External Economic Environment

Despite some improvement, the external environment for developing Asia will likely remain weak in 2013.[1]

While financial markets stabilized last year, real economic activity in the G3 (eurozone, Japan, and the United States [US]) was mixed. The US economy did better than expected, while the eurozone's continued to contract, and the Japanese economy weakened in the second half **(Figure 1)**. For 2013, the eurozone economy should remain subdued as authorities confront daunting structural challenges amid record high unemployment. In Japan, it is unclear how far recent expansionary policies and a depreciating yen will boost the economy.

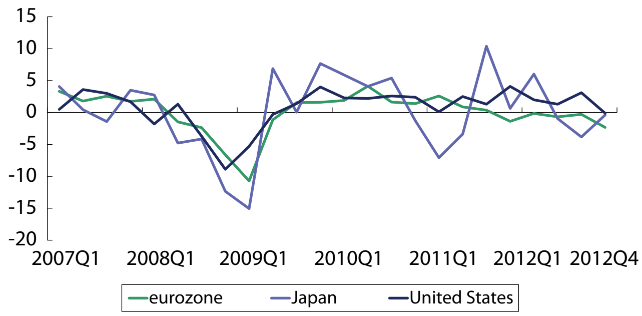
US economic growth is expected to remain below trend in 2013.

Gross domestic product (GDP) grew modestly at 2.2% in 2012, with positive contributions from private consumption and fixed investment (including residential and nonresidential). However, the recovery's momentum stalled in the fourth quarter as GDP contracted 0.1%—on a quarter-on-quarter seasonally adjusted annualized rate (q-o-q, saar)—largely due to a significant decline in private inventories, government spending, and exports. While the fiscal cliff was narrowly averted in early January, it nonetheless continues to slow the US recovery. There are still too few new jobs and unemployment—at 7.8%—remains stubbornly high **(Figure 2)**. Moreover, consumer and business confidence has fallen recently. Therefore, US economic growth will likely remain below trend, with GDP expected to grow 2.1% in 2013.

The eurozone economy will likely continue to stagnate in 2013 with high unemployment and a concern of stalled policy implementation.

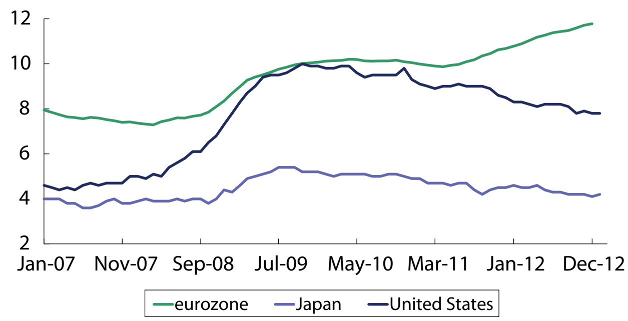
The eurozone economy contracted 0.5% in 2012—falling 2.3% (saar) in the last quarter of 2012 compared with 0.3% in the third quarter. Domestic demand weakened significantly and led to imports growing slower than exports, resulting in an expanded trade surplus. Unemployment continued to creep up, reaching a record high of 11.7% in December. While plans for fiscal consolidation have been set for many peripheral countries, uncertainties remain on how to achieve fiscal targets and address the delicate balance between growth and debt reduction. The dangerous link between sovereign debt and bank stress in weaker economies continues, and needed structural reforms have only barely begun to be implemented. In sum, GDP is expected to stagnate in 2013.

Figure 1: GDP Growth—G3 (saar, q-o-q, %)



q-o-q = quarter-on-quarter, saar = seasonally adjusted annualized rate.
Source: ADB calculations using data from Eurostat and national sources.

Figure 2: Unemployment Rate—G3
(seasonally adjusted, % of labor force)



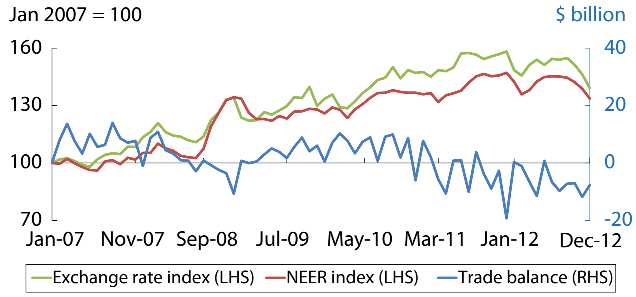
Note: Data for eurozone until November 2012.
Source: US Bureau of Labor Statistics, European Central Bank, and CEIC.

