

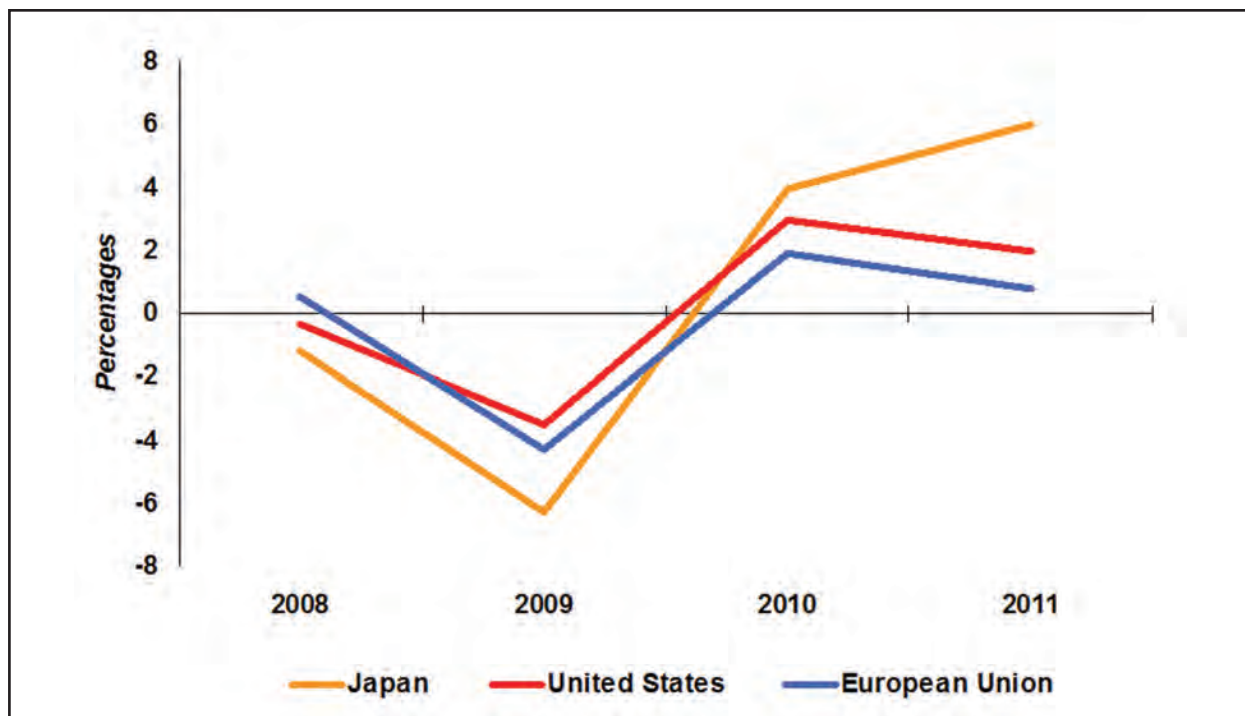
Emerging headwinds for Asia and the Pacific

Second phase of crisis in developed economies

The United States and the economies of the euro zone—the major developed economies and the region's key export markets—have been experiencing stalled growth, due primarily to concerns about sovereign debt levels. Growth data in 2011 indicate a slowing down in the recovery process in these economies (see figure 1). Notwithstanding some fluctuations in quarterly growth performance in 2011, particularly in the United States, annual growth performance for both the United States and the euro zone is expected to be significantly lower than in the previous year. Meanwhile, growth in Japan was adversely impacted due to the after-effects from the tsunami and the nuclear incident in early 2011. The subsequent increase in growth in Japan due to the resumption of normal economic activity and the reconstruction of affected areas, while beneficial for the economy, is not likely to contribute significantly to growth in the rest of the region due to the diminishing importance of the economy as an export market.

The region's key export markets have been experiencing stalled growth due to concerns about sovereign debt levels

Figure 1. Real GDP growth of major developed economies, 2008-2011



Sources: ESCAP, based on national sources and data extracted from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 24 November 2011).

Notes: Data for 2011 are reported as annualized data up to third quarter.

Some reasons for the slowdown in developed economies are fundamental in nature and cloud their prospects in 2012

There are a number of time-specific reasons for the slowdown in the United States and euro zone — high oil prices in early 2011 and the impact on global supply chains of the disaster in Japan. However, additional reasons for the slowdown are more fundamental in nature and lead to concern in terms of the prospects for the economies in 2012. These concerns revolve around the fact that fiscal stimulus measures enacted at the onset of the crisis have been increasingly phased out. Furthermore, the overriding importance being given to reducing debt in these economies means that there is not likely to be significant additional fiscal stimulus in the future.

There are differing reasons for the limited ability of the United States and the euro zone to provide further significant stimulus, although the implications are similar. In the case of the United States, the cause is differences between the fundamental views of the parties in the legislature regarding the country's debt situation. These differences were manifested in the debate over the raising of the country's debt ceiling in August 2011. This debate, apart from its technicalities, was significant in serving to highlight the scant likelihood that there would be any further substantial fiscal stimulus in the United States. Nevertheless, the conditions eventually agreed upon in order to raise the debt ceiling, while relatively stringent, were not sufficient to satisfy many in the financial markets, as evidenced by the subsequent and unprecedented downgrading of the country's sovereign debt from AAA status by the rating agency Standard & Poor's. Apart from the belief that the amount of deficit reduction agreed over 10 years did not go far enough, the fundamental concern driving the downgrade was the realization of the depth of the political impasse, at least until the presidential elections of 2012. This impasse implied that further negotiations on the details of the deficit reduction agreement to be concluded at the end of the year were not likely to be resolved satisfactorily. There is the risk that the negotiations will fail to achieve the necessary mix of policies that would both promote growth recovery in the short term and sufficient debt reduction in the medium term. Such an agreement would require a credible debt-reduction plan which would tackle the major budgetary areas, which are non-discretionary items, but would allow for continued spending in the short term. Without such a combination of policies, there is a possibility that the mix of growth and debt reduction will not be sufficient to reduce debt to GDP ratios substantially in the medium term, resulting in louder calls for even more self-defeating austerity measures.

For most of the euro zone, further fiscal stimulus is even more unlikely, given the pressure from the financial markets to engage in austerity measures. Another source of pressure comes from attempting to avoid the excessive deficit procedure established by the European Commission to discipline countries with insufficiently prudent fiscal policies. Without stringent austerity measures, the financial markets are driving up borrowing costs to punitive levels for a number of euro zone economies that need to continue issuing debt. Apart from Greece, Ireland and Portugal, which have already entered into bailout programmes with the European Union and the International Monetary Fund (IMF), larger euro zone economies with debt concerns, such as Italy and Spain, are also under pressure from the financial markets.

