



## MACROECONOMIC PERFORMANCE, ISSUES AND POLICIES

### REGIONAL OVERVIEW

In March 2002, the secretariat had noted discernible signs of recovery in the global and regional economies following the sharp slowdown in 2001. In the event, while the global economic recovery petered out in 2002 after an encouraging first quarter, the developing economies of the ESCAP region were able to maintain a relatively strong momentum of growth. GDP growth in 2001 by this group of economies was exceeded by nearly 2 percentage points in 2002. Indeed, at 5.1 per cent, it was the fastest-growing group of economies in the world in 2002. All the different subregions improved their growth performance in 2002 relative to 2001. The most impressive improvements in 2002 were recorded by East and North-East Asia and South-East Asia (see table II.1). The Pacific island economies recovered from a decline in GDP in 2001 to positive growth in 2002.

The improved growth performance was based partly on the stimulus provided by easier macroeconomic policies, principally lower interest rates, and partly on the growth of intraregional trade. Macroeconomic easing was facilitated by the low inflationary environment; the collective rate of inflation in developing economies of the ESCAP region declined from 3.5 per cent in 2001 to 2.2 per cent in 2002. International trade by developing countries of the region exceeded world trade growth in 2002 in value terms (plus 2.1 per cent up to August 2002 on a year-on-year basis versus minus 2.4 per cent on the same basis for the world as a whole). However, the increase was offset to some extent by price declines in manufactured goods so that, notwithstanding the improvement in some commodity prices, on an overall basis developing economies of the ESCAP region suffered terms-of-trade losses during the year.

In the later part of 2002, geopolitical uncertainties emanating from the possibility of military conflict in Iraq, the knock-on effects of the terrorist attack in Bali and the situation in the Democratic People's Republic of Korea served to further undermine already low corporate confidence across the globe. Although GDP growth in the region remained largely unaffected by these developments, the uncertainty they generated was discernible in most of the stock markets of the region. By and large, stock markets tended to weaken in 2002 with minor upward rallies.

*ESCAP region  
maintained a  
relatively strong  
momentum of  
growth in 2002  
based on easier  
macroeconomic  
policies and  
buoyant  
intraregional  
trade*

