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The economic recovery in industrial countries, which was weak in 2002 and in the first half of 2003, strengthened considerably over the last 2 quarters of 2003 and in the first quarter of 2004. In such a context, and despite major external shocks in 2003, the economies of developing Asia and the Pacific expanded much faster than earlier anticipated, with their aggregate gross domestic product growing by 6.3%. Although substantial imbalances remain in the world economy, growth in major industrial countries is projected to be quite robust in 2004-2005, while in developing Asia and the Pacific, the improved external environment, combined with strong domestic demand and buoyant intraregional trade, will allow the region to grow at annual rates of around 6.8% over the forecast period.

Part I

DEVELOPING ASIA AND THE WORLD

ECONOMIC HIGHLIGHTS IN 2003 AND PROSPECTS FOR DEVELOPING ASIA AND THE PACIFIC IN 2004–2005

The economies of developing Asia and the Pacific generally showed significant resilience in 2003. Despite the uncertainties caused by the Iraq conflict, high oil prices, the outbreak of the severe acute respiratory syndrome (SARS) epidemic, and a slow recovery in major industrial countries during the first half of the year, gross domestic product (GDP) growth for the region reached 6.3% in 2003, making it the most dynamic region in the world. Among the larger economies, People's Republic of China (PRC), India, Thailand, and Viet Nam turned in particularly strong performances. Average inflation remained low at 2.3%, compared with 1.5% in 2002. The aggregate current account of the region posted a sizable surplus of 4.2% of GDP. Finally, foreign exchange reserves of developing Asia rose to $1.3 trillion at the end of 2003.

However, the overall economic strength of the region hides significant differences in economic performance both among the subregions and among countries within subregions (Table 1). Among the subregions, economic growth in 2003 was particularly strong in East Asia, South Asia, and Central Asia, moderate in Southeast Asia, and still fragile in the Pacific (though much better there than in the past 3 years). Within subregions, developments also varied considerably. In East Asia, the impact

of SARS, together with weak domestic demand conditions, resulted in low growth in Hong Kong, China; Republic of Korea (henceforth Korea); and Taipei,China. In Southeast Asia, the Singapore economy remained weak as economic restructuring continued and the uncertain employment situation kept domestic demand subdued. Indonesia and the Philippines expanded moderately but at rates below potential. In South Asia, most economies showed strong performances in 2003, in part due to very favorable weather conditions. However, uncertain political conditions kept economic growth below par in Nepal. In Central Asia, the Uzbekistan economy continued to grow quite slowly. In the Pacific, several of the smaller economies experienced no growth in 2003, such as the Federated States of Micronesia and Nauru, or a decline, as in the case of Timor-Leste.

The region has witnessed two notable economic developments over the past 2 years. The first is the emergence of the PRC as a major engine for intraregional trade. This trend accelerated in 2003 for most of developing Asia. The economies in East Asia and Southeast Asia benefited most from the strong increase in the PRC's imports. The PRC has become the single largest export market for East Asia while for Southeast Asian countries, its share in total exports has become sizable. In a major new development, exports from South Asia to the PRC also expanded rapidly in 2003, albeit from a low base. Although economic growth in the PRC is projected to settle to more sustainable rates in 2004–2005, intraregional trade will remain a major driver of growth in developing Asia over the next 2 years. Progressively, the whole of the region will benefit from the dynamism in intraregional trade.

The second main feature of recent regional economic developments is the increasing importance of consumer demand in most countries. Although there are notable exceptions, consumer spending in 2003 was an important boost for many of the economies in East Asia and Southeast Asia, in particular PRC, Indonesia, Malaysia, Philippines, and Thailand. In a noteworthy development, similar changes are occurring in South Asia, particularly in India. The increasing importance of consumer demand in GDP growth has been supported in most countries by expansionary fiscal policies, and a low interest rate environment associated with accommodative monetary policies. An expanding urban middle class and the relatively young age structure of populations are fundamentally changing consumption behavior throughout developing Asia. Overall, confidence is high in the economic outlook for the region.

Intraregional trade and strong consumer demand will continue to define the outlook in 2004–2005. Developments in 2003 and the first quarter of 2004 show that the economic fundamentals of the region are strong. Domestic demand has been picking up in some of the East Asian

Table 1. Selected Economic Indicators: Developing Asia, 2001–2005

	2001	2002	2003	2004	2005
Gross Domestic Product (annual percentage change)					
Developing Asia	4.3	5.8	6.3	6.8	6.7
East Asia	4.6	6.7	6.5	6.9	6.8
Southeast Asia	1.9	4.2	4.6	5.7	5.4
South Asia	5.2	3.9	6.9	7.0	7.2
Central Asia	10.8	8.1	8.4	8.1	8.4
The Pacific	0.6	0.8	2.7	2.9	2.4
Consumer Price Index (annual percentage change)					
Developing Asia	2.4	1.5	2.3	3.3	3.1
East Asia	1.2	-0.1	1.2	2.6	2.4
Southeast Asia	4.6	4.2	3.1	3.6	3.8
South Asia[a]	3.7	3.5	4.9	4.9	4.6
Central Asia	14.3	10.9	6.9	8.6	8.3
The Pacific	6.4	7.0	7.4	5.6	6.0
Current Account Balance (percentage of GDP)					
Developing Asia	2.8	3.8	4.2	3.2	2.9
East Asia	2.6	3.7	4.0	2.8	2.6
Southeast Asia	6.9	7.4	9.1	8.2	7.6
South Asia	0.0	1.1	1.1	0.4	0.2
Central Asia	-3.0	-2.2	-2.5	-3.6	-4.3
The Pacific	3.9	-1.7	1.7	0.9	-1.3

[a] India reports on a wholesale price index basis.
Sources: Asian Development Outlook database; staff estimates.

and Southeast Asian economies where it was weak in 2003, notably Hong Kong, China; Korea; Singapore; and Taipei,China. In addition, the strengthening of the recovery in major industrial countries is already showing up in the external sector performance of many regional economies. The stronger outlook in industrial countries for 2004–2005 will provide a cushion against some possible slowing of the surging export growth to the PRC. It will also mitigate the impact of fiscal consolidation measures that need to be taken in some of developing Asia's economies.