The pressure has resulted in fast moving, almost daily, developments, as affected governments attempt progressively more drastic measures to reassure the markets. The "troika" of international organizations involved in lending to Greece in late

October 2011 agreed to an arrangement with the Government of Greece which involved a voluntary restructuring of its debt, resulting in an estimated 50 per cent write-down on the value of its loans, along with further austerity measures, as part of a deal which required the recapitalization of banks at risk and increased the resources of the European bailout fund to buy affected sovereign bonds. The inability of the Government of Greece to obtain the agreement of parliament for the austerity measures required as part of the deal resulted in the collapse of the Government and the appointment of an interim administration. The inability of the Government of Italy to persuade its parliament to undertake further austerity measures had the same result. Both new administrations have professed an intention to continue with similar austerity measures as the previous administrations in order to retain the confidence of their lenders. Relatively healthy economies in the euro zone are also increasingly seeing concerns from the markets; France, for example, has had to undertake austerity measures to convince the markets that it will not lose its AAA credit rating following the rating downgrade of the United States. Deliberations at the G-20 summit in Cannes, France, in November 2011 were dominated by the euro zone crisis, overshadowing other important concerns, although the political complexities of developing a united approach impeded any firm progress on the issue.

A significant concern for the euro zone is that further borrowing from the financial markets at acceptable rates may not be possible even with the austerity measures currently being demanded, as those measures will have such a negative impact on growth that debt as a proportion of GDP may fail to move sufficiently downwards. This is because GDP may not increase significantly due to slowing growth, and debt may not decrease as much as expected as tax revenues decline and social security payments increase in a climate of slow growth. In such a situation, different solutions may be required in order to continue issuing debt or to revive growth. One possibility is for the European Central Bank to purchase the sovereign debt of affected economies at rates lower than those being demanded by the market. This, however, is unpalatable to healthier euro zone economies because of the potential to create inflation, since the result of such a purchase would be a large-scale increase in the money supply of the euro zone. Another option, which would not have such an impact on the money supply, would be to require greater fiscal union between the member economies. This would, for instance, allow debt issuance at more moderate rates of interest by a central euro zone body, which would assume responsibility for spending decisions regarding the debt. However, this option is also unpalatable to the healthier economies in the euro zone, which do not wish to see their borrowing costs increase and do not wish to remove the pressure on affected countries to take appropriate corrective action.

Further borrowing for the euro zone may not be possible even with the austerity measures currently being demanded

At the other end of the spectrum is the option for any of the affected economies to return to a national currency, abandoning the euro completely. This may be a viable option for countries that choose to restructure their debts by a much larger degree than is possible with the voluntary agreement of lenders. An outcome of a switch back to a national currency would be that economies would be able to engage in currency devaluation to increase their export possibilities. Clearly, this would be a last option, given the decades of effort that have gone into the common currency project, and would quite possibly set off an unpredictable and unwelcome chain of events in the global financial markets at a time of continued economic crisis.

A key risk is the possible impact on major banks in Europe and other developed economies. There is the possibility that any defaults on euro zone sovereign debt held by the banks will result in the failure of some banks as well as general confusion regarding the health of major banks due to the complexity of interbank relationships in financial instruments related to sovereign debt. The result could therefore be a renewed global banking crisis characterized by a possible credit crunch and the need for government bailouts.

The main option to stimulate developed economies will be the further loosening of monetary policy

Given the difficulties in undertaking any further fiscal stimulus, the other main option open to policymakers, in both the United States and the euro zone, to stimulate their economies is the further loosening of monetary policy. In the United States, further reduction of interest rates is not possible given their near-zero levels. Therefore, unconventional methods of loosening monetary policy are required. The United States Federal Reserve, in August 2011, undertook one such measure by pledging to not raise interest rates until mid-2013. By doing so, the Reserve is attempting to keep long-term interest rates low by influencing expectations. This has been a significant measure, given that inflation concerns meant that the markets were not sure that interest rates would remain low for such an extended period. Another measure taken to influence long-term interest rates was the Reserve's announcement, in September 2011, of a programme to replace its short-term bond holdings with long-term ones in order to reduce long-term interest rates, which are more relevant for business investment decisions. Nevertheless, in spite of their innovative character, there is a risk that these measures may not be very effective in view of the already low interest rate levels. While there remains some room to further reduce interest rates in the euro zone, as was done in November 2011, that room is also rather limited due to their also fairly low levels, and because of the greater inflation focus of the European Central Bank given the diverse membership of the euro zone.

The most potent tool that remains in the armoury, due to the large scale in which it can be implemented, is another round of quantitative easing. However, the previous round of quantitative easing, often referred to as QE2, did not prove to be very effective. There is little reason to believe that further quantitative easing would be any more effective. As in the previous round, such easing would be expected to work through increased lending by the banking sector and by encouraging the public to borrow, thereby increasing consumption and investment. However, the banking sector already possesses a large amount of funds which it chooses not to lend to the public, as there exist less ostensibly risky investment vehicles, such as United States Treasury bills and emerging markets' assets, and, therefore providing further funds does not offer a significant fillip for domestic lending. For the public, on the other hand, quantitative easing is professed to increase wealth, and therefore consumption, by increasing domestic equity values. As bond prices fall through the easing programme, equities become more attractive. However, there was no substantial consumption effect during the most recent round of easing because domestic equity prices have not seen the full benefit of the programme, as investors have directed part of their attention to more attractive foreign assets, and any increase in wealth from equity price rises is being conserved by the public in the face of stagnant housing wealth and employment concerns in a labour market that is still fragile. Another way in which quantitative easing can act to support growth is by depreciating the dollar and therefore supporting the exports of the United States. However, this is also not likely to have substantial effects, as exports account

for a relatively small proportion of the economy. Despite concerns about its efficacy, the various marginal benefits of a new round of quantitative easing may make the option attractive as one of the few viable alternatives for creating some growth in the absence of fiscal policy measures.