Japan's new fiscal stimulus and rapidly changing monetary regime is designed to spur growth; whether it can kick-start the economy remains uncertain.

While growing 1.9% last year, the economy contracted q-o-q in the last 3 quarters of 2012 as the trade deficit deepened and business investment slumped.

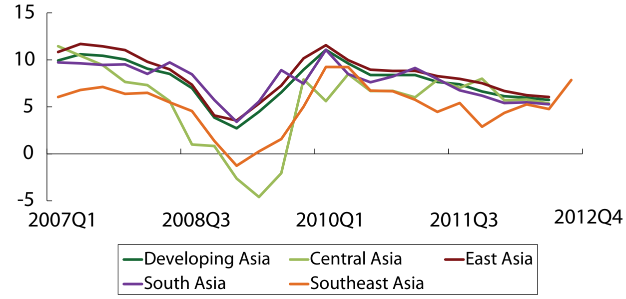
[1]Developing Asia refers to the 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member.

Figure 3: Exchange Rate Indexes and Trade Balance—Japan



LHS = left-hand scale, NEER = nominal effective exchange rate, RHS = right-hand scale.
Note: For exchange rate and NEER indexes, an increase means appreciation while decrease means depreciation.
Source: ADB calculations using data from the Bank for International Settlements, Reuters, and CEIC.

Figure 4: GDP Growth—Asia (y-o-y, %)



Note: Developing Asia includes Central Asia, East Asia, South Asia, and Southeast Asia. The Pacific is excluded as quarterly data unavailable. Central Asia includes Armenia, Georgia, and Kazakhstan. East Asia includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. South Asia includes India and Sri Lanka. Data up to 2012Q3 except for Southeast Asia.
Source: ADB calculations using data from CEIC.

Expansionary macroeconomic policies adopted by the newly elected government late in the year have energized financial markets and resulted in rapid yen depreciation. In less than 4 months, the yen fell from ¥77.5 to the US dollar to about ¥95, a depreciation of over 20%—it was over ¥120 per US dollar in mid-2007 **(Figure 3)**. The depreciation began with the new government's strong commitment to ease monetary policy and deepening trade and current account deficits in recent months. The parliament recently approved the government's supplemental budget, which includes fresh stimulus. To battle stubborn deflation, the Bank of Japan adopted an inflation target of 2% and announced a policy of unlimited asset purchases on 22 January. These expansionary policies, yen depreciation, and consumers' advance purchases in anticipation of a consumption tax increase—from 5% to 8% in April 2014—should spur economic growth. However, previous demand stimulus over two "lost" decades neither cured deflation nor led to sustained growth. Given that it is too early to assess the latest round of macroeconomic stimulus, GDP is forecast to grow 1.4% in 2013.

Regional Economic Outlook

After moderating in 2012, growth across most of developing Asia is expected to improve this year on increased domestic demand and modest recovery in export growth.

Last year saw a slowdown in growth in the People's Republic of China (PRC) and the more open export-oriented economies in East Asia **(Figure 4, Table 1)**. India's economy also moderated as growth in private consumption and investment slowed. However, the relatively robust growth across most of Southeast Asia continued. With the PRC's growth improving and robust domestic demand continuing, growth across most of developing Asia is likely to pick up this year. The only subregion forecast to slow is the Pacific. Overall, however, growth in developing Asia is forecast to accelerate to 6.6% in 2013 after growing 6.0% in 2012.

The growth slowdown in the PRC has bottomed out as the government loosened monetary policy and resumed fiscal stimulus.

The PRC economy expanded 7.8% in 2012 with growth accelerating in the second half. Strong fiscal spending likely contributed to the recovery, offsetting some of the effects of weaker external demand. The government accelerated approvals for infrastructure projects in major cities—giving momentum to the recovery. The economy also benefitted from a more accommodative monetary stance as the central bank began reducing the 1-year benchmark lending rate in June and July. The moderation in industrial production and retail sales growth appears to have run its course and export growth recovered to 25.0% in January. Consumer confidence also rose slightly during 2012 **(Figure 5)**. The Purchasing Managers' Index for January stood at 50.4, signaling modest growth **(Figure 6)**. Overall, GDP is expected to expand 8.1% in 2013.