An important point is that the brighter economic outlook for 2004–2005 will present a timely opportunity to strengthen policies aimed at resolving macroeconomic imbalances, addressing the fragility of banking and financial systems, and implementing structural policy reforms to progressively improve the investment climate. The implementation of such reforms and the combination—for the first time since the Asian financial

crisis of 1997–98—of buoyant domestic, regional, and international markets should significantly boost business investment in the region. Assuming robust growth in industrial countries over the next 2 years, and in the absence of major unforeseen shocks, aggregate GDP growth for developing Asia is projected at 6.8% in 2004 and 6.7% in 2005.

PROSPECTS FOR THE WORLD ECONOMY IN 2004–2005

Prospects for Major Industrial Countries

The recovery in industrial countries, which started at the end of 2001 stayed relatively weak in 2002, and remained subdued during the first half of 2003, but strengthened considerably over the last 2 quarters of the year, mainly in the United States (US), Japan, and the United Kingdom (UK); economic growth in the euro zone has been lagging. In spite of a significant upturn in growth, inflation has remained low in the US while deflation abated somewhat in Japan. In the euro zone, weak domestic demand and the appreciation of the euro have put downward pressure on prices. As a result, monetary policies continued to be highly accommodative in major industrial countries. Such a policy stance should continue for most of 2004 with a tightening of monetary policy and higher interest rates in industrial countries likely to start later in the year.

Fiscal policies are expected to be neutral to moderately contractionary over the next 2 years. Although there are considerable imbalances and uncertainties in the world outlook, in particular with regard to employment creation in the US and the widening US fiscal and current account deficits, projections indicate robust growth in major industrial countries, largely due to a strong recovery in the US, for most of 2004, before some leveling off of growth in 2005 (Table 2).

United States. The US economy showed exceptional strength at the end of 2003 and in the first quarter of 2004, growing well above trend. A combination of factors resulted in exceptionally high GDP growth of 8.2%, at a seasonally adjusted annualized rate (saar), in the third quarter of 2003. These factors included a surge in personal consumption expenditures resulting from the impact of tax refunds, a spike in residential and equipment (information processing hardware and software) fixed investment, and an improved export performance. Despite a slowdown of activity in the residential real estate market and a worsening trade balance, strong business investment spending maintained GDP growth of 4.1% in the fourth quarter of 2003, still above trend growth.

Table 2. Baseline Assumptions on External Conditions, 2002-2005

	2002	2003	2004	2005
GDP growth (%)				
Industrial countries	1.6	2.0	3.1-3.5	2.5-3.0
United States	2.2	3.1	4.2-4.7	3.2-3.7
Euro zone	0.9	0.4	1.7-1.9	2.1-2.4
Japan	-0.3	2.7	2.5-2.8	1.5-2.0
Memorandum Items				
United States Federal Funds rate (%)	1.7	1.1	1.1-1.3	2.5-3.0
Brent crude oil spot prices ($/bbl)	25.0	28.8	28.0-30.0	24.0-26.0
World trade volume (% change)	3.7	4.7	8.0-8.5	6.0-7.0

Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic model.
Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/index.asp; Economic and Social Reaserch Institute of Japan, available: www.esri.cao.go.jp/index-e.html; Eurostat, available: http://www.europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat; World Bank Development Economics Prospects Group; US Federal Reserve, available: www.federalreserve.gov/releases; staff estimates.

A worrisome feature of the strong US recovery in the second half of 2003 was that it did not generate significant increases in employment. From August to December, average monthly employment gains turned out to be less than 56,000, well below historical figures during recovery periods. A range of factors provides some explanation for the jobless growth, including large gains in productivity, and the continued impact of overhiring at the end of the 1990s. Employment will be a key variable in the US economy in 2004–2005.

Along with an improvement in the employment data in the first quarter of 2004, particularly in March, the fundamentals of the US economy appear to be strong, suggesting robust growth in 2004. The outlook for the business sector is very positive as new orders and order backlogs data show positive trends. The March Institute for Supply Manufacturing survey showed that the manufacturing sector continued to grow for the 10th consecutive month. Soaring profits due to declining unit labor costs and the fall in the dollar—bolstering profits from overseas operations—should translate into significant increases in capital expenditures in 2004. In spite of weak gains in average earnings and the uncertain employment outlook, tax refunds in the first quarter of 2004 as well as continued low interest rates, and strong consumer credit growth (up by 8.6% saar in January 2004) should keep consumer spending buoyant at least during the first half of 2004. While activity in the

residential real estate market is projected to slow somewhat, net exports should start to support growth positively as the economy moves to the upward segment of the J-curve.

With inflation projected to remain moderate and job creation still uncertain, the Federal Reserve is likely to keep its target Federal Funds rate of 1% unchanged until later in the year. Changes in core inflation will define the stance of monetary policy. Several factors are at play. First, sustained growth will not only start creating jobs, but also bring the economy closer to capacity, building up inflationary pressures. Second, the impact of the depreciation of the dollar should progressively be felt on domestic prices. Third, high projected oil and commodity prices will feed through and push up core inflation. Core inflation is therefore projected to accelerate during the second half of the year and into 2005, eventually leading to upward adjustments in interest rates. Projections of a further significant increase in the budget deficit for 2004 (to about $520 billion or 4.5% of GDP) will also put upward pressure on interest rates.

Against a background of a tightening of macroeconomic policy taking hold only later in the year and of significant downside risks, the US economy is projected to expand at a rate of 4.02–4.47% in 2004. In 2005, both monetary and fiscal policies are forecast to be less accommodative. In the budget for fiscal 2005 (starting on 1 October 2004), most discretionary spending growth is expected to be contained. Interest rate increases will moderate growth in private consumption expenditures and residential real estate investment. Business investment should, however, continue to expand moderately. Some improvement can be expected in the current account deficit, thus contributing to growth. Projections are for GDP growth in the range of 3.2–3.7% in 2005.

Japan. The economy of Japan turned out much stronger than anticipated in 2003, with GDP posting a 2.7% increase for the year as a whole. Growth in the last quarter of 2003 was a remarkable 7% on an annualized basis, the highest rate since the second quarter of 1990. The recovery was driven by a solid export performance (up 10% in real terms for the year as a whole) and a significant pickup in business investment. Private nonresidential investment contributed 1.5 percentage points to overall growth, and net exports a further 0.7 percentage point. Private consumption accounted for 0.6% of growth as consumer confidence remained weak through most of the year.

At the end of 2003, employment started to respond modestly to the revival of economic activity, particularly in some large businesses. Unemployment declined slightly to 5.0% in February 2004. An improved employment situation will contribute to a progressive strengthening of consumer spending in 2004–2005. Such spending already strengthened

significantly in the last quarter of 2003 and the first quarter of 2004, indicating that the recovery is broadening. There are also indications that deflation is easing, and this would further stimulate consumption spending.