<b>Table II.1. Selected economies of the ESCAP region: rates of economic growth and inflation, 2001-2005</b>										
<i>(Percentage)</i>										
	<i>Real GDP</i>					<i>Inflation<sup>a</sup></i>				
	<i>2001</i>	<i>2002<sup>b</sup></i>	<i>2003<sup>c</sup></i>	<i>2004</i>	<i>2005<sup>c</sup></i>	<i>2001</i>	<i>2002<sup>b</sup></i>	<i>2003<sup>c</sup></i>	<i>2004<sup>c</sup></i>	<i>2005<sup>c</sup></i>
<b>Developing economies of the ESCAP region<sup>d</sup></b>	3.2	5.1	5.4	5.7	5.5	3.5	2.1	2.5	2.3	2.4
<b>South and South-West Asia<sup>e</sup></b>	4.6	4.5	5.8	6.2	6.5	6.5	5.9	5.4	4.9	4.2
Bangladesh	5.3	4.8	5.2	5.7	..	1.6	2.4	3.0	3.0	..
India	5.6	4.4	6.0	6.5	6.8	4.3	3.5	3.5	3.0	3.0
Iran (Islamic Republic of)	4.8	6.5	6.7	6.8	..	11.4	15.3	14.0	13.0	..
Nepal	4.9	0.8	2.5	3.5	..	2.4	2.9	4.5	..	..
Pakistan	2.5	3.6	4.5	5.0	5.5	4.4	3.5	4.0	4.0	4.0
Sri Lanka	-1.4	3.0	5.3	5.9	6.3	14.2	9.5	6.7	6.6	6.4
Turkey	-7.4	6.0	4.2	3.7	4.2	54.4	45.2	30.9	25.5	28.1
<b>South-East Asia</b>	2.2	4.0	4.7	4.7	4.5	5.9	3.7	3.9	3.8	3.9
Cambodia	5.5	4.5	6.4	6.0	6.5	-0.5	3.0	3.5	3.3	3.0
Indonesia	3.3	3.2	4.1	4.4	4.3	11.5	10.5	9.0	8.6	8.8
Lao People's Democratic Republic	5.7	5.8	5.9	6.3	..	7.8	10.6	5.5 <sup>f</sup>	5.0 <sup>f</sup>	..
Malaysia	0.4	4.2	6.3	5.4	5.3	1.4	1.8	2.0	2.2	1.7
Myanmar	10.5	5.5	5.8	5.4	..	21.1	51.3	38.2	24.9	..
Philippines	3.2	4.6	4.6	4.9	5.5	6.1	3.1	4.0	3.5	3.1
Singapore	-2.4	2.2	4.2	4.9	5.0	1.0	-0.4	1.2	1.4	1.8
Thailand	1.8	4.9	4.5	4.4	3.4	1.7	0.7	1.5	1.3	1.9
Viet Nam	6.8	7.0	7.5	7.5	7.5	-0.4	3.9	5.3	6.3	5.8
<b>East and North-East Asia</b>	3.3	5.7	5.6	6.0	5.7	1.4	0.3	1.0	1.0	1.3
China	7.3	7.9	7.7	7.8	7.7	0.7	-0.8	-0.5	-0.3	0.0
Hong Kong, China	0.6	1.7	2.5	4.5	3.9	-1.6	-3.0	-1.5	-0.5	0.3
Mongolia	1.1	3.9	5.0	..	..	8.0	5.0	5.0	..	..
Republic of Korea	3.0	6.1	5.3	5.4	4.3	4.1	2.7	3.3	2.4	2.6
Taiwan Province of China	-2.1	3.2	3.6	4.4	4.9	0.0	0.0	1.3	1.9	2.1
<b>Pacific island economies</b>	-0.8	1.1	3.2	3.0	2.4	7.1	8.5	9.0	7.1	7.1
Cook Islands	-3.3	1.4	2.4	..	..	8.7	4.0	2.5	..	..
Fiji	4.3	4.4	5.7	3.6	3.7	4.2	2.5	3.0	3.0	3.0
Papua New Guinea	-3.4	-0.5	1.8	2.7	1.6	9.3	12.0	13.2	10.0	10.0
Samoa	6.5	1.1	6.0	5.0	5.0	4.0	6.0	3.0	2.0	3.0
Solomon Islands	-13.0	3.0	2.5	2.0	2.0	1.8	11.0	9.0	5.0	5.0
Tonga	3.0	3.0	4.5	3.0	3.0	6.3	4.0	3.0	3.0	3.0
Vanuatu	-0.5	-0.4	1.3	2.2	2.6	3.2	2.5	2.5	2.5	2.5
<b>Developed economies of the ESCAP region</b>	-0.1	-0.3	0.5	0.9	1.3	-0.4	-0.8	-0.5	-0.5	-0.2
Australia	2.7	3.3	3.2	3.6	3.8	4.4	2.5	2.7	2.6	2.5
Japan	-0.3	-0.6	0.3	0.7	1.1	-0.7	-1.1	-0.7	-0.7	-0.4
New Zealand	2.5	3.8	2.6	2.8	3.1	2.7	2.6	1.9	1.8	2.0

*(Continued on next page)*

**Table II.1** (continued)

(Percentage)

	Real GDP					Inflation <sup>a</sup>				
	2001	2002 <sup>b</sup>	2003 <sup>c</sup>	2004 <sup>c</sup>	2005 <sup>c</sup>	2001	2002 <sup>b</sup>	2003 <sup>c</sup>	2004 <sup>c</sup>	2005 <sup>c</sup>
<b>Memo</b>										
Kazakhstan	13.5	9.5	6.7	6.7	8.5	8.5	5.9	6.2	6.7	6.8
Russian Federation	5.0	3.9	4.0	4.1	4.5	21.6	15.1	13.6	11.9	10.0
Uzbekistan	4.5	3.0	3.5	4.0	..	27.2	26.0	26.5	25.0	..

Sources: ESCAP, based on IMF, *International Financial Statistics*, vol. LV, No. 12 (December 2002); ADB, *Key Indicators of Developing Asian and Pacific Countries 2002*, vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); Economist Intelligence Unit, *Country Reports and Country Forecasts* (London, 2002 and 2003), various issues; web site of the Inter-State Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>; and national sources.

