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ASIAN DEVELOPMENT

Outlook 2012 Update

HIGHLIGHTS

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ADO 2012 Update—Highlights

Dimming global growth prospects and soft domestic demand in the region's two largest economies are slowing the pace of developing Asia's expansion. Growth is now expected to slide from 7.2% in 2011 to 6.1% in 2012, with a bounce back to 6.7% in 2013.

The possibility of a shock emanating from the unresolved euro area sovereign debt crisis or a sharp fiscal contraction in the United States pose the biggest downside risks to the economy. Fortunately, most developing Asian economies have room to counteract such shocks with fiscal and monetary policy. However, there is currently no regionwide need for countercyclical policy intervention.

In the medium term, continued weakness in external demand and moderated growth in the People's Republic of China and India mean economies in the region must diversify their growth drivers. Service sector development is poised to play a critical role in the region's future growth.

Key messages

- Developing Asia's growth is slowing more than anticipated in the *Asian Development Outlook 2012* (*ADO 2012*). The region is projected to expand by 6.1% in 2012 and by 6.7% in 2013, down significantly from 7.2% in 2011. Deceleration in the region's two giants—the People's Republic of China (PRC) and India—and in other major exporting economies is tempering earlier optimism.

- The PRC is forecast to grow by 7.7% this year and by 8.1% in 2013, considerably more slowly than the robust 9.3% growth of 2011. While weak external demand is dragging down the PRC and the export-oriented East Asian economies, internal factors are contributing too. Slowing investment and stagnating consumption are holding back gross domestic product (GDP) expansion in the PRC, with knock-on effects for East Asia's outlook through diminished demand for intraregional exports.

- India will not accelerate this year from the 6.5% recorded in 2011 but, rather, see GDP growth slow to 5.6% in 2012 and bounce back to 6.7% in 2013. Tepid consumption has been insufficient to make up for declining investment and export demand. A large fiscal deficit and persistently high inflation have limited the scope for fiscal and monetary policy to stimulate the economy.

- Weakening growth momentum will temper price pressures, pushing inflation in the region down from 5.9% in 2011 to 4.2% in both 2012 and 2013. International food and fuel prices were quite volatile in the first half of 2012. The surge in food and oil prices in the second half of 2012 is a concern, raising the specter of the 2008 price spikes.

- The ongoing sovereign debt crisis in the euro area and the looming fiscal cliff in the United States (US) pose major risks to the outlook despite the stabilizing effect of announcements by monetary authorities in Europe and the US.

- Regional capital markets have not shown excessive volatility, but recent experience shows that drops in global investor confidence can trigger rapid reversals in capital flows. Improving macroprudential policies should have priority on the reform agenda.

- Developing Asia has no widespread, urgent need at the moment for countercyclical policy intervention. Most Asian countries, except those with deepening deficits or persistently high inflation, can mobilize monetary and fiscal policies should a major shock materialize.

- Protracted weakness in major industrial economies bodes ill for a myopic focus on exports. As growth in maturing economies slows, countries will have to rely more on enhancing productivity and efficiency to secure future prosperity. Service sector development can play a critical part in this process.

- Developing Asia's large and expanding service sector already contributes significantly to the region's growth. That role will broaden further as economies that graduated from agriculture to industry evolve further into service economies.

- The service sector still fixates, however, on traditional services with low productivity. A key challenge is to raise service sector dynamism by moving toward high-value modern services, such as information and communication technology, finance, and professional business services.

- A vibrant service sector would have broad economic benefits. Synergies between services and industry could improve overall productivity. The service sector tends to be more effective in job creation, in particular for women, thus supporting inclusive growth. Modern services meet domestic demand for high-end services and, because they are increasingly tradable, provide new export opportunities.

- Lack of human capital and inadequate infrastructure are major bottlenecks for developing the modern service sector. But above all, restrictive government regulations that stifle competition and innovation must yield to policies that promote services:
  - Ramp up investment in services-relevant infrastructure that has broad spillover effects, such as information and communication technology and broadband services.
  - Ease the shortage of highly skilled workers through education reform, in particular reforming tertiary education for business services.
  - Relieve the regulatory burden on new players by exerting strong political commitment to reduce excessive restrictions and strengthen competition law, toward creating more competitive service markets, which hold the key to productivity growth.

