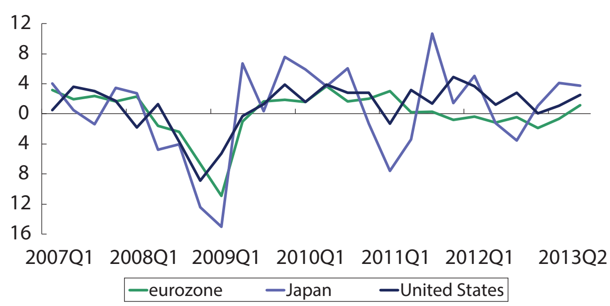
External Economic Environment

The gradual, plodding economic recovery in the G3 has begun to strengthen.

Growth in the real economies of the G3—the eurozone, Japan, and United States (US)—has shown signs of strengthening so far this year (**Figure 1**). Unemployment rates for the US and Japan continue to decline, and has stopped rising in the eurozone (**Figure 2**). In the US, the recovery has led to a discussion on the timing of when to begin the tapering of quantitative easing (QE), with global and regional financial markets fluctuating in response (**Figure 3**). However, with G3 imports from Asia still weak, the solidifying of the G3 recovery may not immediately translate into greater growth prospects for Asia's emerging economies (**Figure 4**).

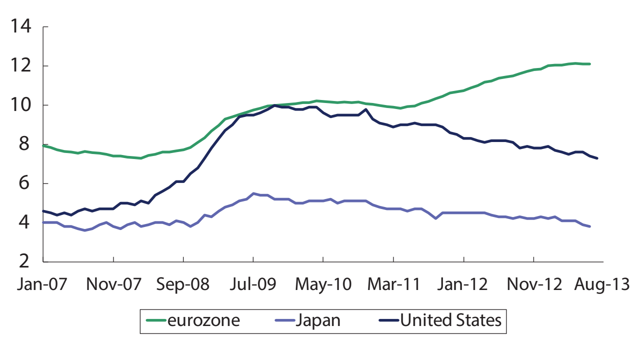
The US economy will continue its modest recovery through the rest of 2013 and in 2014. GDP growth improved to 2.5% (seasonally adjusted annualized rate [saar]) in the second quarter, up from 1.1% in the first quarter, with higher contributions from both private consumption and investment. The unemployment rate and industrial production also improved steadily so far this year. However, the recovery has not yet fully taken hold. While consumer confidence is high, retail and whole sales growth slowed month-on-month during the third quarter. Sales of existing homes continue to rise, but permits for housing starts and new house sales are slowing. In addition, the 16-day partial US government shutdown likely hurt the economy, and to some extent damaged confidence in US Treasuries.

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



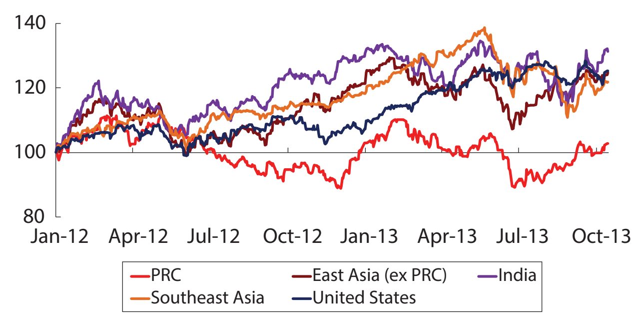
q-o-q = quarter-on-quarter; saar = seasonally adjusted annualized rate.
Source: ADB calculations using data from CEIC and national sources.

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



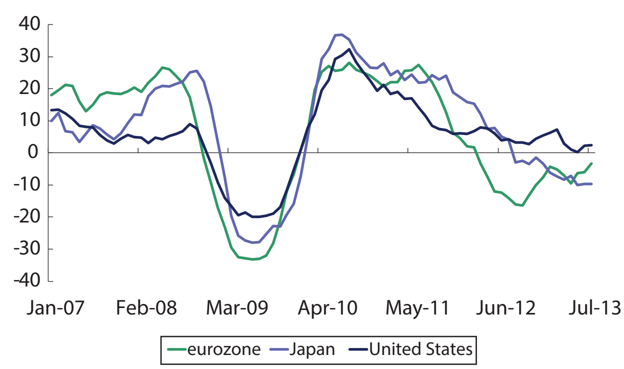
Note: Data for eurozone and Japan until Jul 2013.
Source: US Bureau of Labor Statistics, European Central Bank, and CEIC.