<sup>a</sup> Changes in the consumer price index.  
<sup>b</sup> Estimate.  
<sup>c</sup> Forecast/target.  
<sup>d</sup> Based on data for 28 developing economies representing about 95 per cent of the population of the region (excluding the Central Asian republics); GDP figures at market prices in United States dollars in 1995 have been used as weights to calculate the regional and subregional growth rates.  
<sup>e</sup> The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2002/03 = 2002 for India and the Islamic Republic of Iran; and fiscal year 2001/02 = 2002 for Bangladesh, Nepal and Pakistan.  
<sup>f</sup> End-year figures.

There were few signs of a revival in corporate investment spending. Furthermore, as oil prices rose by some 50 per cent by the end of December 2002 on a year-on-year basis and with little evidence of durable growth in the United States, Japan and the EU, which together account for more than 50 per cent of the exports from the region, the outlook for regional growth in 2003 became less favourable.

As of now (early February 2003) the region is in the grip of a daunting array of uncertainties that render any assessment of the outlook for 2003 problematic in the extreme. Externally, until the situation relating to Iraq becomes clearer, demand for the region's exports in the developed economies could be much weaker than forecast even a few months ago as corporations delay new investment expenditure. Further, the world's financial markets, equities, bonds and foreign exchange, are likely to be buffeted by strong crosswinds of low and fragile investor confidence. This will manifest itself primarily in heightened risk aversion and exaggerated volatility in asset prices and trading volumes. A probable consequence of this could be greater instability in exchange rates, revolving around a weaker United States dollar, and investment funds flowing into safe haven-type outlets, such as precious metals, with deleterious effects even on trade-related cross-border financial transactions. Internally, a prolonged period of uncertainty would clearly have an adverse impact on

**ESCAP region faces  
a daunting array  
of uncertainties**

business and consumer confidence, while the possibility of military conflict in Iraq could deflect Governments in the region from focusing on development issues and implementing their reform agendas owing to a narrower concern with security matters in the short term.

If other things remain the same, however, or if the uncertainties mentioned above resolve themselves quickly and trade and financial flows are not disrupted for a prolonged period, the underlying strength of the economies in the region suggests that the developing economies of the region should be able to maintain their current momentum of growth in 2003 or even enjoy a modest acceleration. But, in order to achieve this, the Governments of the region have to confront major policy issues and challenges. It should be stressed here that the balance of probabilities at the time of writing remains significantly weighted on the downside until the geopolitical situation and associated uncertainties are resolved. In the following paragraphs the recent performance and prospects for each subregion and the common policy issues and challenges facing the ESCAP region as a whole are discussed.

***Least developed and Pacific island countries did not match the rest of the ESCAP region in GDP growth in 2002***

In the least developed countries, GDP growth generally slowed in 2002. This was primarily caused by a slowdown in export growth and not, as in the past, by any adverse domestic developments. Least developed country exports are mainly destined for developed country markets and are still concentrated in a relatively narrow range of items, although newer exports such as garments have made a major contribution to exports and GDP growth in Bangladesh in recent years. Tourism was adversely affected as concerns about security kept tourists away from several of the least developed countries, and especially from countries such as Nepal, where the security situation worsened. On the plus side, inflationary pressures remained muted in the subregion with the exception of Myanmar. For the future, taking the least developed countries as a whole, much depends upon the recovery of global growth in 2003 and more particularly upon growth in the developed countries.

As in the case of the least developed countries, the Pacific island economies did not match the rest of the ESCAP region in showing a significant improvement in GDP growth in 2002. However, taking the economies as a whole, most of which have a narrow production and low population base, GDP stopped contracting and positive growth was attained in all the economies for which data are available, with the exception of Papua New Guinea and Vanuatu. The most visible turnaround occurred in Solomon Islands, where GDP grew in 2002 after experiencing a contraction of 13 per cent in 2001. The lacklustre GDP performance contributed to problems in macroeconomic management. As a result, the inflation rate went up in Papua New Guinea, Samoa and the Solomon Islands but came down in Fiji, Tonga and Vanuatu. Despite the fact that the Pacific island countries are away from the areas of tension, tourism displayed a mixed trend; it recovered in Fiji but not in other

tourism-dependent economies. For 2003, overall prospects are for GDP growth to exceed the performance in 2002. The Pacific island economies are substantially influenced by developments in Australia and New Zealand, of which Australia is expected to achieve GDP growth in 2003 at, or close to that achieved in 2002.