Despite some appreciation of the yen during the second half of 2003, exports have been buoyant, particularly to the PRC and the rest of Asia. In real terms, exports to the PRC grew at annual rates of 35.5% in 2002 and 41.2% in 2003. In contrast, exports to the US actually declined in 2003, while they expanded moderately to the European Union (EU). The PRC now accounts for 12.2% of Japan's exports, just below the EU market share. A wide range of industries has benefited from surging exports to the PRC, including machinery and electrical machinery, metals, and precision instruments. The manufacturing export industries are expected to continue to expand strongly in 2004, mainly on account of robust regional export demand and rising shipments to the US. For example, industrial output increased by a solid 3.4% in January 2004 compared with the previous month.

A key factor affecting export growth will be the value of the yen, which appreciated against the dollar by 8.5% over the period January 2003 to March 2004. Intervention by the Bank of Japan moderated the appreciation: in January 2004 alone, it spent $67 billion to support the yen. At the end of March 2004, Japan's total foreign exchange reserves (including gold) stood at $826.6 billion. Despite deflationary forces still at work in some sectors, business confidence, as measured by the Tankan survey of business conditions, was at a decade high in the first quarter of 2004. In the financial sector, substantial progress has also been made in reducing nonperforming loans (NPLs), which had fallen below 7% of bank loan portfolios at the end of 2003. Assuming that export growth remains on track, business investment continues to strengthen, and real consumer spending revives, the Japanese economy could return to a period of robust growth not seen in over a decade. Projections indicate that GDP is likely to grow by about 2.5–2.8% in 2004, and between 1.5–2.0% in 2005. However, deflation remains severe in some sectors, such as capital goods, and could continue to dampen nominal GDP growth. Finally, in addition to accelerating structural reforms, addressing longer-term issues such as the huge budget deficit and public debt will be required to sustain robust growth.

Euro Zone. Euro zone GDP growth was a meager 0.4% in 2003. In the second quarter of the year, the euro zone economy actually shrank by 0.4% as private consumption, investment, and net exports all declined. The second half of the year saw some recovery as, in spite of the euro's appreciation, exports and business investment improved somewhat,

particularly in France, Germany, and notably Spain where domestic demand is more robust. With few exceptions, corporate confidence improved in the latter part of the year. However, consumer confidence and demand remained very weak. GDP expanded by 1.2% (saar) in the fourth quarter. Constrained by the Stability and Growth Pact limit on budget deficits, fiscal policy was only mildly expansionary, but the three biggest euro zone economies—Germany, France, and Italy—breached the 3.0% deficit limit as a result of tax cuts. Despite inflation falling just below 2%, the European Central Bank (ECB) left its target rate unchanged at 2.0% since July 2003. Domestic demand thus did not benefit from additional monetary policy support. Furthermore, structural reforms to improve the competitiveness of the euro zone economies appear to have slowed during the course of 2003.

By March 2004, the euro had appreciated against the US dollar by about 40% since February 2002, and the strength of the euro is increasingly a source of concern. In March 2004, the Ifo business climate index of manufacturing, construction, retailing, and wholesaling in Germany fell further to 95.4, after declining for the first time in 9 months to 96.4 in February. In contrast, the German purchasing managers' index (PMI), which measures future economic activity, improved somewhat to 54.1 points in March 2004 from 53.4 points in February. With limits to the squeeze on exports' profit margins, the strong euro could start dampening external demand, the main source of growth in the euro zone in 2003 and early 2004. This would affect employment prospects and further depress domestic demand.

Inflation is projected to fall to the 1.5–1.7% range in 2004–2005, opening a welcome opportunity to loosen monetary policy and reduce interest rates. On the fiscal side, not much stimulus can be expected over the next 2 years as the economies exceeding the Stability and Growth Pact limit try to bring back their budget deficits to below 3.0%. On the positive side, in spite of the euro's appreciation over the past year, business confidence in France and Spain has been improving, as shown by several early 2004 PMI surveys. After 3 months of stagnation, the PMI for the euro zone rose in March. In Germany, there has been a pickup in investment in machinery and equipment, as well as in construction, while consumer confidence also appears to have improved. Hence, some modest strengthening of growth to 1.7–1.9% is projected for the euro zone in 2004, assuming no further significant appreciation of the euro. In 2005, GDP growth is projected in the 2.1–2.4% range, as domestic demand and exports contribute more evenly to growth.

Within the EU, the UK economy offers a sharp contrast to that of the euro zone. It was on a rebound in 2003, expanding at an annual rate of 3.8% in the fourth quarter and 2.3% for the year as a whole. Domestic demand is providing a strong impetus to growth, particularly private and public consumption. For example, housing prices were up by 17% in February 2004 from a year earlier. In spite of a second rise in interest rates by 25 basis points to 4.0% in February 2004, domestic demand is seen as remaining robust in 2004–2005, even if some further interest rate rises can be expected later in the year and in 2005. Business confidence has also been rising as the world economy accelerates and stock markets remain fairly robust. Despite a substantial appreciation of the pound against the US dollar and lately against the euro, exports have been rising, with for instance exports to the PRC growing by more than 50% in 2003. Projections show the UK economy growing by 2.8–3.1% in 2004 and by 2.5–2.8% in 2005.

World Trade and Commodity Prices

Growth in world trade consistently strengthened throughout 2003, and remained strong in the beginning of 2004, growing at double-digit rates. According to World Bank estimates, world trade, as measured by world export volume, expanded by 4.7% in 2003, about 1 percentage point faster than in 2002. The trade performance resulted from a confluence of factors. First, trade between the rest of the world and Asia, as well as within Asia, boomed in 2003, led by the PRC and the other East Asian and Southeast Asian economies. In the second half of 2003 and early 2004, shipments of electronics to and from nonregional economies as well as within the region increased rapidly. Exports from Japan, particularly to the PRC and the rest of developing Asia, surged in the second half of 2003, and exports from the US also picked up by the end of the year. The EU (with the exception of the UK) is the only region where exports have been lackluster. With robust growth projected for the world economy in 2004–2005, and developing Asia in particular, the strong performance of world trade in the first quarter of 2004 should translate in world trade volume growth of around 8–8.5% in 2004, slowing somewhat to about 6–7% by 2005.