After slumping in 2012 due to a weak external environment, the highly-open East Asian economies should recover this year.

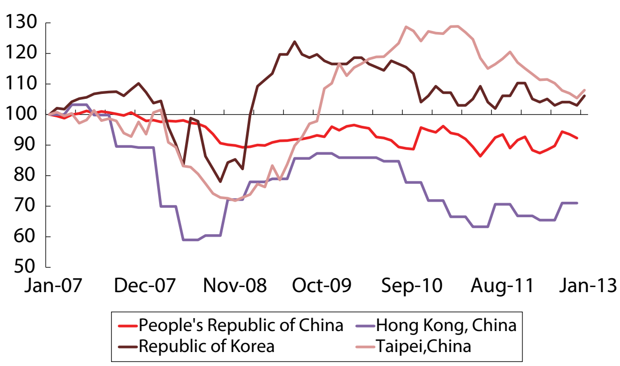
Weak global demand significantly slowed economic growth across the rest of East Asia. In 2012, growth in the Republic of Korea and Taipei,China plunged—

Table 1: Regional GDP Growth[1] (y-o-y, %)

	2009	2010	2011	2012 Estimate[2]	2013 Forecast[3]	Likely revision to 2013 forecast
Developing Asia	6.1	9.2	7.2	6.0	6.6	–
Central Asia[4]	3.2	6.8	6.5	5.4	5.7	▲
East Asia[5]	6.8	9.8	8.1	6.4	7.0	▲
People's Republic of China	9.2	10.4	9.3	7.8	8.1	▲
South Asia[6]	7.7	8.5	6.0	5.0	6.2	▼
India	8.6	9.3	6.2	5.0	6.5	▼
Southeast Asia[7]	1.4	7.9	4.7	5.5	5.5	▼
The Pacific[8]	4.3	5.5	8.1	6.8	4.2	▲
Major Industrialized Economies						
eurozone	-4.4	2.0	1.4	-0.5	0.0	
Japan	-5.5	4.7	-0.6	1.9	1.4	
United States	-3.1	2.4	1.8	2.2	2.1	

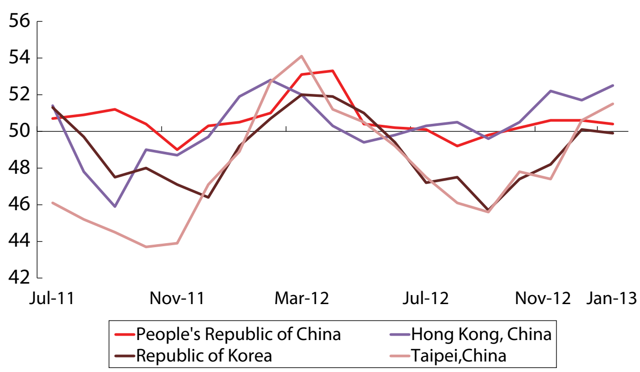
[1]Aggregates are weighted according to gross national income levels (Atlas method, current $) from *World Development Indicators*, World Bank.
[2]ADB estimates, except for eurozone, India, and the United States (advanced official estimates); actual figures for the People's Republic of China and Japan.
[3]ADB forecasts from *Asian Development Outlook Supplement, December 2012*. The new forecasts for 2013 and 2014 will be released in *Asian Development Outlook 2013* to be published in April.
[4]Includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
[5]Includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
[6]Includes Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.
[7]Includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Excludes Myanmar as weights unavailable.
[8]Includes the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. Excludes Nauru as weights unavailable.
Source: ADB calculations using data from various issues of the *Asian Development Outlook,* Asian Development Bank; and CEIC.

Figure 5: Consumer Confidence Index—East Asia
(Jan 2007 = 100)



Source: ADB calculations using data from Bloomberg and CEIC.