The economies of Central Asia were little affected by the global downturn in 2001 and the pace of GDP growth remained broadly stable in 2002. Growth in the subregion was achieved on the back of growing investor and consumer confidence that attracted enhanced external capital to resource-rich economies such as Kazakhstan and facilitated greater macroeconomic stability, particularly exchange rate stability, as production increased and inflation declined in virtually all the economies of the subregion. Against the overall trend, GDP growth tended to ease somewhat in 2002 relative to 2001 in the three largest economies, but was still maintained at a respectable pace. Central Asia remains heavily dependent upon the Russian Federation and strong growth in that country since the 1998 financial crisis has led to higher trade flows within the subregion on a more sustainable basis. The Russian Federation has been recognized as a market economy and its entry into WTO should boost not only its own development but that of the Central Asian economies, by locking them more firmly into the international economy. Prospects for 2003 are, however, subject to the uncertainty prevailing in the global economy at the present time. In particular, much will depend on the course of energy prices over the coming months.

***GDP growth in  
Central Asia  
remained broadly  
stable in 2002***

In South and South-West Asia, GDP growth picked up in 2002 compared with 2001. This was mainly on account of the recovery of Sri Lanka and Turkey from negative growth in 2001 and higher growth in Pakistan and the Islamic Republic of Iran. India, the largest economy in this subregion, saw a marginal decline in its GDP growth rate in 2002 relative to 2001; unfavourable weather affected agricultural production and was essentially responsible for the small overall decline in the GDP growth rate. Inflation in the subregion remained unchanged; it went up in the Islamic Republic of Iran but came down modestly from a very high level in Turkey and in Sri Lanka. On the external trade front, excepting India and Turkey, export growth remained subdued. However, with improved inflows of remittances and foreign capital, the foreign exchange reserve position improved significantly in nearly all countries of the subregion. In the case of India and Pakistan, higher inflows of foreign resources led to balance-of-payments current account surpluses. In 2003, the prospects are for a pickup in the overall GDP growth rate, especially in India, Pakistan and Sri Lanka. However, uncertainties remain: these are primarily external and could affect export growth adversely if growth in the global economy remains tentative or if prolonged military hostilities take place in Iraq. While the economies of the subregion are primarily domestic demand-driven, net exports make a significant contribution to GDP performance at

***GDP growth picked  
up in South and  
South-West Asia  
in 2002 ...***

the margin. In addition, other than the Islamic Republic of Iran, the subregion is a heavy importer of energy and higher energy prices would be a negative development for both growth and inflation in the subregion.

***... and in  
South-East Asia***

In South-East Asia, the rate of GDP growth improved from 2.3 per cent in 2001 to 4 per cent in 2002. Growth was strong in Malaysia and Thailand, driven, for the most part, by buoyant consumption aided by an upturn in electronics and electrical goods exports. Higher commodity prices were another positive feature in the subregion. These factors also applied to Viet Nam, where GDP growth remained buoyant in 2002. Growth was less strong in the Philippines and Indonesia, where the incidence of terrorist attacks tended to dampen business investment expenditures; the attacks, however, had a minimal impact on tourism in the subregion, which accounts for 4-5 per cent of GDP in South-East Asia generally.<sup>1</sup> Slower growth in the global economy in the second half of 2002 caused export growth to taper off in these economies and this phenomenon was responsible for the modest increase in output in Singapore in 2002 following a contraction in 2001. The outlook for 2003 is clouded by uncertainty on the external front. Even though exports to China increased rapidly in 2002 and should continue to grow in 2003, this may not be sufficient to offset the lack of robust growth in the United States, Japan and the EU. Domestically, strong consumption growth facilitated by easier macroeconomic policies is likely to be sustained but could come up against rising personal debt levels and the need to begin fiscal consolidation, given the rising public debt in several economies. Subject to these caveats and the uncertainties in the international situation, the subregion should enjoy stronger growth in 2003.