Oil prices in 2003 were volatile and remained high throughout the year. The average price of $28.80 a barrel (Brent crude) in 2003 is well above forecasts earlier in the year. Supply uncertainties related to the Iraq conflict and unrest in Venezuela, low stock levels, increasing demand from the PRC (30% oil import growth in 2003), which has now become the second-largest oil importer in the world, as well as weather-related demand, have all helped keep oil prices high. By the end of 2003, the

significant fall in the dollar also put upward pressure on oil producers to maintain local currency revenues. Oil prices stayed at above $30 a barrel during the first quarter of 2004 as the Organization of Petroleum Exporting Countries (OPEC) played an active role in managing the oil markets, as stocks remained critically low in major Organisation for Economic Co-operation and Development (OECD) markets, and as seasonal factors pushed up demand. Furthermore, OPEC announced a quota cut of 1 million barrels a day from 1 April to 23.5 million barrels a day, which will support prices during the second quarter in spite of a seasonal decline in demand. Higher non-OPEC production could, however, start putting some downward pressure on prices as 2004 progresses. Overall, given OPEC's apparent determination to support higher prices in the face of a weak US dollar, and robust demand in a strongly growing world economy—particularly the PRC, India, and other Asian countries—Brent crude oil prices are projected to stay relatively high in 2004 in a range of $28–30 a barrel, before easing somewhat to the $24–26 range in 2005 as demand and supply are better matched. Following a substantial decline in 2002, natural gas prices rose by nearly 30% in 2003; moderate increases are projected over the forecast horizon.

The rally in prices of non-oil commodities, which started in 2002, strengthened considerably in 2003, with prices increasing by 13% over the year according to World Bank estimates. The combination of a weak dollar, a stronger world recovery, and soaring demand from the PRC for raw materials and base metals sent most commodity prices close to their mid-1990s peak. Speculative factors also contributed to the high prices in 2003 and early 2004. Demand from the PRC and falling world stocks led to a surge in metals and mineral prices by 28%. Raw materials, including cotton and rubber, rose by 16%, also largely due to strong demand from the PRC. Fertilizer prices rose by 15% over the year. Drought in producing countries led to a jump of 28% in prices for fats and oils while other agriculture prices rose moderately. Rice prices continued their rally, increasing by about 15% (Thai, 5%) between 2001 and 2003. After 3 years of decline, coffee prices rose slightly in 2003. Commodity prices are projected to remain generally strong in 2004 although the recent rates of price increases cannot be sustained for a number of items, particularly some agricultural commodities.

In the first quarter of 2004, mineral and metal prices continued to soar with a quarter-on-quarter price increase of about 20%. Projections indicate a continued strong rally of metals and minerals prices this year, led to a large extent by demand from the PRC and the rest of developing Asia. Price increases should level off in 2005 as world demand slows and stocks are reconstituted. Forecasts from the Oxford Economic Forecasting model

show metal prices rising by about 20% in 2004. The projections point to continued strong price gains for copper, lead, nickel, steel, tin, and zinc. Strong demand from the PRC, increasing demand from industrial countries, and low stock levels will positively impact on the prices of these commodities in 2004.

Due to more rapid supply responses, agricultural prices are expected to continue their rally in 2004–2005 but at a much slower pace. However, agricultural raw materials prices—rubber and cotton in particular—are projected to show strong price gains in 2004 as world demand remains strong, but prices should level off in 2005, except perhaps for rubber. As supply improves, fats and oils prices (including palm and soybean oil) are projected to increase moderately in 2004, and decline somewhat in 2005. Among other main agricultural prices, forecasts for 2004 show stronger gains for rice prices and gains for coffee prices as markets for both commodities will be tight in 2004, before easing in 2005. Finally, the long-awaited revival of the electronics sector will lead to stronger dollar prices in 2004 for products such as DRAM chips, flash memory, and integrated circuits.

Financial Market Developments

Overall, inflation in the world economy, and in industrial countries in particular, remained historically low in 2003. OECD inflation (as measured by the GDP deflator) declined from 2.1% in 2002 to 1.8% in 2003, allowing monetary policies to remain accommodative throughout the year. Although relatively high oil prices have been creating upward pressures, overall consumer prices in the US rose by 1.7% (before seasonal adjustment) in the year to March 2004. Core inflation remains somewhat lower. In Japan, deflation is still apparent, although it has started moderating. In the euro zone, inflation recently abated to just under 2.0%.

Hence, in major industrial countries, interest rates also remain exceptionally low. The US Federal Funds rate has stayed at a 46-year historically low rate of 1.0% since June 2003, while in the euro zone, the ECB rate was 2.0% over the same period. In Japan, the discount rate has been maintained at 0.1% since 2002. A few countries have, however, started to raise interest rates in 2003, notably Australia and the UK, which have been concerned by a possible bubble in asset prices—mainly in real estate—and high household indebtedness. Forecasts indicate inflation in OECD countries slowing somewhat in 2004 before picking up mildly in 2005. Euro zone inflation is, though, projected to decelerate over the next 2 years, possibly leading to a downward adjustment in ECB rates. In the US, a pickup in core inflation is likely during the second half of 2004 as

higher oil prices and the depreciation of the dollar pass through the system and as growth remains robust. The response of the Federal Reserve to an increase in inflation will critically depend on the performance of the labor market. If strong growth does not create a significant number of new jobs, the Federal Reserve is likely to keep rates on hold. A progressive return to somewhat higher rates is likely only later in 2004 as core inflation picks up. The baseline assumption is for the Federal Funds rate to average 1.1–1.3% in 2004, increasing to 2.5–3.0% in 2005. The 6-month London interbank offered rate is projected to increase to about 1.6% in 2004 (from 1.1% in 2003). In contrast, the 6-month euro interbank offered rate is forecast to edge down to 2.0% in 2004 (from 2.3% in 2003).

Corporate profits, which started to improve somewhat in 2002, mainly in the US, recovered sharply during the second half of the year, not only in the US but also in Japan, and to a lesser extent the EU. In the US, strong productivity growth continued to fuel corporate profitability. With corporate prospects improving and the uncertainties linked to the Iraq conflict abating, the US stock market recovered sharply from the second half of 2003; in Japan, the better outlook for the economy led to a surge in the Nikkei 225,; while in the EU, some improvements in the prospects for many economies also translated into significant stock market gains. Despite some setback in the first quarter of 2004, stock markets in major industrial countries should remain relatively robust through 2004–2005 as the cycle moves toward its peak. The improved corporate profitability outlook combined with a revival in stock markets augurs well for capital spending in major industrial countries in 2004–2005. In emerging markets, continued low world interest rates and a strengthening world recovery also led to surging equity markets, particularly across developing Asia. Prospects for regional equity markets in 2004–2005 remain upbeat, which will have a positive impact on business investment.