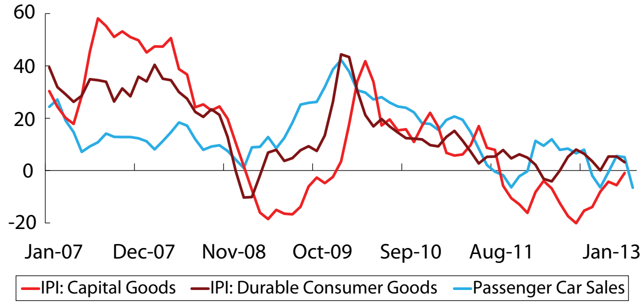
Figure 6: Manufacturing Purchasing Managers' Index (PMI)[1]**—East Asia**



[1]A manufacturing puchasing managers' index reading above 50 points indicates an expansion in the manufacturing sector while below 50 points indicates a contraction. Composite PMI for Hong Kong, China.
Source: Markit Economics and national source for the People's Republic of China.

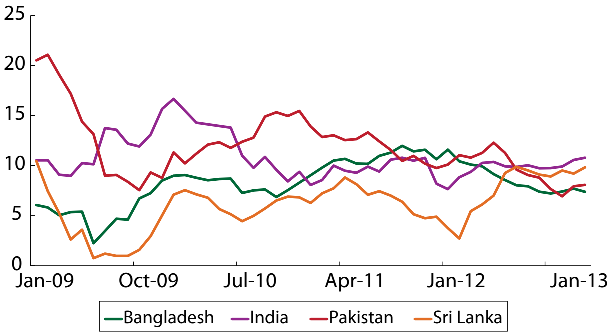
to 2.0% (from 3.6% in 2011) and 1.3% (from 4.1%), respectively. Exports and investment started to show signs of recovery in Taipei,China toward the end of 2012. In Hong Kong, China, GDP expanded 1.3% in the third quarter, up marginally from 1.2% in the second quarter—the slowdown in the PRC likely had a major influence. Including Mongolia, which grew 10.6% in the fourth quarter, East Asia GDP (including the PRC) is forecast to grow 7.0% in 2013, up from last year's 6.4%.

Figure 7: Growth of Leading Indicators for Domestic Demand[1]**—India** (y-o-y, %)



IPI = Industrial Production Index.
[1]3-month moving average. Data for IPI until Dec 2012.
Source: ADB calculations using data from CEIC.

Figure 8: Headline Inflation[1]**—South Asia** (y-o-y, %)



[1]Refers to consumer price index (CPI).
Source: ADB calculations using data from CEIC and Haver Analytics.

India's growth remained sluggish in the first half of fiscal year 2012, but recent monetary easing and a revival of reform momentum may provide some impetus.[2]

In the second quarter of fiscal year (FY) 2012, India's GDP growth dipped to 5.3%, dragged by a continued decline in private consumption and weak investment. In addition, last year's low monsoon rainfall will likely hurt agricultural output in the remainder of FY2012, which will likely constrain consumption growth and push inflation higher. Early indicators also show that consumption and investment remained weak over the past few months **(Figure 7)**. The Reserve Bank of India cut policy rates by 0.25 percentage points to 7.75% in January to stimulate domestic demand. But the high budget deficit, coupled with elevated inflation, limits its ability to cut rates further. The government has announced a series of economic reform measures, including fiscal consolidation and opening markets to foreign investors, which may help the economy regain momentum in the coming years. India's economy is expected to recover to 6.5% growth in FY2013, after slowing to 5.0% in FY2012.

Elevated inflation dampens South Asia's economic prospects.

While falling in some economies, overall, inflation remains elevated in South Asia **(Figure 8)**. In Bangladesh and Pakistan, inflation fell from 10.6% and 11.0% in FY2012 to 7.4% and 8.1% in January 2013, respectively, while it remained about 10% in India and Sri Lanka. Several central banks in the region, including India, Sri Lanka, and Pakistan, have eased monetary policy as inflation fell in recent months, which will likely boost output this year. Tight monetary policies through most of 2012 slowed growth. Sri Lanka's GDP expansion continued to fall in the third quarter of 2012. However, industrial production in Pakistan started to pick up in the second quarter of FY2013, and Bangladesh also saw some recovery in industrial production in the first quarter of FY2013.[3] With India expected to recover, South Asia's economic growth will likely reach 6.2% in 2013—after moderating to 5.0% in 2012.

