Outlook for Asia – 2005 to 2007

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Performance in 2004

2004 was a good year for Asia. GDO growth exceeded 7 percent for the region as a whole, led by growth of nearly 8 percent in East Asia where China grew by 9.5 percent (see Table 1). Both South Asia and Southeast Asia grew by over 6 percent. Growth was led by strength in foreign demand complemented by stronger domestic investment. There was a revival in the global electronics market that helped the regions' exports to continue to grow rapidly at over 20 percent, led by China at 35 percent.

Inflation remained subdued as consumer prices rose by between 3 and 4 percent (see Table 2). A flexible exchange rate stance by Singapore, Taiwan and Thailand resulted in appreciation against the US dollar reducing the impact of imported inflation. With low inflation, monetary policy remained accommodating throughout the year.

Current account surpluses continued to accumulate, although higher oil prices resulted in lower surpluses than in 2003 (See Table 3). As a percent of GDP, the surpluses were highest in Southeast Asia at 7.1% of GDP with somewhat lower levels at 4.2 % in East Asia, and South Asia had a small deficit. Foreign exchange reserves increased, primarily in China, due to the weakness of the US dollar and increased spending on infrastructure to further boost competitiveness. Policy adjustments continued in several countries, particularly in South Asia as this sub-region continued to maintain high rates of growth led by India.

Table 1 Economic Growth 2004-2007

Year	2004			2005			2006			2007
	ADB	IMF	CE	ADB	IMF	CE	ADB	IMF	CE	ADB
East Asia	**7.8**			**6.7**			**7.0**			**7.2**
China	9.5	9.5	9.5	8.5	8.5	8.4	8.7	8.0	7.8	8.9
Hong Kong	8.1		7.9	5.7		4.6	4.1		4.3	5.6
Korea	4.6		4.6	4.1		3.0	5.1		4.7	4.9
Taiwan	5.7		5.7	4.2		4.2	4.5		4.3	4.6
Southeast Asia	**6.3**			**5.4**			**5.6**			**5.9**
Indonesia	5.1	5.1	5.1	5.5	5.5	5.4	6.0	6.0	5.7	6.5
Malaysia	7.1	7.1	7.1	5.7	6.0	5.4	5.3	6.2	5.7	5.8
Philippines	6.1	6.1		5.0	4.7		5.0	4.5		5.0
Singapore	8.4			4.1		4.2	4.5		4.8	4.4
Thailand	6.1	6.1		5.6	5.6	5.4	5.8	6.2	5.6	6.0
South Asia	**6.4**			**6.7**			**6.2**			**6.9**
Bangladesh	5.5	5.4		5.3	5.5		6.0	5.9		6.0
India	6.5	7.3		6.9	6.7		6.1	6.4		7.0
Pakistan	6.4	6.5		7.0	6.7		7.0	6.3		7.5
Sri Lanka	5.5	5.2		5.2	5.3		5.8	6.0		5.9

Legend: ABD - Asian Development Bank, IMF - International Monetary Fund World Economic Outlook and CE - Consensus Economics

Table 2 Inflation 2004-2007

Year	2004			2005			2006			2007
	ADB	IMF	CE	ADB	IMF	CE	ADB	IMF	CE	ADB
East Asia										
China	3.9	3.9	3.9	3.6	3.0	3.2	3.3	2.5	3.1	3.2
HongKong	-0.4		-0.4	1.5		1.2	1.6		2.1	2.1
Korea	3.6		3.6	3.0		3.1	3.3		3.1	3.6
Taiwan	1.6		1.6	1.7		1.5	1.5		1.6	1.5
Southeast Asia										
Indonesia	6.2	6.1	6.1	5.9	7.0	7.0	5.4	6.5	6.1	5.5
Malaysia	1.4	1.4	1.3	2.4	2.5	2.1	2.5	2.5	2.1	2.5
Philippines	5.5	5.5		6.5	6.8		6.0	4.9		5.5
Singapore	1.7		1.7	1.4		1.5	1.2		1.7	1.2
Thailand	2.7	2.7	2.8	3.5	2.9	3.0	3.0	2.1	2.7	2.5
South Asia										
Bangladesh	5.8	6.1		7.0	5.7		6.0	4.5		5.0
India	6.0	3.8		4.2	4.0		3.0	3.6		3.6
Pakistan	4.6	6.7		7.5	7.9		5.0	6.5		5.0
Sri Lanka	7.9	7.6		12.0	12.0		9.0	7.5		7.5