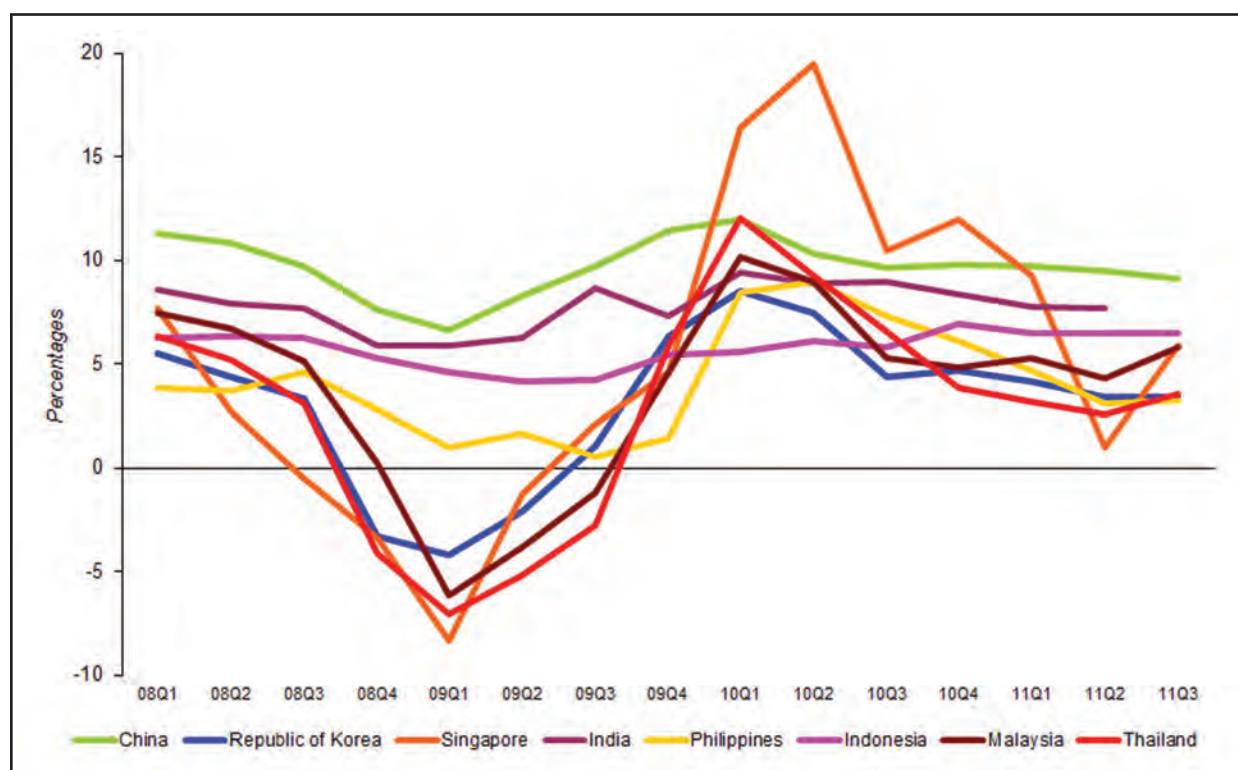
However, if loose monetary policies are pursued in developed economies, emerging Asia-Pacific economies, along with other developing economies around the world, will have to manage the resulting influx of foreign portfolio capital. Furthermore, the increase in global liquidity may be directed, in part, to the commodity markets in food and oil, thereby spurring inflationary pressure for the region through the import of these items. Another risk for the region would come from an increase in protectionist measures in the developed economies. During most economic downturns, there is typically a temptation to protect domestic industries by restricting competition from imports. This can lead to both measures to depreciate the currencies of developed economies and trade-related measures to support exports or restrict imports. As a consequence of the weakening exchange rates of some developed economies and continued pressure from short-term capital inflows, there is the possibility of a global currency war in which the region will be obliged to engage in significant exchange rate intervention, as well as measures such as capital controls, to maintain export competitiveness. This situation arises for economies which are seen as investment havens at a time of scant global investment opportunities. A number of such economies across the globe, for instance Switzerland and Japan, have already reacted with rarely used measures, such as declaring exchange rate bounds, and engaging in large-scale currency intervention. In August 2011, Japan intervened with nearly \$60 billion to prevent the yen from breaking the barrier of 76 to the dollar, and, in early September, Switzerland declared an upper bound to the exchange rate between the Swiss franc and the euro and intervened to avoid excessive appreciation of the franc.

Loose monetary policies pursued in the developed world will lead to the region having to manage the resulting influx of foreign portfolio capital

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

Despite the perilous state of the developed economies, the growth impact on Asia and the Pacific will depend very much on the individual circumstances of each economy. The initial signs of slowing growth in some economies of the region can be seen in their performance in recent quarters (see figure 2). There are two key aspects driving the degree of exposure of economies in the region. One is the extent to which the export sector is important as opposed to domestic demand. In this respect, the Asia-Pacific region possesses prominent examples of both sets of economies. While many economies in the region are notable for their export dependence, others are key players in driving global growth due to considerable domestic demand. The other aspect, which provides a widening avenue of opportunities, is the scope and depth of intraregional trade that can be channelled to the economies with large domestic demand and investment.

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



Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 30 November 2011).

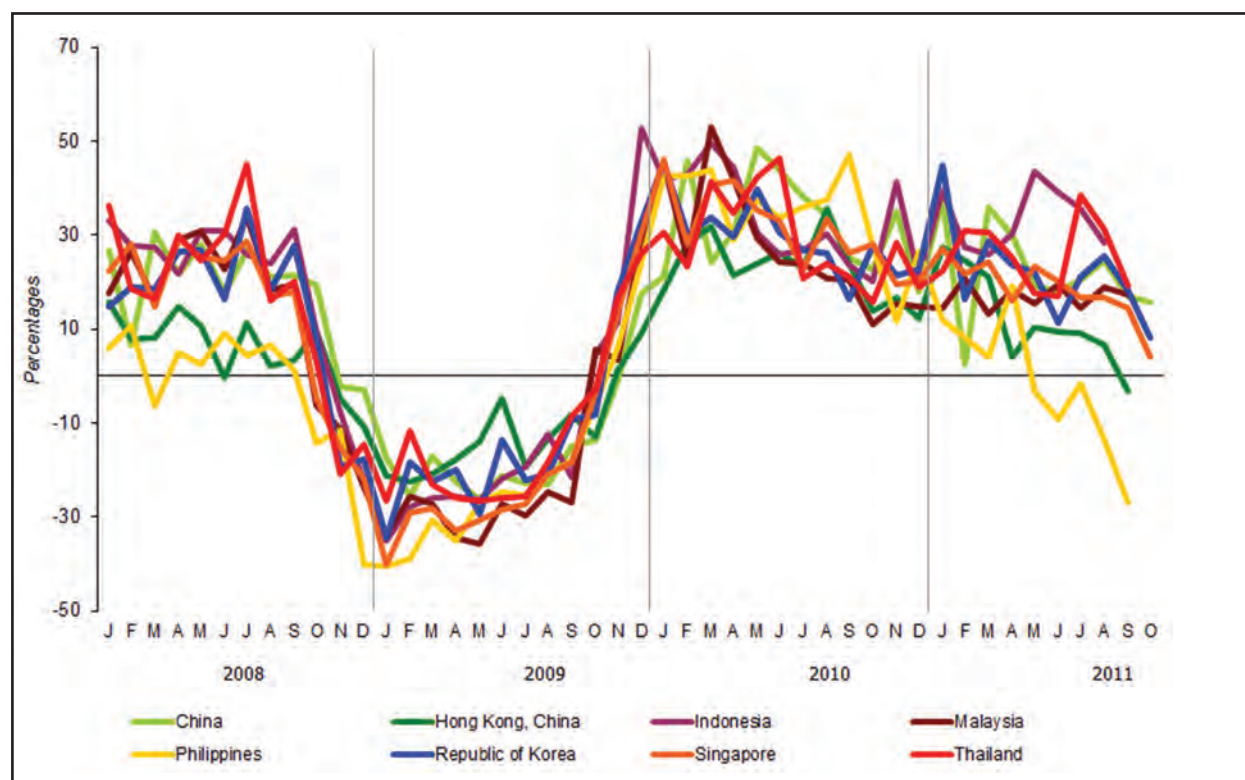
The economies which will face the greatest growth pressure are the manufacturing export-dependent economies of East and South-East Asia

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

On the other hand, the economies with the smallest impact on growth from the slowdown of developed economies are those with large and robust domestic sectors and limited reliance on exports as drivers of growth, the most prominent examples being India and Indonesia. Strong domestic demand in India and Indonesia are related to a high proportion of consumption in GDP. China is a special case in that, while exports are important to the economy and a significant proportion of investment is tied to the export sector, domestic demand and investment also play an important role and will provide some cushioning to growth. However, investment in China since the onset of the 2008 crisis has not always been based on fundamental

factors, having been supported in some cases by policies engendering strong credit growth. It is also somewhat the case that consumption in India and Indonesia has been supported by real interest rates which have been relatively accommodating and have therefore encouraged the public to redirect some of its income from savings to spending. China and India remain concerned with relatively high inflation rates by historical standards, and their ongoing moves to tighten monetary policy over the past year may constrain previously robust domestic demand to some degree. Indeed, recent growth performance in these large economies indicates the impact of policy tightening: GDP growth in India and China in the third quarter of 2011 was at 6.9 per cent and 9.1 per cent respectively —the lowest rate in two years for both countries.