Figure 3: Composite Stock Price Indexes—Asia subregions, PRC, India, and United States (2 Jan 2012 = 100)



PRC= People's Republic of China.
Note: For subregions, index refers to the main stock price index for each economy weighted by market capitalization in US dollars. East Asia includes Hong Kong, China; the Republic of Korea; and Taipei,China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. For the PRC, index refers to the combined Shanghai and Shenzhen composites weighted by market capitalization; India refers to the Bombay Stock Exchange 100; and for the United States the Dow Jones Industrial Average. Data as of 14 October 2013.
Source: ADB calculations using data from Bloomberg.

Figure 4: Growth of Imports from Asia—G3 (y-o-y, %)



Note: Based on 3-month moving average of commodity imports.
Source: ADB calculations using data from CEIC.

The fiscal impasse, though postponed from a mid-October to a mid-December deadline, may continue to threaten the modest recovery. The US economy is forecast to grow 1.7% in 2013 and pick up to 2.4% in 2014.

Japan's new troika of economic "arrows" or Abenomics, has given the economy a boost. But the recovery's sustainability depends much on the so-called "third arrow" of deep structural reforms. Supported by monetary and fiscal stimulus, Japan's growth jumped from 1.1% (saar) in the fourth quarter of 2012 to 4.1% and 3.8% in the first and second quarters of 2013, respectively. Second quarter growth was broad-based, with contributions from private and government consumption, investment, and net exports. The stubborn deflation of recent decades started to turn the corner in April with some inflation taking hold. Thus far, Abenomics has been largely successful. Yet, the positive momentum has been largely due to the Bank of Japan's radical quantitative easing, which led to significant currency depreciation and increased confidence. This has allowed the government to push through with the planned increase in the consumption tax in April 2014. Inflation has been driven mainly by a rise in fuel and food prices, which is related to yen depreciation. Critically, the sustainability of these policy effects depends on the success of the deep-seated structural reforms needed to boost productivity and potential growth. Japan is expected to grow 1.9% in 2013, moderating to 1.4% in 2014.

The eurozone may be exiting the recession, with growth returning in 2014. GDP returned to growth in the second quarter of 2013 (1.1%, saar) for the first time since the third quarter of 2011. While growth appears to be broad-based—supported by a recovery in consumption, fixed capital investment, and net exports—it is rebounding from last year's low base. With unemployment no longer rising, consumption could recover further. Yet, industrial production plunged in July and building permits and housing prices continue to decline. The hope now is that second half growth will mark the turning point for the eurozone economy. To address both fiscal vulnerabilities and record unemployment, the recovery would need to reach key economies still in recession. Eurozone GDP is expected to contract 0.5% in 2013, but grow 1.2% in 2014.

Regional Economic Outlook

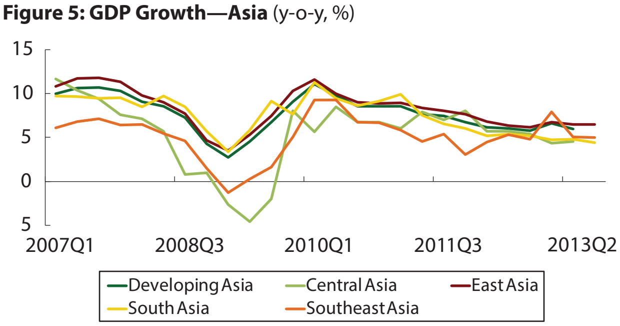
Despite the slightly more positive external environment, developing Asia's growth will likely slow slightly this year before picking up next year.

Developing Asia is forecast to grow 6.0% in 2013, slightly below the 6.1% growth in 2012, recovering to 6.2% in 2014 (**Table 1, Figure 5**). This largely reflects the slowdown in the People's Republic of China (PRC), India, and Southeast Asia—all for different reasons. The PRC is using slower growth to adjust its economic structure and ensure its medium-to-long term growth is sustainable. India may continue to suffer from the slow pace of the structural reforms needed to return the economy to the higher growth of the mid-2000s. Slower growth in Southeast Asia can be attributed to moderation from the above-potential growth in 2012. Central Asia and the Pacific are also expected to see growth slow, with the moderation this year and next hopefully helping sustain growth in the long term.