Legend: ABD - Asian Development Bank, IMF - International Monetary Fund World Economic Outlook and CE - Consensus Economics

Table 3 Current Account Balance as % of GDP 2004-2007

Year	2004			2005			2006			2007
	ADB	IMF	CE	ADB	IMF	CE	ADB	IMF	CE	ADB
East Asia										
China	3.3	4.2		1.2	4.2		0.4	4.0		-0.2
Hong Kong	9.7			7.7			7.3			5.4
Korea	4.0			3.9			3.5			2.8
Taiwan	6.2			6.8			6.7			6.3
Southeast Asia										
Indonesia	2.6	2.8		2.1	2.2		1.5	0.9		1.0
Malaysia	12.5	13.3		10.2	13.6		8.3	12.2		6.7
Philippines	2.4	4.6		3.0	2.6		2.2	2.0		2.0
Singapore	26.1			26.1			25.7			26.2
Thailand	4.5	4.5		2.3	2.0		1.3	1.4		1.3
South Asia										
Bangladesh	0.2	-1.2		-1.0	-2.4		-1.0	-2.5		-1.5
India	-1.0	0.3		-1.0	-0.3		-1.4	-0.3		-1.9
Pakistan	1.9	0.3		-1.7	-1.2		-1.6	-0.8		-1.9
Sri Lanka	-3.2	-3.2		-5.8	-5.3		-5.2	-4.2		-3.0

Legend: ABD - Asian Development Bank, IMF - International Monetary Fund World Economic Outlook and CE - Consensus Economics

Table 4 Baseline Growth, Trade and Oil Price Assumptions 2004-2007

GDP Growth	2004	2005	2006	2007
Industrial countries	3.5	2.5	2.5	2.4
United States	4.0	3.7	3.4	3.1
Japan	2.7	1.1	1.3	1.3
Euro zone	2.0	1.6	1.8	2.1
Brent crude oil price/barrel in US$	38.0	41.0	39.0	37.0
World trade volume (% change)	10.2	7.4	6.0	6.0
Source: Asian Development Bank, Asian Development Outlook 2005				

Outlook for 2005-2007

Against a baseline of more modest growth in the industrial countries (Table 4) the forecast for 2005 and 2006 suggest that growth in the Asian region will moderate. In East Asia, growth in China will slow somewhat as will the rest of the countries in this sub-region. Further tightening of monetary policy in China may be needed particularly in light of continued strong capital inflows and upward pressure on the exchange rate. Liberalization of overseas investment to permit capital outflows, including relaxation of regulations requiring domestic firms to convert foreign exchange earnings into local currency, is another way to adjust the balance of capital flows without resorting to currency appreciation. Korea will continue to recover from the 2003 growth slowdown although forecast growth in 2005 and 2006 is modest. The extent of the recovery of the Korean economy will depend on the rate of consumption growth which is constrained by continued high consumer debt and the extent of moderation in export growth. Growth in Taiwan will moderate as external demand eases

In Southeast Asia, Indonesia is projected to continue to accelerate through the forecast period while the rest of the region achieves solid growth. To maintain momentum Indonesia will have to attract more foreign investment, reduce fuel subsidies and improve tax administration in order to reduce government deficits and public debt. In Thailand infrastructure spending must continue in order to maintain industrial competitiveness and while there are risks related to the spread of Avian flu and higher oil prices. In the Philippines a number of policy reforms are needed in order to bring the economy to a higher growth trajectory including generating greater revenue, better debt management, power sector reforms and improving the investment climate.

A continuation of policy reforms will help South Asia record a further modest acceleration in growth over the forecast period, led by a strong performance of India, which accounts for the bulk of GDP and nearly 80 percent of economic growth in this region over the forecast period. Fiscal consolidation is important for India given the magnitude of the government deficit, particularly state government finances. India must also address additional policy issues including strengthening the financial sector, labor market rigidities, agricultural reform and trade liberalization if it is to achieve the projected increase in growth. In Pakistan and Bangladesh further fiscal adjustments and strengthening of tax collection and administration are required to maintain growth momentum as well as further restructuring of industry and restructuring of banking (Bangladesh).