Dimming global growth prospects

Developing Asia's outlook

- **Asia's growth is cooling more rapidly than forecast in April in the *ADO 2012*.** Growth in developing Asia's GDP will slow from 7.2% in 2011 to 6.1% in 2012 before picking up somewhat to 6.7% in 2013.
  - » The *Update* forecasts for GDP growth revise down *ADO 2012* estimates by 0.8 percentage points in 2012 (from 6.9%) and by 0.6 percentage points in 2013 (from 7.3%) because of pressure from the weak external environment.
  - » Economic activity in the major industrial economies remains weak. The US economy has failed to build strong growth momentum, and the euro area is continuing to contract mildly. Japan began 2012 well, but its growth prospects are nevertheless subdued for the rest of the year by sluggishness in the US and the euro area.
- **The slowdown is manifest in the region's two giants.** Growth this year in the PRC is forecast to decelerate to 7.7% from 9.3% in 2011, and in India to 5.6% from 6.5% last year. External and internal factors combined to weaken their growth prospects.
  - » Export growth in these two economies declined significantly. In the PRC, it decelerated to 9.2% in the first half of 2012 from 24.0% in the same period of last year, while in India exports contracted by 6.7% in the first 5 months of fiscal year 2012. The lagged impact of monetary tightening, the normalization of fiscal policy in both economies, and delayed reforms in India have contributed to falling investment and consumption, particularly in real estate and infrastructure.
  - » Projections were also downgraded in the other export-oriented economies in East Asia as they have had to contend with weak demand from the major industrial economies and the PRC.
  - » However, growth in the other subregions is forecast to remain resilient this year. In fact, average growth in developing Asia excluding East Asia and India is projected to increase to 5.2% in 2012 from 4.9% in 2011.
- **Sluggish growth prospects are keeping price pressures in check**. Average inflation in developing Asia is expected to moderate to 4.2% in both 2012 and 2013, improving on the 5.9% recorded last year. International food and fuel prices were quite volatile in the first half of 2012. The surge in food and oil prices in the second half of 2012 is a concern.

- **The weakening momentum of growth in the PRC and India will exacerbate the growth outlook for the rest of Asia.** The rising importance of the two Asian giants is evident in the greater influence their economies have on regional and international business cycles. Because import demand from the PRC and India amount to significant shares of global trade, spillovers from them into Southeast Asian countries and the major industrial economies are significant. External forces play a large role in the PRC's slowdown, explaining about two-thirds of it, while internal factors are dominant in India's.

Risks to the outlook

- **The unresolved euro crisis and the threatened US fiscal cliff pose the biggest downside risks to the outlook.** Intensified financial market stress in Europe may deepen the recession, with disastrous spillovers to the rest of the world. Further, failure in the US to extend important fiscal policy measures into 2013 would further erode private demand.
  - The most open economies in developing Asia are particularly vulnerable. Spillover analyses suggest that a negative shock from industrialized countries would have substantial impact on the region's growth. The adverse effects of the US fiscal cliff could have a larger impact on Asia than bad news of the same magnitude from Europe.
  - Recent supportive announcements from the European Central Bank and the US Federal Reserve diminish—but do not eliminate—the potential of these risks to undermine the global outlook.

- **The possibility of sudden capital flow reversals is a continuing concern.** While the region's financial markets have been relatively resilient, the deleveraging of large banks in advanced economies could, together with heightened global uncertainty, cause investor confidence to ebb and sharply reverse capital inflows to developing Asia, as happened in 2008 and 2010.

Policy response in the face of uncertain prospects

- **Developing Asia currently has no urgent regionwide need to pursue countercyclical macroeconomic policies**. The output gap in many regional economies is not large. Core inflation shows signs of moderating as domestic demand eases.

- **Most economies in the region have ample room to use monetary and fiscal policy tools if needed.** Nevertheless, future countercyclical policy must support inclusive growth while ensuring long-term sustainability. Some countries with large structural fiscal deficits or high and persistent inflation need to implement fiscal consolidation and prioritize the imposition of macroprudential policies to regain market confidence.

- **Weakness in major industrial countries and decelerating growth in the region's two giants point to a less-favorable future growth environment.** Economies in the region must adapt by speeding up the rebalancing process, improving productivity, and enhancing efficiency. Developing a vibrant service sector in the region can supplement growth.