PRC growth may continue to moderate, reflecting weak external demand and government efforts to sustain growth over the medium to long term.

PRC's GDP growth slowed from 7.9% in the fourth quarter of 2012 to 7.7% the first quarter and 7.5% the second quarter of 2013. With year-on-year quarterly growth below 8.0% since the second quarter of 2012, the economy seems to be entering a lower growth trajectory than earlier believed, mainly because domestic demand has waned. Growth in exports decelerated significantly

Figure 5: GDP Growth—Asia (y-o-y, %)



Note: Developing Asia includes Central Asia, East Asia, South Asia, and Southeast Asia. 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 for Developing Asia and Central Asia until 2013Q1.
Source: ADB calculations using data from CEIC.

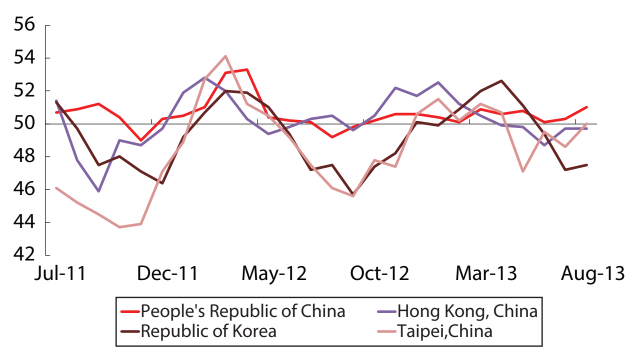
Table 1: Regional GDP Growth[1] (y-o-y, %)

	2009	2010	2011	2012	Forecast[8] 2013	2014
Developing Asia[2]	6.1	9.2	7.3	6.1	6.0	6.2
Central Asia[3]	3.2	6.8	6.8	5.6	5.4	6.0
East Asia[4]	6.8	9.8	8.2	6.5	6.6	6.6
People's Republic of China	9.2	10.4	9.3	7.7	7.6	7.4
South Asia[5]	7.7	8.4	6.0	5.1	4.7	5.5
India	8.6	9.3	6.2	5.0	4.7	5.7
Southeast Asia[6]	1.4	7.9	4.7	5.6	4.9	5.3
The Pacific[7]	4.3	5.5	8.3	7.5	5.2	5.5
Major Industrialized Economies						
eurozone	-4.4	2.0	1.5	-0.6	-0.5	1.2
Japan	-5.5	4.7	-0.6	2.0	1.9	1.4
United States	-3.1	2.4	1.8	2.8	1.7	2.4

[1]Aggregates weighted by gross national income levels (Atlas method, current $) from *World Development Indicators*, World Bank.
[2]Refers to ADB's 45 developing member economies.
[3]Includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
[4]Includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
[5]Includes Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Data for Bangladesh, India, and Pakistan are fiscal-year. For India, fiscal year is from April of the specified year through the following March. For Bangladesh and Pakistan, fiscal year is from the previous year's July through June of the specified year.
[6]Includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Excludes Myanmar as weights unavailable.
[7]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.
[8]ADB forecasts from *Asian Development Outlook Update, October 2013*.
Source: ADB calculations using data from various issues of the *Asian Development Outlook*, Asian Development Bank; and CEIC.

in the second quarter of 2013, largely due to weakened global demand, some friction with major trading partners, and rising export prices. PRC authorities seek to engineer a strategic shift away from growth led by exports and investment toward more balanced growth. The shift is most evident in recent efforts to wrestle down credit bubbles and come to grips with the burgeoning shadow banking system. GDP growth is forecast to slow slightly from 7.7% last year to 7.6 % in 2013 and to 7.4% in 2014.

Figure 6: Manufacturing Purchasing Managers' Index (PMI)—East Asia



Note: A reading above 50 indicates an expansion in the manufacturing sector, while below 50 indicates a contraction. Composite PMI for Hong Kong, China.
Source: Markit Economics and National Bureau of Statistics of China.

As the recovery in major advanced economies firms up, growth in the highly-open East Asian economies will likely stabilize in 2013 and 2014.