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



Source: ESCAP, based on data extracted from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 24 November 2011)

A mitigating factor is the increasing importance of intraregional trade. Boosting such trade in tandem with domestic demand in the region is the most critical medium-term policy approach necessary in order to adjust to the shifting global balance of growth. However, the shift from extraregional to intraregional trade and demand will not be sufficient to make up for the slowdown in the markets of the developed economies in the short term. Thus, it may be necessary to temper expectations of larger support for the region's exports than in previous instances of a slowdown in demand from the traditional export markets. The slowdown in the overall manufacturing sector in many economies of the region, as seen from the declines in Purchasing Managers' Indices (PMIs) in recent months, is a clear indicator of the continued importance of the developed economies, as it coincides with the slowdown in the developed economies. Trade within the region is indeed growing faster than the region's trade

with the rest of the world. While exports from the Asia-Pacific region to the rest of the world roughly doubled between 2000 and 2009, intraregional exports rose almost 2.5 times.³ However, the importance of intraregional exports, when compared to total exports, has so far only increased marginally as a result of these trends. The share of intraregional exports in total Asia-Pacific exports increased from about 49 per cent in 2000 to about 52 per cent in 2009⁴ with a potential to be even higher. Furthermore, the proportion of intraregional exports which supply final demand in the region is substantially lower, as a significant portion of exports of the medium-income and high-income economies of the region are intermediates which are processed in another country and exported onward to the developed economies. China is the most prominent destination for intraregional intermediate inputs, with the country's large proportion of exports to developed economies providing a somewhat better picture of the true importance of developed economies to the economies in the region. If demand from developed economies were to slow down significantly and remain sluggish in 2012, the ripple effect across the regional supply chain might eventually be reflected in intraregional exports.

Intraregional demand will not be as supportive as it was at the start of the crisis due to less stimulus in large regional economies

A major reason why intraregional demand will not be as supportive for exporting economies as it was at the start of the crisis is the lower likelihood of significant stimulus in the major economies with large domestic demand. The two largest developing economies in the region, China and India, have been more concerned with controlling price increases than with maintaining growth, which remains at relatively robust levels. ESCAP analysis⁵ shows that strong growth in China was a key factor in the export recovery of the region after the onset of the crisis and before the subsequent uptick in demand from the developed economies. Demand from India was also a factor in supporting growth in the region. India is known as an economy with large and growing domestic consumption which maintains trade deficits with most of the region. In 2010, for example, the ASEAN economies had a trade surplus with India of \$13 billion, representing 17 per cent of the total trade surplus of ASEAN members, and China had a trade surplus with India of \$21 billion.⁶ Currently, the policy regimes in both China and India have moved from stimulus to monetary tightening in order to moderate the respective drivers of domestic demand in the economies through greater reliance on productive investment and private consumption demand. It is this two-track nature of growth in the region, with the domestic-demand oriented group dominated by inflation concerns and the export-oriented group dominated by growth concerns, which implies that intraregional demand may prove less supportive for growth in the short term than in previous years.

Nevertheless, it is clear that the widely diverging growth performance of the large developing economies of the region and the developed economies of the world means that intraregional demand will become increasingly important to the exporting economies of the Asia-Pacific region. China has become the most important export market for a number of economies in the region because, since the crisis, robust growth in exports to China has outpaced exports to the sluggish developed economies. However, it is unclear whether economies will benefit in the same fashion from growing intraregional demand, as was the case when robust developed economies outside the region supported demand in the past. China, which remains the largest domestic market in the region at present, is gradually moving towards a more domestic-demand-led economy. However,

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

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

⁵ *Ibid.*, Chap. 1, p. 11.

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

the most important sector of the domestic economy is the investment sector. The import demands of this sector are centred around natural resources. Therefore, the benefiting economies in the region would tend to be commodity exporters. On the other hand, manufacturing exporters would need to rely on the further growth of consumption in China. Furthermore, studies have indicated that the import content of consumption goods in China is quite low compared with that of advanced countries.⁷ This implies that a consumption boom in China may have a limited impact on export growth in the region. To become a sustainable trade leader in the region, China will need to raise not only domestic consumption, but also the intraregional import content of its domestic consumption.⁸ Other large economies in the region, such as India and Indonesia, offer a more consumption-led economy for exporters of manufactured goods. However, the income level of Indonesia and India are currently lower than that of China.

Continuing inflationary pressure from abroad

The rising pace of inflation during the earlier part of 2011 has been moderated by monetary policy tightening across much of the region, as well as by decreases in some global commodity prices. While much of the pressure for price increases was supply-led and came from abroad due to high global food and oil prices, strong growth in economies due to robust exports and strong domestic demand also contributed to demand-led inflation. The importance of these drivers of inflation differs in degree across the region. Domestic-demand-led economies are more concerned about demand-side inflation, whereas exporting economies are influenced more by imported inflation. For such exporting economies, with demand-led pressure receding due to the less supportive global environment for exports in recent months, the main inflationary spur is now concentrated on the outlook for global food and oil prices. It is not certain if lower global growth will necessarily result in significant reductions in such prices as there are a number of countervailing price drivers at work. For domestic demand-led economies, managing the domestic drivers of inflation will continue to be a policy issue. In some of these economies, growth has also been slowing down due to the strong monetary policy measures taken to bring prices under check. Managing the different drivers of inflation across the region will be a challenge for policymakers as the economies in the region are currently experiencing a period of imperilled growth performance.

Growth has been slowing in domestic-demand led economies due to the strong monetary policy measures taken to bring prices under check

During 2010, inflation emerged as a pressing concern across much of the region (see figure 4), though the increase in prices was driven by different factors for particular groups of economies. In the more globalized exporting economies of South-East and East Asia, price rises were spurred by high global food and oil prices (see figure 5) along with capital inflows into the relatively open financial markets. High global food and oil prices were supported by a combination of concerns regarding political upheaval in oil-producing economies in the Middle East, weather-related supply disruptions in key food-producing countries, the redirection of food crops to produce biofuels, and speculation on commodity financial markets in a climate where many market participants expected global growth and commodity demand to remain relatively robust. Price rises were also supported by strong capital inflows into many of these economies as a result of high global liquidity, interest rate differentials with the developed economies, and relatively healthy growth prospects. These

⁷ Yilmaz Akyüz, "Export dependence and sustainability of growth in China", *China & World Economy*, vol. 19, No. 1, pp. 1-23 (Institute of World Economics and Politics, Chinese Academy of Social Sciences, 2011).