After hitting a 45-year low in June 2003 and after the Federal Reserve indicated that deflation was no longer likely, US bond prices fell and the yield on 10-year US treasury bills jumped by more than 100 basis points to 4.85% on 31 July 2003. At that time, there was serious concern that long-term interest rates would start to rise as growth accelerated in the US and expectations of huge US treasury financing requirements would influence market expectations. As it turned out, the recovery indeed gained momentum in the US but it was “jobless.” The lack of job creation appears to have dominated market sentiment, moderating long-term (10-year) bond yields at around 4.5% since November 2003. At the short end of the market (up to 2 years), the US yield curve has steepened somewhat since the third quarter of 2003, as the market did not expect further rate cuts. At

the long end (10 years), yields have remained virtually unchanged and even fallen somewhat since the end of the third quarter of 2003, reflecting market sentiment that interest rates will not be raised for some time. However, the reaction of the bond market to the Federal Reserve's January announcement that it will "be patient" on rate increases indicates that it could react fast (and furiously) to any hint of rate increases.

The euro benchmark yield curve continues to show an inverted shape, sloping down at the short end as further rate cuts by the ECB are expected, before sloping up for maturities beyond 1 year. At the long end, rates rose in July 2003 but by only 40 basis points to 4.2%, and they have stayed virtually unchanged since then. Since the beginning of 2004, euro bond yields for 10-year maturities have been falling somewhat, indicating that the markets expect no major interest rate hike.

Emerging markets have benefited from a long period of about 15 months of compression in sovereign risk spreads. Average spreads were 526 basis points in 2003, compared with 728 in 2002. Developing member countries (DMCs) took advantage of these favorable conditions by issuing nearly $75 billion of bonds and notes in international capital markets in 2003, and by offering about $30 billion in stock issues. As opportunities for higher returns in mature markets materialize in the period ahead with increases in interest rates, the decline in spreads is expected to reverse in later 2004 and the spread will continue to widen in 2005. This development will be very important for countries with lower credit ratings as external funding will become more onerous for them. This will call for careful planning of funding external requirements over the next 2 years.

According to Institute of International Finance data, net private capital flows to emerging markets rose to a 3-year high of $194.1 billion in 2003, up from $128.3 billion in 2002. Net private flows to developing Asia accounted for $116.7 billion, nearly double the amount of $66.3 billion in 2002. Half of this total ($58.3 billion) was financed by direct investment, much of it flowing to the PRC. An improving economic environment and rising corporate profitability led to a surge in portfolio inflows to developing Asia from $2.8 billion in 2002 to $29.4 billion in 2003. Bank and nonbank lending accounted for a further $29.0 billion, up from $6.7 billion in 2002.

The prospects for private capital flows to developing Asia remain bright for 2004. The large foreign direct investment (FDI) commitments over the past few years, particularly in the PRC, should translate into continued strong growth in FDI inflows to the region. India and Thailand should also benefit from larger inflows of FDI in 2004. Estimates by the Institute of International Finance put total FDI inflows to the region at about $62 billion net, with about 85% going to the PRC. The region's stock

markets will remain very attractive to investors, though inflows are likely to be somewhat lower than the high levels observed in 2003. In contrast, as yields move up and spreads widen for emerging markets, bond issues might be significantly lower than in 2003. The PRC might also take measures to discourage external borrowing.

RISKS TO THE OUTLOOK FOR DEVELOPING ASIA AND THE PACIFIC

ADO 2003 and *ADO 2003 Update* identified three sets of risks for developing Asia: geopolitical, SARS related, and global economic. The geopolitical risks associated with the threat of terrorism remain, unfortunately, very much a reality for developing Asia, while the end-2003 and early-2004 outbreak of an avian flu epidemic has been a clear reminder that epidemics will continue to be a major risk for Asian economies. Enhanced regional cooperation is of paramount importance in containing the human and economic impact of such epidemics.

Global economic risks have not abated, and they essentially pertains to the sustainability of the economic recovery in major industrial countries and to world economic imbalances. While developing Asia is increasingly playing a major role in the global economic context, developments in major industrial countries remain very important to the regional outlook. Imbalances in the recovery of industrial countries hold significant risks for Asian economies.

ADO 2004 adds a new set of economic risks that are more specifically regional. They are linked to rapidly increasing regional economic interdependence itself. The surge in intraregional trade has been a major positive development for the region, but it also carries with it these new risks.

Global Economic Risks

By the first quarter of 2004, and for the first time since 2000, a broad and robust economic recovery appears to be under way globally, led mainly by the US and developing Asia. In Japan, the economic pickup was deepening while in the euro zone some signs of improvements were also apparent. In spite of rising oil and commodity prices, inflationary pressures remained generally subdued. In major industrial countries, generally expansionary fiscal policies—and a huge fiscal stimulus in the US in particular—together with accommodative monetary policies have fueled the recovery. As a result, since mid-2003, interest rates have all been at historical lows across all maturity ranges while fiscal deficits have been widening particularly in the US. Room for further macroeconomic stimulus appears to have hit its limits.

Behind this upbeat picture of the world economy, there are however significant imbalances and risks, which could threaten economic performance over the forecast period. In the nearer term, the major concern is the uncertain employment situation in the US. While employment data released in March 2004 appear to indicate a revival in the labor market, uncertainties remain. If the improved job market outlook is not confirmed over the next few months, consumer spending could be negatively impacted, and US growth would slow. The strengthening of labor markets in industrial countries, and with it the broadening of the expansion, is particularly crucial as the current stances of macroeconomic policies are not sustainable over the medium and longer term, especially in the US.

Monetary policy will have to be tightened within the next year, first in the US and later probably in the EU. The current extremely low interest rate environment cannot be maintained for several reasons. First, rising oil and commodity prices together with a prolonged period of production growth in the world economy will put upward pressure on inflation. Second, low interest rates have led to a ballooning of household debt—at over 100% of disposable income in the US—and the possible emergence of asset bubbles. Finally, the increasing burden of financing the US fiscal deficit will put upward pressure on interest rates, particularly if Asian central banks scale back their purchases of US debt (as is likely over the forecast horizon). While the timing remains very uncertain and looks still some time off, the rate increases will have a very significant impact on bond markets, financial markets, and asset prices.