***Led by China  
East and North-East  
Asia was the best  
performing subregion  
in 2002***

East and North-East Asia was the best performing subregion in 2002, led by strong growth in China and the Republic of Korea. Mongolia, the smallest economy in the subregion, also improved its GDP growth rate in 2002. In China, growth was particularly robust in the first half of the year. Both domestic demand and exports supported growth in the subregion. Domestic demand is mainly investment-driven in China but rapidly rising middle-class incomes are boosting personal consumption expenditure as well, leading to the production of a wide array of consumer goods and a surge in FDI. In the Republic of Korea, domestic demand is both investment- and consumption-driven, the latter by the more liberal availability of personal credit from the financial system. Exports increased sharply in the first half of 2002 as a result of the upturn in the ICT sector. In the case of China, there was strong growth of imports from the region, with eight economies increasing the volume of exports to China by around 50 per cent in the first half of 2002. Growth was less strong in Taiwan Province of China and barely perceptible in Hong Kong, China. The former economy remains closely tied to the dynamics of

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<sup>1</sup> World Bank, "Making progress in uncertain times: regional overview", *East Asia Update*, November 2002.

boom and slowdown in the global high-tech industry, while the latter, which is now primarily a services oriented economy, has been affected by the slowdown in cross-border financial transactions. Domestically, rising unemployment and falling property prices in Hong Kong, China, have shaken consumer confidence and, as in Japan, the economy has become mired in deflation, prices having fallen for four straight years. Deflation also affects China to some extent and Taiwan Province of China has seen no rise in prices for three years. Prospects for the subregion in 2003 are that GDP growth rates will be broadly maintained. This is likely to be the case in both China and the Republic of Korea, and some recovery in Hong Kong, China, and Taiwan Province of China.

Of the three developed countries of the region, in 2001 and 2002 Japan experienced its third and severest recession for several years. By contrast, Australia and New Zealand, with buoyant domestic demand, showed relatively strong growth at the upper end of growth within the OECD economies. This was despite drought in Australia, which reduced agricultural output substantially. There was deflation in Japan, while price pressures remained mild in Australia and New Zealand. The consensus view is that the Japanese economy appears to have bottomed out in 2002 and could see positive growth, albeit at a modest pace in 2003, as measures to speed up reforms in the banking sector begin to take effect. In Australia and New Zealand, strong domestic demand should preserve the current momentum of growth. However, with a deteriorating external environment and other uncertainties, there are risks on the downside. These are already reflected in lower consumer confidence in the two economies and a slower pace of output growth in the second half of 2002.

*Japan experienced recession but Australia and New Zealand performed well in 2002*

## **POLICY ISSUES AND CHALLENGES**

The greatest threat to the region lies in the danger of a major military conflict in Iraq. In addition, the situation in the Democratic People's Republic of Korea or a major terrorist attack could markedly worsen prospects in the region. Indeed, to some degree the uncertainties thus generated are already manifesting themselves in higher oil prices and weak and volatile financial markets in the region, which, if prolonged, are likely to undermine both consumer and business confidence. In a worst-case scenario, a prolonged war in Iraq could set in train its own unpredictable security and sociopolitical dynamics and Governments would have to respond with policy adjustments as appropriate. The following paragraphs discuss the policy issues and challenges facing the region on the assumption that there will be no major and/or prolonged military action in Iraq.

*Geopolitical uncertainties raise major policy issues and challenges*

Given the absence of any evidence of a strong pickup in the global economy, at least in the first half of 2003, sustaining growth in the region will depend primarily upon growth-stimulating domestic policies. Any impetus from higher intraregional trade flows would enhance the effects of such policies.

Sustaining a high momentum of growth is needed not merely for its own sake but to address the issues relating to poverty in the region and simultaneously assist economies in the region in continuing to make progress in tackling corporate and financial sector reform. In this regard, it should be stressed that higher public expenditure on domestic law and order and security, while clearly diverting resources from other uses in the short term, is actually essential for development because of its positive impact on levels of confidence in the relevant economies. It is particularly important in economies that have significant tourism sectors.