⁸ See *Asia-Pacific Trade and Investment Report 2011* (United Nations publication, Sales No. E.11.II.F.8.), Chap 1, p 12.

capital inflows contributed to substantial rises in asset markets, such as equities and property. High inflationary pressures especially high food and fuel prices have significant poverty impacts rolling back the hard-won development gains of many years. ESCAP estimated that rising prices of food and fuel could lead to 42 million additional people in poverty in 2011, joining the 19 million already affected in 2010.⁹

In economies where domestic demand plays a major role, price rises due to global food and oil prices were supplemented by demand-side forces. Some economies in South Asia, such as India, were especially affected by consumption-demand-led price increases. China and Viet Nam, on the other hand, were particularly impacted by investment-demand-led price increases, with prices increasing beyond the target level of policymakers as investment was spurred by strong credit growth.

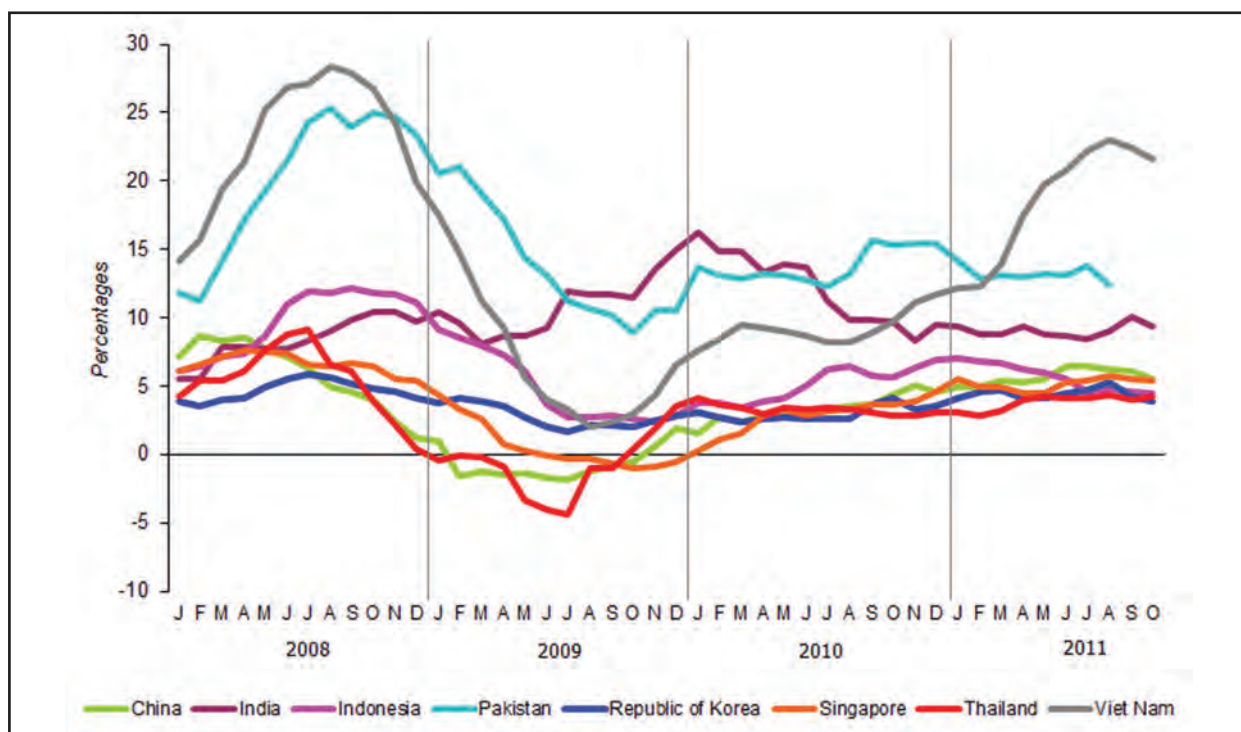
As growth prospects for exporting economies move downwards, the trade-off with inflation has assumed increasing importance

Economies across the region reacted to rising prices by enacting monetary policy tightening over successive steps since 2010 (see figure 6). As growth prospects for exporting economies have moved downwards in line with the global environment, the trade-off with growth has assumed increasing importance. The impact of monetary tightening in past months, coupled with lower commodity prices, has also led to some stabilization in inflation rates across some economies in the region (see figure 4). China, for instance, witnessed a reduction in inflation for three consecutive months as of October 2011. In India, inflation has continued to remain high despite the Reserve Bank of India increasing the policy rates 13 times over the past 19 months, while the tight monetary policy has affected the country's growth momentum. Concerns regarding growth prospects, as well as the somewhat more positive inflationary forecast, have in recent months led some economies to hold off on further monetary policy tightening (see figure 6). Indonesia decreased its interest rate in October 2011 and Indonesia and Thailand decreased in November 2011, with other countries signalling possible moves in the near future.

In contrast, economies where growth is significantly due to domestic factors have continued to use monetary policy to dampen demand-side price pressures. Monetary policy and other controls on lending have been tightened throughout 2011 in a number of South Asian economies and China. The downward impact of such measures on growth in these economies has been accepted as necessary in order to manage the threat of insufficient capacity in the economy and to manage robust growth without the build-up of excessive price pressures. Nevertheless, the situation in China is somewhat unique in that both exports and investment exert impact on growth through various channels. Measures to dampen demand-side inflation due to excessive investment at a time of slowing exports would introduce an additional source of pressure on growth in the economy, raising concerns of a "hard landing" for the economy.

