growth in the developed economies which are grappling with a combination of weak household demand and fiscal retrenchment.

With developed economies putting greater reliance on monetary policy to stimulate growth through major expansion of liquidity, many developing economies in the region are having to contend with a deluge of short-term speculative capital flows causing their exchange rates to appreciate, asset bubbles to form and price pressures to build up especially of food.

The Year-end Update of UN-ESCAP’s annual flagship publication, Economic and Social Survey of Asia and the Pacific 2010, considers the implications of these challenges for policy-makers in the region. The principal message of the Update is the need for the countries in the region to adopt a cautious approach in ending of fiscal stimulus packages while building in the medium term alternative sources of demand in the region, both domestic and external. For the former, the Update looks to reduce poverty and boost demand combined with more investment in infrastructure. For the latter, it highlights the need to deepen regional integration in the areas of trade and finance and more broadly in policy coordination in order to face the challenges confronting the region in 2011 and beyond. Management of capital flows is another important challenge for the region’s policy makers for maintaining financial stability.