Outlook by subregion

- **Developing Asia's growth is slowing on account of weaker growth in the region's two giants and in the other highly open East Asian economies.** Other developing Asian economies, however, appear to be resilient.

- **East Asia is still the fastest-growing subregion, but its deceleration is manifest.** Weak external demand from major industrialized economies is having a severe impact on East Asia's exports. The subregion's growth prospect is dimming—now forecast at 6.5% in 2012 (lower than the 6.8% of 2009 after the Lehman shock) and at 7.1% in 2013. In the PRC, domestic factors such as the pullback in real estate investment and the reduced pace of infrastructure development have reinforced the growth slowdown. The rest of East Asia has to contend with the twin blows arising from the weak global environment and the PRC's growth deceleration, and will also see slower growth. Inflation pressures will be contained as a result and are expected to moderate at 3.1% and 3.3% in the next 2 years.

- **South Asia will slow sharply while still combating inflation.** Downward revision for India slows the forecast for South Asia's growth from 6.6% to 5.5% in 2012 and from 7.1% to 6.4% in 2013. India's domestic economy is weakening as investment continues to be subdued, consumer confidence wanes, and deficient monsoon rains weigh in. The outlook for most other South Asian economies appears to be generally stable. Inflation continues to be the big concern for the subregion, limiting latitude for easing monetary policy to stimulate demand and counter the slowdown in economic growth. All in all, South Asia's inflation is forecast to average 8.6% in 2012 before calming to 7.4% in 2013.

- **Southeast Asia maintains resilience as inflation pressure abates.** Growth in Southeast Asia is expected to quicken to just over 5% in 2012. This partly reflects recovery in Thailand from severe flooding in 2011. Higher government spending has contributed to Malaysia and the Philippines achieving stronger growth than forecast in April. Investment and private consumption generally are buoyant in this subregion. However, exports have been eroded by the weak global environment, so GDP growth forecasts for this year and next are pared for Indonesia, Singapore, Thailand, and Viet Nam. Viet Nam's finance sector is under worsening stress from the slowdown in economic activity, falling asset prices, and the high ratio of nonperforming loans. In 2013, growth in Southeast Asia as a whole is seen edging up to 5.5% (though this forecast is trimmed from the *ADO 2012*). Inflationary pressures have abated such that the projection for 2012 is revised down to 3.9% and for 2013 to 4.0%.

- **Central Asia is softening as the oil price stabilizes and the external environment moderates.** Economic activity during the first half of 2012 fell short of the April forecast. The subregion's growth is forecast to decelerate to 5.7% in 2012, revised down from the 6.1% forecast in April, before edging up to 6.0% in 2013. The economy of the Kyrgyz Republic in particular is expected to stagnate this year because of slower gold production, before recovering in 2013. Growth prospects in Azerbaijan and Kazakhstan are likewise marked down because of weaker growth in the subregion's main trading partners, particularly the euro area and the PRC, as well as lower oil prices. The *Update* lowers the inflation projections of the *ADO 2012* for Central Asia from 7.2% to 6.4% in 2012 and from 7.3% to 6.7% in 2013.

- **Resource-rich Pacific economies continue to insulate this subregion from external headwinds.** GDP for the Pacific is still expected to expand by 6.0% this year, driven by Papua New Guinea, Solomon Islands, and Timor-Leste, where growth forecasts are unchanged as they push ahead with the development of infrastructure and resource projects. Growth prospects for Fiji have improved from April, but forecasts for some smaller economies are lowered. In 2013, aggregate growth is expected to moderate to 4.2%, mainly a result of major projects reaching completion. The forecast for inflation in the Pacific is trimmed to 6.3% this year and kept at 5.4% in 2013.

Special theme: Services and Asia's future growth

Rising importance of services in Asia

- **Services play a critical role in developing Asia's growth.** The sector is already large, accounting for almost half of the region's GDP in 2010. Services contribute substantially to economic growth across Asia, providing 66% of India's growth from 2000 to 2010 and 43% of growth in the manufacturing-oriented PRC in the same period.

- **Structural changes in the region's economies will further expand the role of services.** Developing Asia is following the same path travelled in the past by the advanced economies, with agriculture's dominance giving way to industry, and then industry being supplanted by services. Rising incomes and rapid urbanization are boosting demand for services domestically. As manufacturing sees wages rise and labor intensity fall, Asia will look even more to services to create jobs for the millions who join the workforce every year.