The severity of the impact will crucially depend on the quality and depth of the recovery at the time, particularly in terms of employment and income generation. Investor and consumer perception of the depth of the recovery will determine the financial markets' responses to rate increases. Weak sentiment could create significant volatility in financial markets, and in fixed income markets in particular—as seen in June–July 2003—pushing long-term interest rates substantially higher. Costlier debt repayments would directly impact highly leveraged households and corporations. Real estate markets would be affected across industrial countries, and government borrowing costs would jump. The upshot is that the circumstances and imbalances characterizing the current economic recovery make the necessary adjustments to tighter macroeconomic policy particularly delicate and uncertain. A period of low growth in industrial countries with inflation and real interest rates both higher is a definite possibility.

Two major imbalances that do not appear to overly concern the markets so far could exacerbate the above outcome over the forecast horizon: the US fiscal and current account deficits. First, under present

policies, projections indicate that the US will be running a very large fiscal deficit for a long time. Over the longer term, the burden of financing the needs of aging populations in industrial countries will also put pressure on national budgets. As interest rates rise, markets might start factoring in more strongly the prospect of financing widening fiscal deficits. This would tend to push up further long-term interest rates.

Second, while financial markets have not shown much concern about the US current account deficit so far, this situation may change. As monetary policies are tightened, greater volatility in financial markets amid rising interest rates could spill over into greater dollar exchange rate volatility. Markets could start evaluating more closely whether a visible correction of the US current account is under way. A number of outcomes are possible. A very large depreciation of the dollar itself will not suffice to narrow the US current account deficit. A compression of US demand will be needed to reduce imports, and hence the likelihood of a low- growth period with higher interest rates. However, the negative impact of this outcome could be substantially mitigated if global growth is more broadly dispersed across countries. The implications are that growth needs to accelerate in industrial countries other than the US, and that more flexible exchange rate policies need to be followed, particularly in Asia. A worst-case scenario would be for governments to seek adjustments through a sharp rise in trade protectionism.

It is obvious from the above analysis that there is a large degree of uncertainty associated with the adjustment process that the global economy needs to go through over the next 2 years. For developing countries in Asia, it is important to evaluate what this negative outcome could be. It is also important to realize that, increasingly, developing Asia is an intrinsic part of the adjustment process. A smooth adjustment in the global economy will greatly benefit from continued strong growth and the pursuit of pragmatic economic policies in the region.

Regional Economic Risks

While, as mentioned, developing Asia is an increasingly important element in shaping global developments, there are a number of risks in the outlook that relate more specifically to the region. In most cases, risks can also be viewed as opportunities—opportunities to cooperate and reform. In fact, the current strong underlying economic growth trends in the region create a unique occasion to turn these risks into opportunities.

Two distinctive and very positive features of economic developments in the region over the past few years have been the emergence of intraregional trade as a major driver of growth and the increasing importance of domestic consumption demand in many countries. These features could

become even more important if the recovery in major industrial countries were to falter. While these developments are positive elements in the medium-term outlook for developing Asia, they also inherently carry risks to regional growth as the interdependence among the economies of the region is becoming stronger. Managing the concomitant risks is creating new challenges for policy makers as their national policy decisions are increasingly impacting on other countries in the region.

Among the regional risks that also have substantial global implications, an overheating of investment in the PRC is probably the most important. The phenomenal growth of investment in that country could increasingly become inflationary, as prices of raw materials, land, and factors of production other than labor could soar. Already, many commodity prices and transportation rates are being boosted by demand from the PRC. The Government has indeed announced measures to contain overinvestment. However, the situation will have to be closely monitored as the impact of overheating in the PRC could have repercussions on export trade in many other economies in developing Asia. Over the longer term, overinvestment would result in a capacity overhang which would also adversely affect the region. Other major policy challenges in the PRC are well known, and include the need for fiscal consolidation and for financial sector—particularly banking—reforms and SOE reforms. The successful handling of these challenges is extremely important to regional growth.

The shift toward progressively stronger domestic demand-led growth can be welcomed. Household debt levels must, though, be monitored and contained if financial systems, which have not fully recovered from the financial crisis, are not to face a new form of NPLs as well as a new crisis, if income growth slows. There is evidence that, in several Asian developing countries, continued accommodative monetary policies, and the proactive efforts of financial institutions to diversify their earnings base is fueling rapid growth in household debt. Improved regulation and supervision is called for, along with some tightening of monetary policies. The policy dilemma will be to mitigate the impact of higher interest rates on badly needed business investment, which has remained weak in a number of countries, particularly in Southeast Asia.

It is clear that the deepening of financial sector reforms, including the further development of nonbanking financial institutions, remains central to the reform process and sustained high growth in all economies of the region. There is concern that financial sector reforms have been slowing or have stalled over the past 2 years in several countries in developing Asia, partly because stronger growth masks possible problems (such as lack of resolution of NPLs—see following section). High growth thus offers a unique opportunity for accelerated economic reforms; it should not be used as an excuse for complacency.

The huge accumulation of foreign exchange reserves by many countries in Asia over the past 2 years is a striking phenomenon. Reserves are now estimated at $1.3 trillion. As pointed out in *ADO 2003*, reserves in most countries have significantly overtaken short-term debt. While originally the accumulation of reserves reflected the prudent behavior of policy makers, increasingly however, it appears to be fueled by speculative market behavior stemming from rigidities in many of the region's exchange rates. Such a development carries significant risks for the region. First, except for countries with closed capital accounts, capital flows could reverse briskly, sending negative signals about the economies affected, even though the economic fundamentals remained unchanged. Second, and more important, interventions to maintain stable exchange rates against the dollar could result in significant further increases in domestic liquidity, which if not sterilized—an increasingly difficult task—might lead to unbridled domestic credit expansion and possibly create the conditions for a new Asian financial crisis. Third, the reserves, which are held mainly in the form of US dollar deposits and US treasury bills, are vulnerable to a loss in value as the dollar depreciates. Hence, it might be an opportune time to reassess the policies underlying the large accumulation of foreign exchange reserves in the region.