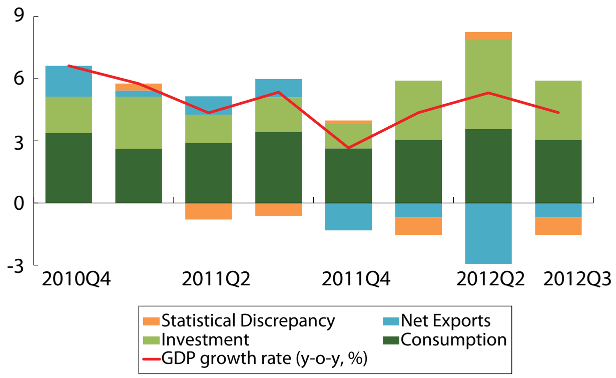
Strong domestic demand in Southeast Asia is expected to help sustain robust economic growth.

Despite falling export demand, Southeast Asian countries maintained growth momentum by relying more on domestic demand **(Figure 9)**. The Philippines' GDP growth jumped to 6.6% in 2012 from 3.9% in 2011 on strong investment and government spending. Supported by domestic demand, Indonesia maintained growth momentum with GDP expanding 6.2% in 2012 from 6.5% in 2011. Thailand's GDP growth accelerated to 6.4% from 0.1% in 2011 on reconstruction efforts following massive flooding, and Malaysia's output expanded 5.6%, after 5.1% in 2011. However, last year's weak external environment hurt Singapore's highly open economy, which, as exports contracted, grew just 1.3% in 2012, significantly down from 5.2% in 2011. Robust domestic demand is expected to continue across most economies, while consumer confidence remains high in Indonesia and the Philippines **(Figure 10)**. Together, Southeast Asia's economies are expected to retain growth at 5.5% in 2013. The five largest economies (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) are forecast to expand 5.8% in 2013, after growing 5.6% in 2012.

[2]FY2012 for India refers to April 2011 to March 2012.

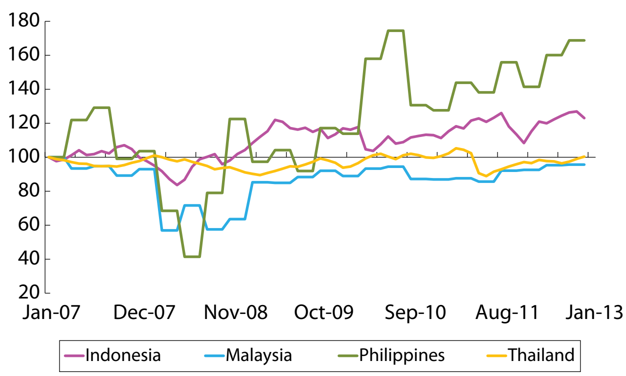
[3]FY2013 for Bangladesh and Pakistan refers to July 2012 to June 2013.

Figure 9: Contributions to GDP Growth—Southeast Asia[1]
(percentage points[2])



[1]Includes Indonesia, Malaysia, the Philippines, Singapore, and Thailand.
[2]Based on year-on-year (y-o-y) changes.
Source: ADB calculations using data from CEIC.

Figure 10: Consumer Confidence Index—Southeast Asia
(Jan 2007 = 100)



Source: ADB calculations using data from Bloomberg and CEIC.

Growth in Central Asia has weakened, mainly due to slower natural resource output and domestic issues in its two largest economies—Azerbaijan and Kazakhstan.

Kazakhstan's GDP grew 5.3% in the first 9 months of 2012, compared with 7.2% over the same period in 2011. Mining output has been hurt by the drop in global metal prices, and agricultural output was also down. Delays in major investment projects are also contributing to weaker growth. In Azerbaijan, the growth outlook remains weak on falling oil production and a delayed rollout of salary increases for civil servants. Nonetheless, with a somewhat improving external environment, Central Asia's economies are forecast to grow 5.7% in 2013, slightly above the 5.4% growth in 2012.

Economic growth in the Pacific is expected to slow in 2013 on the lagged impact of last year's weaker global economy.

Due mainly to the winding down of major infrastructure spending in Papua New Guinea (PNG) and Timor-Leste (two of the largest economies in the Pacific subregion), growth is expected to slow from an estimated average of 6.8% in 2012 to 4.2% in 2013. However, this masks improved growth prospects in nearly half of the countries of the subregion. Tourism in the Cook Islands, Fiji, Palau, Samoa, Tonga, and Vanuatu remained robust in 2012 and this should continue in 2013. Resource exports and expenditures on major infrastructure projects, especially in PNG and Timor-Leste, remain the primary drivers of regional economic growth over the medium term. While lower regional growth is expected in 2013, if PNG and Timor-Leste are able to execute their governments' ambitious infrastructure spending plans more effectively than in recent years, this would raise growth prospects in the Pacific.