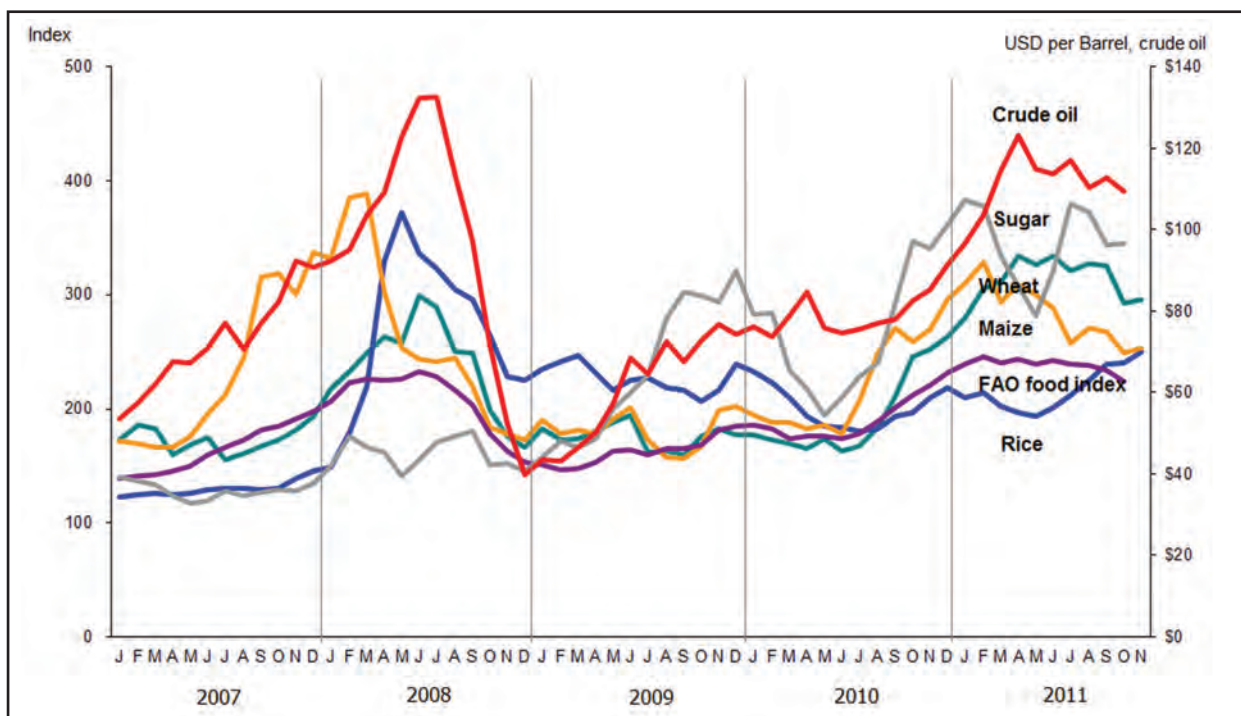
The outlook for inflation in coming months has become less certain due to a number of countervailing forces pressing on the region. Normally, slowing global growth would be expected to reduce demand for commodities and therefore substantially lower food and, especially, oil prices. However, these prices are dependent on a number of factors other than global demand. On the supply side, there are ever-present risks of supply disruptions given weather conditions and continuing instability in the Middle East. On the demand side, the interaction of food and oil through biofuels and high global liquidity spurring speculation in commodity markets may continue

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



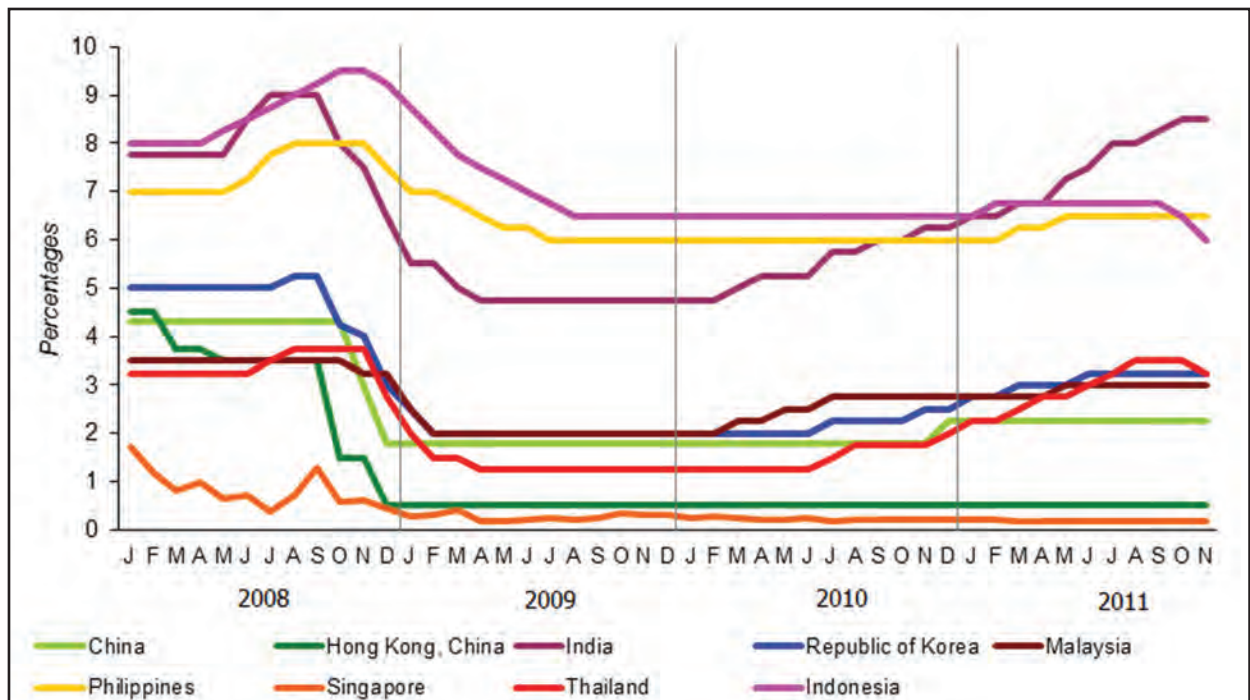
Source: ESCAP, based on data extracted from CEIC Data Company Limited (as of 30 November 2011).

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



Sources: Food and Agriculture Organization, <http://www.fao.org/es/esc/prices/PricesServlet.jsp?lang=en>; United States Energy Information Administration, http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm; and IMF Primary Commodities Price, <http://www.imf.org/external/np/res/commmod/index.aspx> (accessed 24 November 2011).

Figure 6. Policy rates in major Asian developing economies, 2008-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 25 November 2011).

Notes: The policy rates for each country include the rediscount rate for China; the discount window base rate for Hong Kong, China; the Reserve Bank of India repo rate for India; Bank of Korea base rate for the Republic of Korea; the overnight policy rate for Malaysia; the repurchase rate for the Philippines; the overnight repo rate for Singapore and the 1-day bilateral repurchase rate for Thailand.

to exert upward pressure on prices. There is concern that measures which may be adopted by the developed economies to support growth through maintaining accommodative monetary policies, and possibly engaging in a further round of quantitative easing, would introduce considerable new liquidity into global financial markets. While speculation is on the basis of beliefs about real supply and demand, there may always emerge lines of argument that logically indicate real causes for increases in oil and food prices, even at a time of slow global growth.

Speculation in commodity markets exaggerates the price volatility that stems from supply and demand factors

The main concern about speculation in commodity markets is that any price volatility due to real supply and demand factors would be exaggerated by the addition of speculative money. Furthermore, at a time of slow global growth and concerns about safe assets, commodities may be viewed as a reasonably dependable investment class. This is because they are real goods the supply of which is finite and the demand for which is intrinsic and increasing in the long term due to increasing wealth in developing economies. Such financial investment in commodity markets would present the problem that the prices of these key commodities would be rising, remaining stable or at least not falling significantly at a time of slowing growth. For non-commodity-producing economies in the region, the implication of such a scenario would be the dilemma of attempting to support growth at a time when price pressures through the commodities channel have not completely abated.