***Domestic demand stimulation needed to maintain the momentum of growth in most economies***

Domestic demand stimulus measures have relied on a mixture of fiscal and monetary policies. There is no doubt that with levels of public debt exceeding 50 per cent of GDP in most economies of the region the question of fiscal consolidation has to be tackled in earnest before too long. In the case of monetary policy also, interest rates have reached quite low levels as a result of falling inflation, so that the scope for further reduction is limited in most countries. Given the varying positions of individual economies of the region in this context, any general policy recommendation would clearly be inappropriate. However, there would appear to be a strong case for Governments to put both fiscal and monetary policies within a medium-term framework in which short-term flexibility can be combined with medium- or longer-term discipline. Countries could begin implementing a programme of refinancing older, higher-cost debt with lower-cost debt, given the lower interest rates currently available, and anchor it within a credible debt target, measured as a ratio to GDP, to be achieved, say, over the next five years taking into account currency and other risks.

With regard to monetary policy and the use of inflation targeting, there is some concern that the authorities may be erring on the side of keeping inflation low and thus sacrificing growth to some extent. Since very low rates of inflation, or even deflation, rather than high inflation are prevalent in a number of economies in the region and could potentially be as intractable as high inflation, the need for more flexible monetary policies is obvious. In particular, low inflation caused by a collapse in demand following the bursting of an asset bubble is likely to require rather more aggressive policy interventions than incremental adjustments in interest rates.

***Corporate and financial sector reform should be reinvigorated to sustain long-term growth***

The programmes of reform of the corporate and financial sectors that have been formulated in several countries over the last five years must continue to be implemented with renewed vigour. The problem of corporate restructuring involving major balance-sheet adjustments in terms of lower debt-equity ratios has made only slow progress thus far. This problem is intimately related to the NPL problem in banks, which, in turn, is an impediment to the revival of credit demand in many economies of the region. Ideally, both of these problems need to be substantially reduced over the next three to five years. It is worth noting that levels of

investment in the private sector are still below pre-1997 levels in South-East Asia. Without a pickup in private investment, long-term growth is likely to be jeopardized.

The reform effort applies equally to improved standards of governance and more efficient delivery of services in the public sector. Governments in the region need to instil much greater discipline, higher standards of accountability and more effective utilization of the limited resources available to them for the provision of public services. Waste and corruption not only lead to the poorer delivery of services but also lower the morale of providers and users alike and undermine productivity in the economy.

By the same token, as emphasized in the past, countries dependent upon ODA need to redouble their efforts to improve the utilization of external assistance by drawing up realistic projects for such funding and improving their aid management skills. The improved climate for ODA flows may suffer major harm if aid utilization skills do not match up to much higher expectations in the future.

One of the central challenges of globalization is that countries have to compete for markets. Globalization manifests itself in intensified competition among firms on a transnational basis, necessitating efficiency in the utilization of both capital and human resources. Governments must strive to provide a stable macroeconomic environment, realistic exchange rates and improvements in the physical infrastructure to enable firms to compete, and the firms themselves must promote innovation, improve product and service quality and become more receptive to change.

The momentum of trade liberalization, including action in trade facilitation, should be maintained. It is widely accepted that regional trading arrangements can be a useful complement to the multilateral trading system and enhance its effectiveness. Nevertheless, the recent increase in bilateral trade agreements in the region should not serve to reduce the commitment of Governments to promote the multilateral objectives of the Doha Development Agenda agreed at the fourth WTO Ministerial Conference, held at Doha, Qatar, in November 2001.

The current weaknesses in the global economy and concerns with security issues such as terrorism and the use of the international financial system by terrorists require significantly enhanced cooperation at the regional level in the exchange of information, intelligence and policy-making in the area of security. In previous years the need for vigilance in pre-empting financial crises and containing their contagion has been stressed. Policy coordination to enhance growth is another area deserving attention and such coordination could be promoted initially through the various subregional organizations in the ESCAP region. An area in which this would be particularly appropriate is developing policy responses to the unravelling of the global balance-of-payments position involving major exchange rate adjustments in the months ahead.

*ESCAP economies  
must strive  
to enhance  
international  
competitiveness*

*Greater regional  
cooperation  
needed to counter  
terrorism, enhance  
security and  
maintain vigilance  
over financial  
markets*