Risks to the Outlook and Policy Issues

The 2013 economic outlook for developing Asia is subject to three major risks: (i) an economic slowdown in the US from missed fiscal deadlines; (ii) a worsening eurozone debt crisis, and (iii) destabilizing capital flows.

Downside risks to the outlook are less severe than just a few months ago, as the US averted its "fiscal cliff" and the risk of a eurozone breakup has receded. But there remain significant risks nonetheless. First, looming fiscal deadlines in the US threaten to derail the fragile recovery and could push the economy back into recession. While the US congress delayed its fiscal reckoning, there remains the 1 March spending sequestration and the debt ceiling deadline to confront. Government operations could be disrupted with a huge contractionary impact. Also, the eurozone debt crisis remains unresolved and could worsen. Recession in periphery countries continues, while it could spread to the eurozone core of Germany, France, and Italy. Also, banking losses in the periphery countries may worsen. Progress toward a banking and fiscal union is slow and discontent over hardships from austerity measures is growing. Finally, uncertainty in the global economy and continuing quantitative easing in advanced economies could bring large and volatile capital flows into developing Asia. This could drive excessive credit growth and currency appreciation, and exposes the region to sudden shifts in risk aversion.

While preparing counter-cyclical measures in case the short-term global outlook worsens, policymakers in developing Asia should target polices for a better balanced, sustainable, inclusive, and integrated future economy in the region.

As the external environment will remain weak in 2013—despite some positive developments in the US and eurozone over the past several months—developing Asia's policymakers should remain vigilant and ready to implement measures to safeguard the region's robust growth. Moreover, as advanced economies face a prolonged period of structural weakness, global growth will likely be lower than in recent decades. The region needs to transform its economies to adapt to this new global economic landscape. The 2008/09 global financial and eurozone debt crises showed that while day-to-day "firefighting" is needed in the short-term, policymakers should also take time to invest more capital in developing sound medium- and long-term policy options. Short-term fixes cannot solve structural problems.

Policymakers in the region should remain cautious and prudent, and be prepared to respond quickly to any deterioration in the global economy.

Global economic conditions and prospects for future recovery remain uncertain. Policymakers must be prepared to use available macroeconomic tools to safeguard economic growth while making growth more inclusive. Several developing economies in Asia have been loosening monetary policy or introduced new fiscal stimulus to offset some of the impact of the weaker global environment. Subdued inflationary pressures offer further scope to support growth. In addition, policymakers should stand ready to ensure financial systems in the region are liquid and well-capitalized. Governments must ensure that adequate social protection mechanisms are in place to support the poor and most vulnerable in case of falling employment or price shocks.

Financial sector development and macroprudential policy remain key to managing capital flows more effectively and ensuring long-term financial stability.

Developing deeper, more broad-based, and transparent financial markets can help economies allocate financial resources more efficiently for productive use and apply large pools of savings more effectively—thus better managing volatile capital flows. While economies in the region have made progress, policymakers need to keep up with the fast-changing financial environment and remain in step with financial globalization and innovation. Authorities can also curb financial excess stemming from capital inflows by providing macroprudential supervision and regulation to prevent systemic crises. Monetary policy must be augmented by macroprudential tools, such as capital requirements, additional capital buffers for banks, guidance on leverage ratios, and liquidity management to build a firewall against financial excess.

Developing Asia should continue to promote economic transformation to adjust to the new global economic landscape.

In the medium to long term, advanced economies face an extended period of structural weakness while repairing balance sheets. The region must confront the difficult task of adjustment—diversifying sources of growth, allocating financial resources more effectively and efficiently toward productive and socially equitable investment, and bolstering domestic and regional demand. Given the sluggish growth in advanced economies, developing Asia should further expand trade—particularly within the region, across its subregions, and with other emerging markets such as Latin America and Africa. Just as important, the region must ensure future growth is not merely sustainable but increasingly inclusive. Policies should be designed to improve people's welfare and the environment. Key features of public policy could include developing and broadening human capital, creating more productive jobs, building inclusive financial systems, narrowing infrastructure deficits, investing in environmentally sustainable development, and providing effective social safety nets. Progress will increasingly be determined by the quality of growth rather than simply its level.