While countries in developing Asia all face major macroeconomic policy challenges and long reform agendas which, if not tackled, will become risks to their outlook, they all need also to maintain sustainable robust economic growth over the medium and long term in order to generate employment opportunities for large and fast-growing labor forces. In a sense, this is a key risk faced by the whole of developing Asia over the medium term. In this context, countries will need to implement structural reforms to improve their investment climate and competitiveness, and enhance productivity. These reforms will be particularly complex as they are needed at a time when the fiscal situation in many Asian countries needs consolidation. Ensuring greater efficiency of the public sector, competent public debt management, improved corporate governance, and enlightened public-private partnerships will be key policy challenges over the medium term. Again, greater regional integration has given a new dimension to the need for such policies. These issues will be particularly important in 2004 as many Asian economies are holding elections, including Hong Kong, China; India; Indonesia; Korea; Malaysia; Philippines; Sri Lanka; and Taipei,China.

Finally, an issue to be looked at is how much fast-rising consumption demand in some countries reflects rapidly growing income inequalities. This could be a risk to the medium-term outlook, since not only income growth, but also employment generation for large and rapidly growing

labor forces will be essential for economic growth to be sustainable. Labor market reforms and measures to lift the skills of the labor force will be critical to address these inequalities, as well as the inequalities between the countries of the region. Economic policies will thus need to emphasize how growth can be socially inclusive, benefiting progressively larger segments of the population. Increasingly, microreforms to foster the development of small and medium enterprises and the establishment of social safety nets will need to be a part of the core policy agenda. Also, in the context of greater participation of people in policy decision making in developing Asia in general, such inclusive growth will be important for people to feel any ownership of the continuing reform process.

In conclusion, the opportunity provided by the next 2 years of robust growth must be used to initiate and sustain a wide-ranging raft of reforms in developing Asia. These reforms should aim to support socially inclusive development, which is essential to rapidly expand the constituency for reform. The sustainability of the reform process and high growth rates hinges on building and broadening this constituency.

Part II

DEVELOPING ASIA: SUBREGIONAL TRENDS AND PROSPECTS

EAST ASIA

East Asia's aggregate GDP expanded by 6.5% in 2003, a little slower than in 2002 but a much stronger result than was anticipated during most of 2003 (Table 3). Expectations were relatively low because, in addition to the setbacks in the first half caused by SARS, the weak international economy, and conflict in Iraq, three of the five East Asian economies struggled with deep-seated problems of their own—widespread personal debt delinquencies in Korea; the slide in the Hong Kong, China property market, which did not bottom out until August; and the aftermath for Taipei,China of the ending of the global information technology (IT) boom.

Table 3. Growth Rate of GDP, East Asia, 2001-2005, %

	2001	2002	2003	2004	2005
East Asia	4.6	6.7	6.5	6.9	6.8
China, People's Rep. of	7.3	8.0	9.1	8.3	8.2
Hong Kong, China	0.5	2.3	3.3	6.0	5.0
Korea, Rep. of	3.8	7.0	3.1	4.8	5.2
Mongolia	1.1	4.0	5.5	5.8	6.0
Taipei,China	-2.2	3.6	3.2	5.4	4.7

Sources: Asian Development Outlook database; staff estimates.

Economic conditions varied between economies in the subregion (Table 4). The PRC stood out with growth accelerating to 9.1%, bolstered by buoyant domestic demand, booming exports, and surging FDI. Hong Kong, China; Korea; and Taipei,China experienced brisk export growth, but their domestic demand was subdued for most of the year. In Mongolia, a recovery in agricultural output and expansion of services more than offset a slowdown in industrial growth. The generally firmer economic growth in the second half of 2003 reduced deflationary pressures in Hong Kong, China and in Taipei,China. In the PRC, concerns about overheating in some sectors prompted government measures to curb credit. Unemployment tended to rise in the subregion during the first half, then started to fall as economic growth picked up.

Table 4. Contribution to GDP Growth, East Asia, 2003-2005

Item	2003	2004	2005
PRC			
GDP growth	9.1	8.3	8.2
Consumption	3.9	3.2	2.9
Investment	6.3	7.1	5.7
Net exports	-1.1	-1.9	-0.4
Hong Kong, China			
GDP growth	3.3	6.0	5.0
Consumption	0.2	3.9	3.0
Investment	0.4	3.8	1.7
Net exports	2.7	-1.7	0.3
Republic of Korea			
GDP growth	3.1	4.8	5.2
Consumption	-0.3	0.0	2.1
Investment	0.5	2.3	2.6
Net exports	2.8	2.5	0.5
Taipei,China			
GDP growth	3.2	5.4	4.7
Consumption	0.6	2.8	2.7
Investment	0.3	1.5	1.3
Net exports	2.4	1.1	0.7

Note: Figures may not add up due to statistical discrepancy.
Sources: Staff estimates.

The prospects for 2004–2005 are bright. Global economic conditions have improved, Hong Kong, China's property market is recovering strongly, IT demand has picked up, and Korea is addressing its household debt problems. Average growth for East Asia in 2004 is expected to increase to 6.9%, the highest rate in 4 years, and to stay close to that level in 2005.

One significant development is that rising domestic demand will play an important role in lifting overall growth. While exports will remain strong, the contribution to growth of net exports will probably moderate in most economies because imports will rise as domestic demand increases.

Again, the PRC will stand out with likely growth of 8.3% in 2004 and 8.2% in 2005, on the back of buoyant domestic and external demand. Strong investment growth will contribute the majority of its overall growth. Consumption will accelerate, supported by rapid urbanization and changing consumption patterns, such as increased demand for higher-quality and a wider variety of goods and services. Growth in exports will slow from the torrid 34.6% pace in 2003, with the result that net exports will contribute little to overall GDP growth in the PRC.

The strong demand from consumers and industries in the PRC will continue to fuel growth in exports from many economies, especially the PRC's neighbors, though rising domestic demand will become the main factor propelling the economies of Hong Kong, China and Taipei,China as robust growth in their imports outpaces still-strong growth in exports.

The importance of exports, however, should not be underestimated because buoyant foreign sales will be a major factor leading to stronger domestic demand. In Taipei,China, for example, strong international demand for IT exports in recent months has raised capacity utilization at exporting firms, prompting them to expand their production capacity. This has laid a solid foundation for stronger investment growth. In turn, the labor market will receive a fillip from the greater production capacity and related construction activity. Increased employment will spur consumer spending. Consequently, GDP growth in Taipei,China is expected to jump by more than 2 percentage points in 2004. In Hong Kong, China, strong exports and a rebound in the property market will boost investment, employment, and consumption. GDP growth in that economy is likely to nearly double to around 6% in 2004, then slow a little to around 5% in 2005.