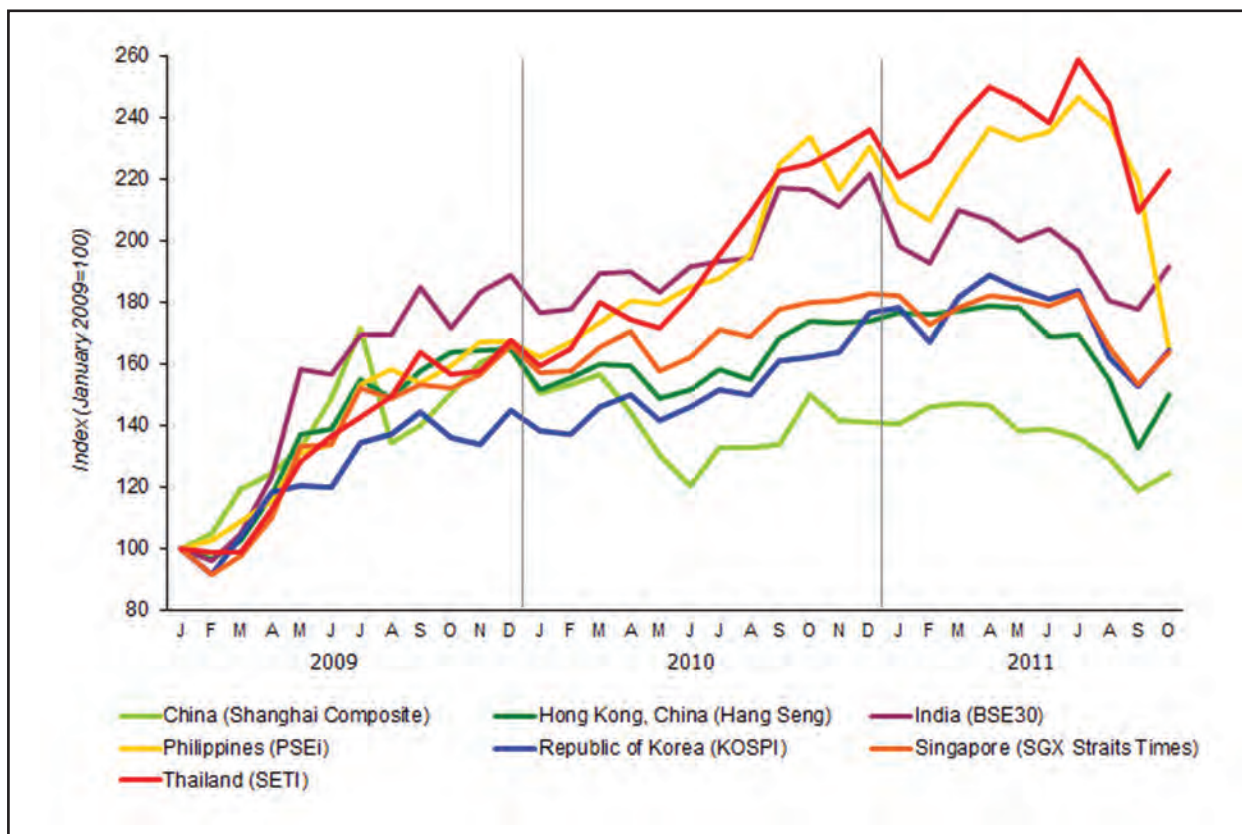
Increased volatility in financial markets

The financial markets in the region are faced with a period of considerable volatility as investors attempt to insulate themselves against a perceived increase in the risks facing both the global and the Asia-Pacific economies. Asset prices and exchange rates in the region are likely to face both periods of capital outflows and inflows in response to global liquidity and financial conditions as well as major news events. Policymakers will have to be prepared for periodic bouts of volatility which will complicate their macroeconomic planning.

Policymakers will have to be prepared for bouts of financial market volatility which will complicate their macroeconomic planning

The Asia-Pacific region has recently experienced periods of substantial capital outflows as investors have realized that slowing growth in the global economy will inevitably affect the export-led growth model of many economies in the region. Consequently, growth projections for enterprises have been scaled downwards, thereby having a negative impact on equity markets (see figure 7). Furthermore, the reduced likelihood of monetary policy tightening in an environment of constrained growth has lowered former assumptions of interest rate levels, thereby affecting bond markets. At a more general level, at times of perceived global economic uncertainty, the region is also affected by the standard reaction of a “flight to safety” —a retreat to assets that are perceived to be safe. Thus, despite the sovereign debt concerns in the United States and the loss of its Standard & Poor’s AAA rating, investors have retreated once again to United States Treasury bills in large numbers. These capital outflows have led, in recent months, to marked regional depreciations in exchange rates against major currencies (see figure 8).

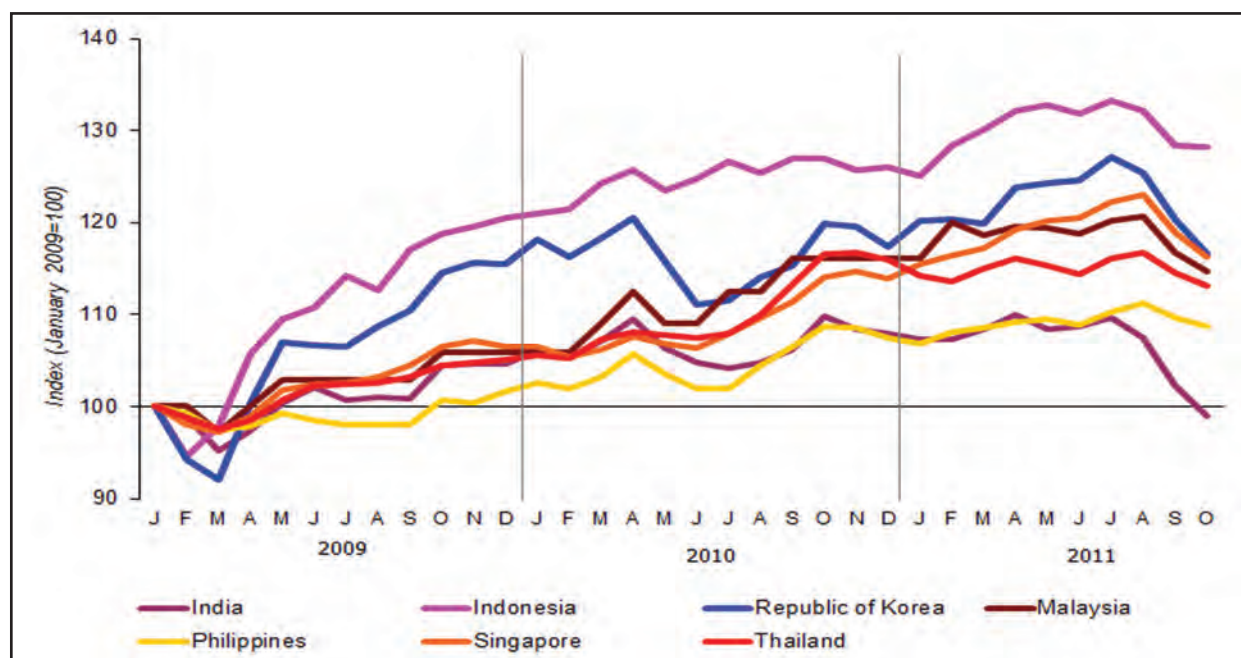
Figure 7. Equity market performance in major Asian developing economies, 2009-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 24 November 2011).