Helped by improving external demand, the highly-open East Asian economies of the Republic of Korea and Hong Kong, China picked up in the first half of 2013. In the same period, however, growth in Taipei,China was below that of the previous 6 months. Slower PRC growth also weighed in as purchasing managers' indexes (PMI) fell (**Figure 6**). Mongolia endured a sharp drop in coal exports and in commodity prices in the first quarter, but received a boost from increased public expenditure in the second quarter. In general, East Asia is expected to maintain stable growth in 2013 and 2014. GDP growth is projected to remain at 6.6% for both years (see Table 1). Despite the downward revisions to growth projections, East Asia still outpaces other Asian subregions—as high PRC growth dominates the subregional average. As in the past year, growth rates will vary substantially across the East Asian subregion.

India's growth outlook continues to be hampered by challenges in both policy and execution.

India's economic growth rate has been slowing—from 9.9% in the March quarter of 2011 to 4.4% in the June quarter of 2013. Annual growth for the fiscal year (FY) ending March 2013 (FY2012) was 5.0%, the lowest since 2002. While last year's slowdown partially reflects the bad monsoon, structural issues—including a poor investment climate and high fiscal deficit—have contributed to the lower growth. Subsidies have driven fiscal deficits higher, resulting in excess demand, rising inflation, and higher trade and current account deficits. Policies adopted—along with the US Federal Reserve's (US Fed) September decision to retain QE levels—stanched portfolio outflows and stopped currency depreciation. However, tight monetary policy targeting price stability, along with limited fiscal headroom for stimulating growth, will constrain economic activity in the near term. While a favorable monsoon is expected to help agriculture, economic growth may remain subdued as structural reform continues to be implemented slowly (**Figure 7**). India's economy is expected to grow 4.7% in 2013 before picking up to 5.7% in 2014.

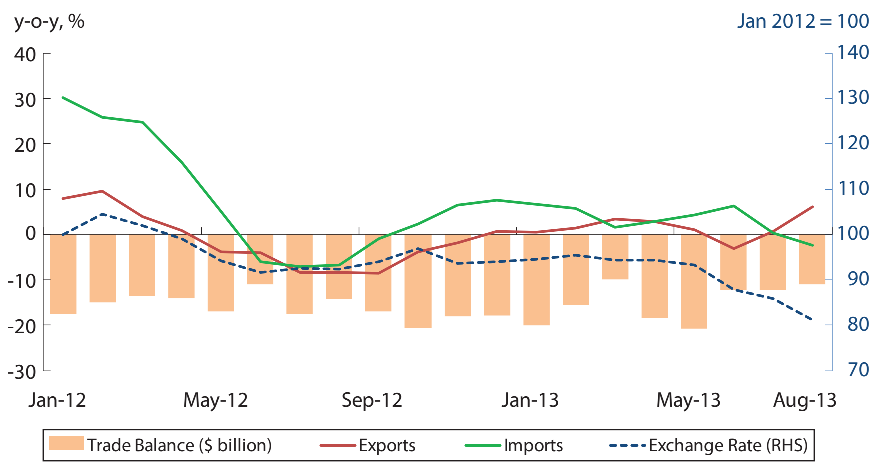
The prospects for other major South Asian economies remain mixed.

With a current account surplus fuelled by remittance inflows, the Bangladesh currency held steady despite the mid-year talk of QE tapering. However, output growth for FY2013—ending June—marginally slowed to 6.0% as domestic demand weakened due to poor agricultural output. As remittance inflows are slowing, output growth is expected to further ease in FY2014. Worsening fundamentals in Pakistan's economy led the newly elected government to undergo some needed structural reforms in hopes of regaining healthy fundamentals. These structural reforms are expected to slow economic growth in the short run, with GDP growth expected to be 3.0% in FY2014 (ending in June 2014), down from 3.6% in FY2013. While Sri Lanka is also suffering from a current account deficit and currency depreciation, robust domestic demand to support the recovery from domestic civil strife is expected to underpin a growth of close to 7%, up from 6.4% in 2012. Combined, growth in South Asia is likely to slow to 4.7% in 2013 before rising to 5.5% in 2014.

Growth in Southeast Asia is moderating, crimped by weakness in its three biggest economies.