Domestic demand will play a crucial role in the forecast period as investor and consumer sentiment both improve. Asia is projected to remain a preferred location for foreign investors compared with other developing regions. Countries in Asia are working to maintain their competitive advantage by upgrading infrastructure, attracting FDI, improving governance (including reducing corruption) streamlining bureaucratic procedures and increasing operational efficiency. Inflation is projected to remain modest throughout the region and monetary tightening will be modest. Higher interest rates due to rising rates in industrial countries could adversely affect economies with high household and public debt, including China and Korea in East Asia, Indonesia, Philippines and Thailand in Southeast Asian and Sri Lanka in South Asia.

The external sector will remain a growth driver over the forecast period in the Asian region, even with strong domestic demand. Current account surpluses will fall in East Asia and Southeast Asia and the current account deficit will rise somewhat in South Asia. External sector performance will remain robust although down somewhat from 2004, when exports grew at over 20 percent per annum in all three regions (see Table 5). Export growth in the forecast period will average around 13 percent in East Asia and South Asia and over 8 percent in Southeast Asia. Competitive forces from other countries in the region such as China and Taiwan will put pressure on profit margins and constrain growth rates. To maintain international competitiveness over the forecast period will require all economies in the region to intensify their efforts to enhance competition and improve efficiency. Continued streamlining of bureaucratic procedures, further liberalization of trade, adapting new technology and strengthening financial sectors will be critical, particularly in Southeast and South Asia.

Asian economies will continue to accumulate foreign reserves. South Korea (now 26% of GDP), China (37% of GDP), and Taiwan (75% of GDP) as well as Singapore and Hong Kong are all expected to increase their level of international reserves. In addition to Japan and Russia, the developing countries in Asia will play an increasingly crucial role as the primary source of savings to finance the rising US current account deficit.

The economic giants of China and India will continue to provide growth impetus to the region. Trade within greater China (Hong Kong, Taiwan and China) will remain robust despite disputes between China and Taiwan while China's trade and investment ties with Southeast Asia will expand. Greater trade linkages between South Asia and Southeast Asia are envisioned as trade barriers are lowered and bureaucratic procedures streamlined.

Table 5 Export Growth 2004-2007

Year	**2004**	**2005**	**2006**	**2007**
East Asia				
China	35.4	20.4	14.8	12.5
Hong Kong	15.9	12.2	12.3	14.2
Korea	30.6	11.8	9.6	9.0
Taiwan	20.7	12.1	8.2	9.5
Southeast Asia				
Indonesia	9.4	6.0	7.0	8.0
Malaysia	20.5	12.0	10.2	12.6
Philippines	9.6	8.0	8.0	7.0
Singapore	24.2	8.0	8.0	8.0
Thailand	23.0	10.0	5.0	8.0
South Asia				
Bangladesh	15.9	15.0	10.0	8.0
India	23.2	14.1	13.8	13.2
Pakistan	13.5	11.0	10.0	10.0
Sri Lanka	12.7	9.0	11.0	12.0

Source: Asian Development Bank, Asian Development Outlook 2005

Risks

Oil The first risk is that oil prices will remain substantially above the baseline. This could derail the world recovery as well as growth prospects in Asia. We show two scenarios for Asia using the Oxford Economic Forecasting model and reported by Citibank. In the first scenario, we consider the impact of a temporary price shock on GDP, inflation and the current account balance. These results are shown in Table 6. The impact on GDP growth, inflation and the current account are rather modest. GDP falls by less than half a percent in all but a few countries (Indonesia, Malaysia, Philippines and Thailand in 2005 and Hong Kong in 2006) and the overall impact to these economies is still under 1 percent. The inflation impact is also modest except in India, Malaysia and the Philippines where it exceeded .5 percent. The current account impact is negative for most countries in the first year and then tails off in the latter part of the forecast.