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

Figure 8. Exchange rate movements in selected developing economies against the United States dollar, 2009-2011



Source: ESCAP calculations based on data from CEIC Data Company Limited, available from <http://ceicdata.com/> (accessed 24 November 2011).

Note: A positive trend represents appreciation and vice versa.

Fundamental factors will result in periods of continued capital inflows to the region

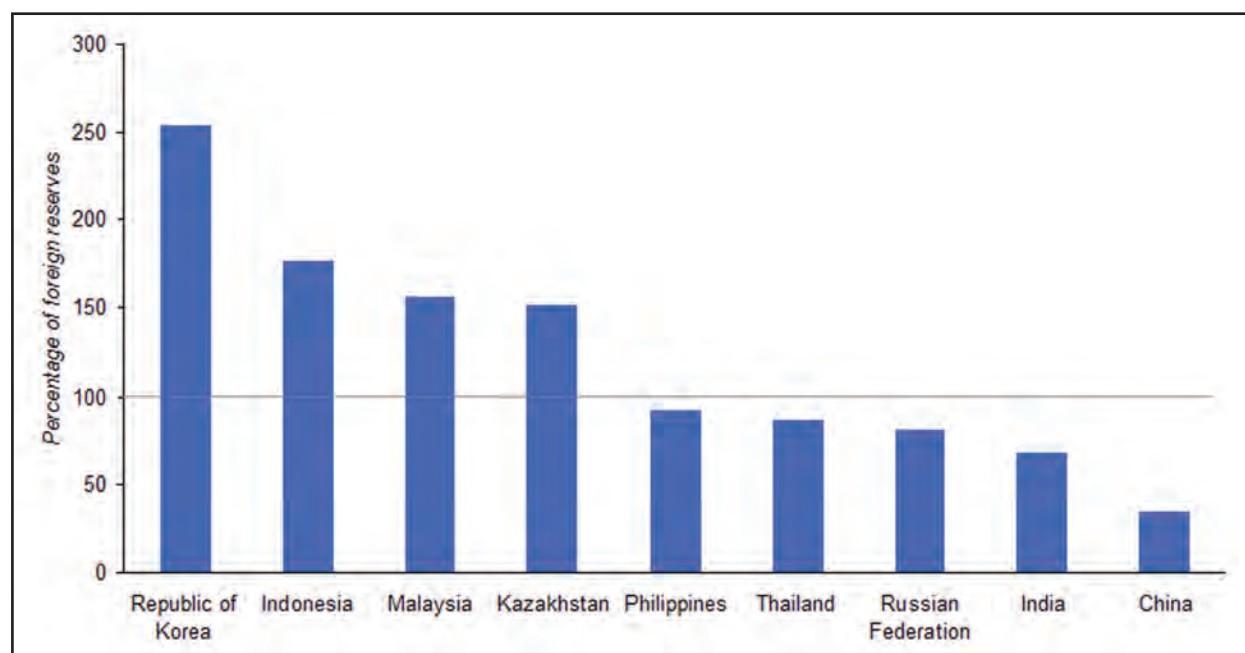
There are reasons, however, to believe that fundamental factors will result in periods of continued financial inflows to the region. Despite the growth slowdown in the region, economies continue to experience far more robust growth than the developed economies, therefore supporting the performance of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

In an environment of both negative and positive factors influencing capital flows to the region, economies should be prepared for volatility in such flows. There is, therefore, the risk that macroeconomic stability will be impacted through substantial movements in exchange rates and asset values. Exchange rate movements would affect inflation, export performance, and domestic financial sector stability, while asset value changes create the risk of a further build-up of asset price bubbles and an eventual bursting of such bubbles.

Economies in the region have traditionally managed the risk of exchange rate volatility by building up foreign exchange reserves, although it is not clear that this approach provides sufficient protection. Economies have accumulated reserves both to protect currencies in case of sudden capital outflow, and as a by-product of management of exchange rates to maintain export competitiveness. The ESCAP foreign reserves vulnerability index, however, indicates that, in a number of cases, it is not evident that reserves are adequate to protect exchange rates, and thus macroeconomic stability, in the case of substantial capital outflows (see figure 9). If the worst-case global scenario results in a renewed banking crisis sparked, for instance, by sovereign debt defaults and bank collapses in the euro zone, then a number of economies in the region could be at significant risk of exchange rate pressure. The mechanism may be a flight to safe assets by investors, triggering a sudden exit of short-term capital flows. The economies which would be at most risk would be those who have deep, highly open and relatively sophisticated financial markets that have seen substantial inflows over the past few years, and where there is the possibility that reserves do not fully take into account the scale of possible capital outflows. As at the outset of the crisis in 2008, countries are acknowledging such risks by arranging for other sources of foreign exchange support. In 2008, the Republic of Korea entered into a precautionary arrangement with the United States Federal Reserve and, in October 2011, increased the amount of its currency swap arrangement with Japan from \$13 billion to \$70 billion.

In the worst-case global scenario a number of economies in the region could be at significant risk of exchange rate pressure

Figure 9. Vulnerability yardstick as a percentage of foreign reserves in selected developing economies, latest data available



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

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

Even if reserves are adequate, the use of such reserves does not assist in dealing with the issue of asset price declines in the case of outflows. However, in the case of capital inflows, the use of reserves does not prevent an undesired excessive increase in domestic asset values. Interest rate rises, a common tool for dealing with the inflationary consequences of capital inflows, are self-defeating to some degree as they inevitably attract more capital. If capital inflows to the region are expected to be a long-term trend, then the continued use of foreign exchange reserves as the primary tool for managing the consequences presents a host of difficulties. Other than the efficacy of using reserves, an ever-present and increasingly important issue is the cost of holding them. Declines in the value of the United States dollar and the euro have reduced the value of holdings in local currencies substantially, and these currencies may well depreciate further in the medium term. An additional cost is the interest rate differential between holding European or United States bonds at close to zero interest rates, as compared to the comparatively high domestic interest rates which have to be paid to mop up the inflation created by the injection of local currency.

Economies in the region have increasingly turned to capital controls to deal with volatile inflows

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

Outlook for 2012

The key downward pressure on growth performance for economies in the region in 2012 will come from continued sluggishness in the growth recovery of the developed economies, with aggregate growth for developing ESCAP economies slowing from an expected 7.2 per cent in 2011 to a forecast 6.6 per cent in 2012. This pressure will be greatest on the export-dependent economies of the region. This will not necessarily imply drastic reductions in growth performance, as many governments will be able to call on significant fiscal and monetary policy flexibility due to strong macroeconomic fundamentals. Growth in the region is consequently forecast to remain, by far, the highest among the regions of the world, as it was in 2011 (see figure 10).

While the environment for exports will not be as great a concern for domestic-demand-led economies, the impact from the global situation will come in terms of possible reductions and instability in financial flows which impact growth performance. However, a number of domestic-demand-led economies also have internal pressures on growth deriving from uncomfortably high levels of inflation leading to a restrictive monetary policy stance.