- **A vibrant service sector has broad benefits for the economy.** Four key factors highlight the urgent need to foster the development of the service sector:
  - » **Positive spillovers to other sectors.** Vibrant business services, such as information and communication technology (ICT), industrial design, and marketing, may facilitate investment and the development of new products. The cross-benefits work both ways, as a dynamic industry sector creates demand for more business services. This synergy between services and industry can raise the productivity of the economy as a whole.
  - » **Support for greater inclusiveness.** Job creation is central to inclusive growth, and services tend to be labor-intensive. The sector's share of total employment in the region is large—employing 34% of all workers in 2009—and growing. Empirical evidence suggests that service sector growth helps reduce poverty. More directly, services such as health care and education enable individuals to be more productive and enhance their quality of life.
  - » **Diversified production for stability.** The extended slowdown in the major industrial countries is weighing heavily on merchandise exports from the region. Developing the service sector can diversify the production base, which will enhance the resilience of the economy and boost its growth momentum.

» **New opportunities for foreign trade.** Technological progress has enabled the rise of cross-border trade in services. For example, the advent of ICT has catalyzed the global exchange of outsourced business processes. India and the Philippines have established themselves as world leaders in the export of such services. Asia accounts for a large share of this trade already, but greater openness can support a more competitive and productive service sector.

Trapped in traditional services

- **Labor productivity in developing Asia's service sector lags far behind that of advanced economies.** For most economies in the region, labor productivity is less than 20% of the figure in advanced economies. It languishes at around 10% in the PRC and India. In the worst cases, it may take up to 30 years to reach 20%.

- **Low productivity partly reflects the dominant role of traditional service industries.** These services—such as wholesale and retail trade, real estate, transport, personal services, and public administration—still account for the bulk of the sector's output. In contrast, modern services such as ICT, finance, and professional business services occupy less than 10% of Asia's service economy, well below the 20%–25% in advanced economies.

- **Enabling the shift to modern services and modernizing traditional services are essential to close the productivity gap with advanced economies.** Modern services enjoy higher productivity, have greater potential for synergies with other sectors, and are more amenable to cross-border trade. They also strengthen the link between services and inclusive growth by generating high-quality, high-wage jobs. Traditional services too can reap considerable productivity gains by updating their practices using modern tools.

- **Regulatory, infrastructure, and human capital bottlenecks are holding back service sector productivity.** Infrastructure for services, such as ICT, still lags advanced economies. The highly skilled workers that are required for modern services, such as scientists and bankers, are in short supply. And above all, excessive regulation that protects incumbent firms and other vested interests keeps markets less competitive and thus undercuts prospects for improved productivity and efficiency.

Policy priorities for competitive services

- **Regulatory reform is needed to foster a more competitive service sector.** The burden of heavy regulation is the single tightest bottleneck constraining the sector. A slew of regulations and restrictions currently protect incumbent firms, stifling competition and innovation in services. In India, for instance, a staggering 13 official bodies regulate higher education. Trade barriers in the PRC, the Philippines, Thailand, and others are higher than those in countries with similar incomes. International experience shows that regulatory reform can catalyze competition and deliver significant economic benefits. It must be a top priority for policy makers.

- **Investment in infrastructure for services needs to be ramped up**. ICT infrastructure, for example, has large positive spillover effects for the whole economy. Examples of the benefits of such investments are the world-class Indian and Philippine service industries in ICT and outsourced business processes. While Asia has invested in ICT infrastructure at a furious pace, it still lags advanced economies.

- **Education reform is vital to easing the shortage of highly skilled workers.** While education attainment has risen rapidly in Asia overall, the region still suffers acute shortages of some skills. Modern high-productivity services require highly skilled workers. The shortage is especially evident in professional groups: accountants, business managers, engineers, lawyers, medical doctors, scientists, and software specialists.

- **The region must improve its collection and publication of service sector data.** The lack of high-quality and timely data on services limits understanding of the sector, which constrains the ability of Asia's policy makers to formulate and implement appropriate policies. To foster evidence-based policy analysis, the strengthening of service sector statistics needs to be pursued in tandem with other reforms.