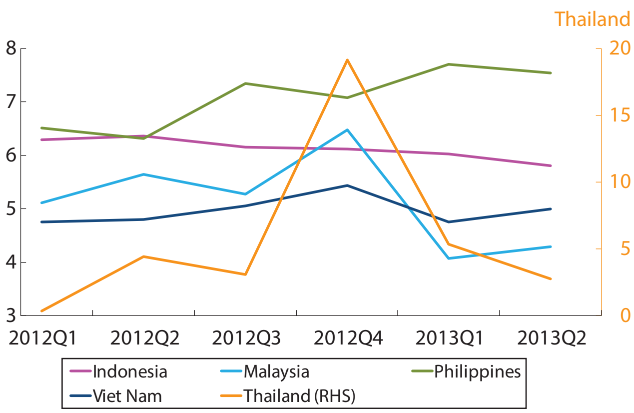
Lackluster export markets and moderating investment weighed on growth in Indonesia, Thailand, and Malaysia (**Figure 8**). By contrast, the Philippines is performing strongly, with growth higher than expected over the past few quarters. While inflation is more subdued in Southeast Asia generally, it has accelerated sharply in Indonesia since June, when the government lowered fuel subsidies. Inflation remains moderate in the Philippines, but rapid money supply growth and an increase in the share of real estate lending signal the

Figure 7: Trade Balance, Merchandise Trade Growth, and Exchange Rate Index—India



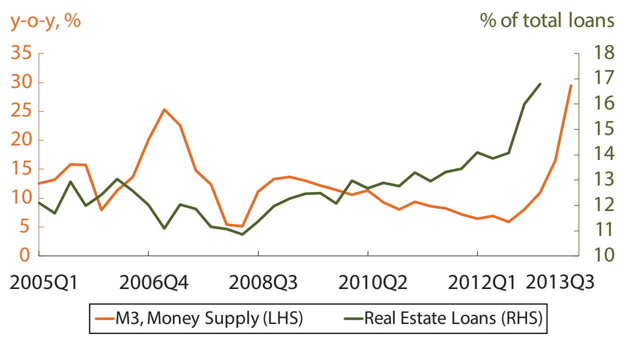
RHS = right-hand scale.
Note: Trade growth based on 3-month moving average. For exchange rate, an increase means appreciation while decrease means depreciation.
Source: ADB calculations using data from CEIC.

Figure 8: GDP Growth—ASEAN-4 and Viet Nam (y-o-y, %)



RHS = right-hand scale.
Source: ADB calculations using data from CEIC and national sources.

Figure 9: Money Supply Growth and Real Estate Loans—Philippines



LHS = left-hand scale, RHS = right-hand scale.
Note: Data for M3 (broad money liabilities) for 2013Q3 refer to July/August average. Real estate loans refer to the sum of loans by universal and commercial banks and thrift banks, data up to 2013Q1.
Source: ADB calculations using data from CEIC and Datastream.

possibility of overheating (**Figure 9**). The Southeast Asia subregion is forecast to grow 4.9%, this year from 5.6% in 2012. In 2014, growth should quicken to 5.3%, as investment recovers and exports benefit from improved global trade and recent currency depreciations in several economies.

Central Asia's growth will slow marginally in 2013 before recovering in 2014.

Slower growth is expected in Central Asia—except in Azerbaijan, where domestic demand remains strong, and the Kyrgyz Republic, where gold production is recovering from last year's plunge due to technical problems. The reasons for slower growth vary among countries. For instance, Kazakhstan's sluggish performance in industry and exports can be linked to lower demand from partners—including the Russian Federation and the PRC, while Georgia's slowdown in the first 7 months reflects investors' caution linked to the political transition, delays in public infrastructure projects, and weak domestic demand. As slower growth in the other countries outweighs the higher growth in Azerbaijan and the Kyrgyz Republic, Central Asia's growth as a subregion is expected to slow marginally to 5.4% in 2013 from 5.6% in 2012, before recovering to 6% in 2014.

Growth in the Pacific may moderate in 2013 and 2014.

While a few economies may perform better in 2013 and 2014, most are likely to see slower growth. Papua New Guinea, the largest developing member economy in the Pacific, may see growth slow in 2013 and 2014 while waiting for the completion of work on the new 850 km liquefied natural gas pipeline. Public expenditure in Timor-Leste was lower than budgeted, and Solomon Islands' production in gold mining, logging, and agriculture fell short of expectations. While improving consumption and investment in Fiji and unexpectedly large increases in tourism arrivals in the Cook Islands may marginally offset negative factors, the Pacific is expected to grow 5.2% in 2013 and 5.5% in 2014, significantly below the 7.5% growth in 2012.