Table 6 Effects of a *Temporary* increase of oil prices by $10 per barrel in deviations from Baseline on GDP (% points), Inflation (% points) and Current Account (% of GDP)

Year	2004			2005			2006		
	GDP	Inflation	CA	GDP	Inflation	CA	GDP	Inflation	CA
East Asia									
China	-0.2	0.1	-0.4	-0.4	0.3	0.4	-0.1	-0.1	0.6
Hong Kong	-0.1	0.1	-0.2	-0.4	0.1	-0.3	-0.6	-0.1	0.1
Korea	-0.1	0.3	-0.9	-0.2	0.2	0.1	-0.3	0.2	-0.1
Taiwan	-0.1	0.2	-0.7	-0.2	0.1	-0.7	-0.1	0.1	-0.1
Southeast Asia									
Indonesia	-0.1	0.4	0.9	-0.9	0.2	0.1	-0.4	0.3	0.1
Malaysia	-0.3	0.7	-0.2	-0.6	0.4	0.6	-0.4	0.3	-0.2
Philippines	-0.3	0.8	-0.8	-0.7	0.6	0.4	-0.3	0.5	0.1
Singapore	-0.3	0.7	-0.9	-0.1	0.4	0.3	0.1	0.2	-0.3
Thailand	-0.4	0.8	-1.1	-0.6	0.6	0.2	0.2	0.6	-0.1

Source: Citigroup estimates based on Oxford Economic Forecasting model. No estimates are available for South Asia from this model.

Table 7 Effects of a *Permanen*t increase of oil prices by $10 per barrel in deviations from Baseline on GDP (% points), Inflation (% points) and Current Account (% of GDP)

Year	2004			2005			2006		
	GDP	Inflation	CA	GDP	Inflation	CA	GDP	Inflation	CA
East Asia									
China	-0.2	0.1	-0.4	-0.7	-0.5	-0.1	-1.0	0.5	0.7
Hong Kong	-0.1	0.1	-0.2	-0.6	0.3	-0.7	-1.5	0.2	-0.6
Korea	-0.1	-0.8	-0.9	-0.4	0.3	-0.9	-0.8	0.8	-0.8
Taiwan	-0.1	0.2	-0.7	-0.4	0.4	-0.6	-0.6	0.5	-0.6
Southeast Asia									
Indonesia	-0.1	0.4	0.9	-1.1	0.9	1.3	-1.9	1.2	1.5
Malaysia	-0.3	0.7	-0.2	-1.1	1.5	0.4	-1.8	1.9	0.0
Philippines	-0.3	0.8	-0.8	-1.3	1.7	-0.6	-1.8	2.3	-0.5
Singapore	-0.3	0.7	-0.9	-0.6	1.5	-1.0	-0.4	1.8	-1.3
Thailand	-0.4	0.8	-1.1	-1.3	1.8	-1.2	-1.3	2.6	-1.2

Source: Citigroup estimates based on Oxford Economic Forecasting model. No estimates are available for South Asia from this model.

In the second scenario, we consider a permanent $10 price hike. This presents a bigger hurdle for growth, inflation and the current account as shown in Table 6. The effect of a permanent price increase of $10 is to reduce GDP growth by between half a percentage point in some countries and up to around 2 percentage points in Indonesia, Philippines and Malaysia. The overall impact on GDP is somewhat higher on the Asian economies than the "conventional wisdom result" for industrial countries that a $10 increase in the price of oil will shave a half percent off GDP growth.

The impact on inflation is to increase prices by as much as 2.6 percent over baseline in Thailand and around 2 percent in other Southeast Asian countries. Current account balances are projected to fall by as much as 1 percent of GDP across the board.

Foreign exchange market volatility Asian developing countries returned to maintaining a *de facto* dollar anchor following the Asian financial crisis. However as the dollar has weakened over the last two years several countries have found this anchor more difficult to maintain. Concerted efforts need to be made to maintain intraregional currency stability while at the same time introducing more flexibility against the US dollar. The problem created by a widely different array of exchange rate regimes within the region makes this challenge even more daunting. Furthermore, as Asia trades more and more within its own borders (developing Asia is now it's largest trading partner, not the United States) greater volatility in cross-country exchange rates increases the risk of creating further trade and financing difficulties for some countries. In addition substantial sterilization measures have been undertaken to maintain domestic internal monetary balance.

Foreign exchange reserves in emerging East Asia increased by over $300 billion in 2004, equivalent of over 9 percent of its gross domestic product (GDP), an unprecedented number. East Asian economies have large current account surpluses and large inflows of private capital at the same time, so dollars are being accumulated even faster than during the mid-1990's. Asia's central banks now control more than two third of global foreign exchange reserves amounting to $2.5 trillion. Some observers believe that this is excessive and that there is a need to plow them back into Asia.