- **Policy makers must create a more competitive environment for services.** Regulatory barriers—including domestic obstacles and foreign trade restrictions—protect vested interests from new market entrants. Dismantling such barriers is critical to unleash competition. Easing constraints on infrastructure for services, and training workers in the skills demanded by modern services, will provide the means to move to modern high-productivity services. A more competitive, dynamic service industry can boost overall productivity to support the region's future growth.

Growth rate of GDP (% per year)

Subregion/Economy	2011	2012		2013	
		ADO 2012	*Update*	*ADO 2012*	*Update*
Central Asia	**6.6**	**6.1**	**5.7**	**6.2**	**6.0**
Azerbaijan	0.1	4.1	3.0	3.5	3.5
Kazakhstan	7.5	6.0	5.8	6.5	6.3
East Asia	**8.1**	**7.4**	**6.5**	**7.7**	**7.1**
China, People's Rep. of	9.3	8.5	7.7	8.7	8.1
Hong Kong, China	4.9	3.0	1.6	4.5	3.9
Korea, Rep. of	3.6	3.4	2.7	4.0	3.4
Taipei,China	4.0	3.4	1.7	4.6	3.8
South Asia	**6.2**	**6.6**	**5.5**	**7.1**	**6.4**
Bangladesh	6.7	6.2	6.3	6.0	6.0
India	6.5	7.0	5.6	7.5	6.7
Pakistan	3.0	3.6	3.7	4.0	3.7
Sri Lanka	8.3	7.0	6.5	8.0	7.0
Southeast Asia	**4.6**	**5.2**	**5.2**	**5.7**	**5.5**
Indonesia	6.5	6.4	6.3	6.7	6.6
Malaysia	5.1	4.0	4.6	5.0	4.8
Philippines	3.9	4.8	5.5	5.0	5.0
Singapore	4.9	2.8	2.2	4.5	3.8
Thailand	0.1	5.5	5.2	5.5	5.0
Viet Nam	5.9	5.7	5.1	6.2	5.7
The Pacific	**7.0**	**6.0**	**6.0**	**4.1**	**4.2**
Fiji	2.0	1.0	1.3	1.2	1.7
Papua New Guinea	8.9	7.5	7.5	4.5	4.5
Developing Asia	**7.2**	**6.9**	**6.1**	**7.3**	**6.7**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member. East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam. South Asia comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Central Asia comprises

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Inflation (% per year)

Subregion/Economy	2011	2012		2013	
		ADO 2012	*Update*	*ADO 2012*	*Update*
Central Asia	**8.9**	**7.2**	**6.4**	**7.3**	**6.7**
Azerbaijan	7.9	9.0	6.5	8.5	6.0
Kazakhstan	8.3	6.5	6.0	6.8	6.3
East Asia	**5.0**	**3.7**	**3.1**	**3.7**	**3.3**
China, People's Rep. of	5.4	4.0	3.2	4.0	3.5
Hong Kong, China	5.3	3.8	3.8	3.3	3.3
Korea, Rep. of	4.0	3.0	2.7	3.0	2.9
Taipei,China	1.4	1.5	1.9	1.6	1.8
South Asia	**9.4**	**7.7**	**8.6**	**6.9**	**7.4**
Bangladesh	8.8	11.0	10.6	8.5	8.5
India	8.9	7.0	8.2	6.5	7.0
Pakistan	13.7	12.0	11.0	10.0	10.0
Sri Lanka	6.7	8.0	8.5	7.0	7.5
Southeast Asia	**5.5**	**4.4**	**3.9**	**4.4**	**4.0**
Indonesia	5.4	5.5	4.4	5.0	4.5
Malaysia	3.2	2.4	1.9	2.8	2.5
Philippines	4.6	3.7	3.5	4.1	4.1
Singapore	5.3	3.0	4.1	2.5	3.0
Thailand	3.8	3.4	3.0	3.3	3.2
Viet Nam	18.7	9.5	9.1	11.5	8.6
The Pacific	**8.6**	**6.6**	**6.3**	**5.4**	**5.4**
Fiji	8.7	5.1	4.7	3.0	3.0
Papua New Guinea	8.7	7.0	6.5	6.0	6.0
Developing Asia	**5.9**	**4.6**	**4.2**	**4.4**	**4.2**

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Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

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.

Asian Development Outlook 2012 Update Highlights

The full report is available on the ADB website at www.adb.org/publications/asian-development-outlook-2012-update-services-asias-future-growth

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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