Risk to the Outlook and Policy Issues

The economic outlook for developing Asia is subject to three major risks: (i) increased volatility in global and regional financial markets—in particular due to uncertainties over monetary and fiscal policies in advanced economies; (ii) a more pronounced slowdown in major regional economies than expected—such as the PRC, India, or Indonesia—which will affect other economies within the region; and (iii) a disruption in the G3 recovery.

While the recent decision by the US Fed to wait before beginning to unwind quantitative easing—and the fiscal compromise reached in mid-October—have given developing Asia some short-term reprieve, the level of uncertainty among investors over the direction of monetary and fiscal policy in major advanced economies is startling. Any volatile market reactions could undermine developing Asia's outlook, even if high levels of reserves and current account surpluses continue throughout much of the region. Financial stress may also increase the possibility of policy errors—as policy makers could be forced to adopt inconsistent policies, aggravating financial volatility. The second risk is that growth in the PRC, India, or Indonesia slows too fast due to rising financial stress and existing structural imbalances, subsequently affecting others in the region through more integrated trade and financial channels. The third risk is that policy missteps, such as another fiscal impasse in the US, new financial stress or sovereign risks in eurozone, or delayed structural reforms in Japan, could reverse the fragile recovery in the G3, damaging developing Asia's economic prospects.

Authorities in developing Asia need to respond promptly, decisively, and collectively should downside risks from financial market volatility escalate dramatically.

In general, developing Asia now has more flexible exchange rates, much higher foreign exchange reserves, healthier current account balances, better financial regulation, increased macroeconomic transparency, and better structured foreign debt than before the 1997 Asian financial crisis. Had financial turbulence escalated into financial crisis, the most immediate challenge would relate to pressures on foreign currency liquidity and the risk of spillovers into the region's financial systems. Slowing growth could also expose new financial vulnerabilities, and contingency plans are needed to safeguard financial stability. Preemptive and proactive policies may help, thus breaking a potentially vicious loop between financial weakness and the real economy.

Short-term responses are needed to bolster the foundations of financial stability and avoid deterioration in market confidence.

Confidence rests on authorities continuing to pursue sound macroeconomic policies. Recent financial crises—from the 1997 Asian financial crisis to the 2008/09 global financial crisis to the ongoing eurozone sovereign debt crisis—offer valuable lessons for developing Asia in its quest for financial stability. Policymakers can increase resilience to potential shocks by strengthening economic fundamentals in four ways. First, prudential policies can be strengthened to ensure cross-border capital flows do not undermine banking soundness. Bank regulations must also be tightened to help banks cope with volatile capital flows and protect bank integrity. Second, the region needs to better monitor asset markets and help shield the financial system from asset price trend reversals. Third, maintaining sufficient foreign reserves can enable authorities to use them as a buffer to smooth increasingly volatile capital flow and exchange rate movements. And fourth, the region should also strengthen its regional financial safety nets through bilateral and multilateral swap agreements to counter regional contagion.

The recent financial turmoil is a timely reminder of the need for continued structural reform.

The market impact on India, Indonesia, and others in developing Asia underscored the urgency of structural reforms to keep economic growth strong and sustainable. Developing Asia has the opportunity to reinforce growth prospects by working on "hard" infrastructure investment and structural "software" reforms supported by regional cooperation. In themselves these policies can have a stabilizing market impact. High priorities include reforms that encourage foreign direct investment, diversify the industrial base, close gaps in infrastructure and human capital, consolidate fiscal positions by cutting inefficient subsidies, and strengthen social protection, among other constraints to long-term growth.

Easing supply-side bottlenecks can reduce the cost of doing business, encouraging investment and spurring further growth. As most economies in the region still suffer large infrastructure gaps, expanding and improving infrastructure can pay large dividends in productivity and growth. Efficient "software" must complement good hardware. Many Asian economies could reduce excessive regulation and red tape to reduce business costs, unleash innovation, greater competition and entrepreneurship, and encourage more foreign direct investment.