The challenge is to manage these foreign exchange reserves without creating inflationary pressure. In China, the authorities will need to find a way to make domestic assets more expensive for foreigners. In other countries, there is room to expand investment and consumption to counter slowing world demand. If the Yuan does appreciate, as many observers believe is becoming more likely, it could result in appreciation in other countries in the region as well. This would be a first step in resolving the structural imbalances in the world financial system that has become more acute in recent years.

These global imbalances make it likely that more structural reforms will be needed in the region. This will be easier to implement because, in most countries, banks, companies, governments and households have strong financial positions thanks to rapid growth since 2001 and it's important for governments to take advantage of this period of high growth to strengthen the financial sector and the capital markets. These are the institutions that channel foreign capital into the domestic economy. All of these regional issues can be further addressed by strengthening regional cooperation particularly with respect to proposals to strengthen swap arrangements and perhaps moving toward a common foreign exchange resource pool.

Overheating in China While the forecast includes a soft landing for the Chinese economy as we shows growth declining to the range of 8 to 9 percent in the forecast period, there is a risk that investment growth will return to high levels fueled by foreign investment, high saving and profit rates and a compliant banking system. Investment in China has reached a record estimate of 45 percent of GDP, as the Chinese authorities continue to take measures to cool down the economy, including a small rise in interest rates. China has already benefited from this year's expiration of garment quotas which had previously favored smaller nations. In the first quarter of 2005 textile shipments to Spain and France increased by over 90 percent, to Germany, UK and Italy by more than 80 percent and to the US by 78 percent compared with the first quarter of 2004. Government officials in the US and Europe are now considering tariffs or quotas to retrain trade growth. As a result of this acceleration in exports China will have an even more difficult time reducing its trade surplus in the short term. Further overheating in manufacturing and construction is possible and the Government might have to resort to more draconian measures that could lead to a severe growth slowdown in the Chinese economy. If such a slowdown does occur it would result in damage to the small and medium scale industries that have historically had limited resource to finance from the banking system and which would be among the first sectors to suffer if credit was cutback. It would also have adverse spillover effects on the rest of the Asian region, particularly Taiwan and Hong Kong and the economies of Southeast Asia which has become more closely integrated with the Chinese economy over the past decade.

Avian flu and SARS The avian flu reportedly killed 29 people out of 37 affected in Viet Nam and the fear of further spreading has resulted in the culling of fowl in Viet Nam, Thailand in some other countries. The threat of a further spread of this flu is heightened by the potential mutation into another form that could spread more easily to humans and the lack of a widely available vaccine. Nevertheless, the economic and health threat remains minimal at the present time. A recurrence of SARS is also possible. Precautions are being taken to monitor and a regional warning system is in place in case there is another outbreak. Health authorities are now better prepared given the experience with SARS two years ago.

Tsunami The impact of the tsunami that hit Indonesia, Maldives, Sri Lanka, Thailand and parts of India were felt during the first quarter of 2005 and its macroeconomic effects are reflected in the outlook. The primary impact was on the poor living in the affected areas and associated workers in the services and fishing industries. Citigroup estimated that up to two million additional poor people would be added to the poverty roles in the five affected countries as a result of the tsunami. Poverty head count ratios would increase by less than one percentage point except in the Maldives where poverty is projected to rise from 22 percent to 35 percent. Aside from human suffering the overall macroeconomic impact of the disaster is likely to be minimal. Much of the international aid will go toward rebuilding infrastructure and there will be some additional government spending to fund the remainder. Tourists are beginning to return to the affected areas although it will be at least another year before there is a return to a normal level of tourist arrivals.

Collapse of US dollar The rising US current account deficit and dollar weakness is a worrisome fact that has troubled the international financial community for some time. With regard to Asia it is noted that the vast bulk of the increase in international reserves that have been accumulated in the last decade (close to 85%) has come from Asia, including Japan. Should the central banks in these Asian countries decide to hold fewer dollars or even to shift their portfolios significantly toward the euro, it would put significant further downward pressure on the dollar and force a rise in US interest rates. However, most observers argue that this would be to kill the goose that laid the golden egg. It is the voracious appetite for US imports from Asia that has provided fuel for the economic boom in the Asian region during the past three decades. For this reason (at least for now) the forecast for Asia does not put a high probability on this scenario. Yet as noted above in the section looking at exchange rate volatility there will have to be some adjustments in order to keep these imbalances from growing further.