Korea presents a somewhat different scenario because net exports will continue to be the main driver of growth. Strong exports will increase investment demand, but it might be some time before private consumption growth revives as severe household debt problems have hit consumer confidence. When domestic demand strengthens later in 2004 and 2005, the relative contribution to growth of exports will fade. Korea's GDP growth is forecast at 4.8% in 2004, rising to 5.2% in 2005. In Mongolia, the least developed of the five East Asian economies, further expansion of agriculture and moderate gains in industry and services are projected to lift GDP growth to 5.8% in 2004 and to 6.0% in 2005.

Despite the positive outlook, all of the East Asian economies face policy challenges in 2004. One major challenge for the PRC is to prolong robust growth without causing serious imbalances, some of which emerged in 2003. A lending boom is fueling overinvestment in some sectors and pushing up prices of raw materials. There are concerns that the surge in lending may lead to more NPLs in the already weak banking system. Strong demand for electricity from industry and consumers has caused increasingly frequent power shortages. Economic policies need to maintain the growth momentum, facilitate expansion in sectors that need extra supply capacity, and also curb overheating, as the PRC monetary authorities have started to do by tightening credit.

The functioning of factor markets—labor and capital—requires attention in several economies. High unemployment is especially acute in the transition economies of the PRC and Mongolia. The PRC's rapid growth still is inadequate to absorb surplus agricultural labor, new labor market entrants, and workers laid off from state-owned enterprises (SOEs). Unofficial estimates put the jobless rate at 8%. Much of the unemployment comes from structural changes and cannot be quickly solved through rapid economic growth. Governments faced with such a situation need to ease the adjustment costs through retraining assistance, job creation, and by providing basic social safety nets if they are to maintain broad support for economic reforms. The key, though, is to improve the environment for the private sector to create jobs. Hong Kong, China; Korea; and Taipei,China have also experienced rising unemployment in recent years. Although employment has started to improve, strategies for the longer term require more flexible labor markets, mainly in Korea, and the related issue of training and support for people moving between jobs.

In the capital markets, financial reforms remain incomplete in the subregion. NPL ratios in Korea and Taipei,China have declined because of extensive financial reforms, though in Korea the need for further reforms was demonstrated by failures in risk control and regulation that allowed a consumer credit bubble to build. The Government of the PRC has a long way to go to strengthen its banking sector. Much also needs to be done to strengthen capital markets and nonbank financial institutions in much of the rest of East Asia.

Fiscal policy issues are another area for attention in 2004. As growth gathers momentum, the need to use fiscal policy for short-term demand management has lessened. Instead, fiscal policy needs to shift to address the longer-term market failures and structural problems. In the PRC, budgetary resources are needed to tackle issues of poverty, structural unemployment, inadequate education and health care in rural areas, a

weak social security system, a deteriorating environment, and underdevelopment of the central and western regions. In Taipei,China, rising public deficits and debt have raised questions about the adequacy of tax revenues. The bursting of Hong Kong, China's property bubble exposed the vulnerability of its land-based revenue system and the authorities are considering changes to this system.

Subregional governments should also consider further measures to deal with poverty. Although the PRC's rapid growth has lifted millions out of poverty, eliminating absolute poverty remains a distant goal, and in Mongolia, poverty incidence is still high. They also need to tackle rising income inequalities, which have been widening in most of the subregion.

East Asia remains a dynamic region with a better record than most in terms of facing up to policy challenges. It is likely do so again, which will alleviate the risks emanating from the domestic factors as well as those from external events.

Southeast Asia

Despite a series of external shocks, aggregate GDP for Southeast Asia expanded by 4.6% in 2003, more than half a percentage point faster than anticipated (Table 5). Thailand and Viet Nam posted particularly strong and broadly based growth. In Cambodia and the Lao People's Democratic Republic (Lao PDR), growth remained relatively robust. Malaysia's economy, the second highest in per capita income in Southeast Asia, pursued its recovery, growing well above the subregional average. GDP growth remained moderate in Indonesia and the Philippines, though

Table 5. Growth Rate of GDP, Southeast Asia, 2001-2005, %

	2001	2002	2003	2004	2005
Southeast Asia	1.9	4.2	4.6	5.7	5.4
Cambodia	5.7	5.5	5.0	5.4	5.4
Indonesia	3.5	3.7	4.1	4.5	4.5
Lao People's Dem. Rep.	5.8	5.9	5.9	6.0	6.2
Malaysia	0.3	4.1	5.2	5.8	5.6
Myanmar	11.3	10.0	10.6	—	—
Philippines	3.0	4.4	4.5	5.0	5.0
Singapore	-1.9	2.2	1.1	5.6	4.8
Thailand	2.1	5.4	6.7	7.2	6.2
Viet Nam	5.8	6.4	7.1	7.5	7.6

Sources: Asian Development Outlook database; staff estimates.

improving somewhat relative to 2002. In contrast, Singapore's economy hardly grew as major structural changes dampened domestic demand. It was also the most affected by the SARS epidemic.

A key feature of the 2003 performance is that, in all countries (with the notable exception of Singapore), consumption expenditures, particularly private consumption, contributed the most to GDP growth (Table 6). The continued strengthening of consumption in 2003 was fueled by generally accommodative monetary policies, combined with moderately expansionary fiscal policies. The fiscal stimulus was more aggressive in Malaysia where government consumption expanded rapidly. In Thailand, expenditures in rural areas were further boosted by off-budget programs. Strong growth in remittances supported consumer spending in the Philippines.

In a worrisome development, the 2003 outcome showed continued weakness in business investment in most Southeast Asian countries. The notable exceptions were Thailand and Viet Nam. Weak investment in the other countries stemmed from a variety of reasons, including remaining excess capacity, political uncertainties linked to elections in 2003 and 2004 in several countries, and uncompetitive investment climates checking FDI.

The acceleration of recovery in many industrial countries as well as the huge increase in the PRC's demand for regional imports spurred strong export growth in many Southeast Asian countries in 2003. Despite the upward pressure of buoyant consumption demand on imports, net exports also contributed substantially to overall growth in most countries. (The only reason for Singapore's growth in 2003 was the contribution of exports.) Exceptions were the Philippines and Viet Nam: in the Philippines, some major exports such as electronics and garments turned in a lackluster performance, while in Viet Nam, despite a surge in exports, imports increased faster due to high demand for capital and intermediate goods by a fast-growing industry sector. Strong growth in the PRC and rapidly rising production-sharing in developing Asia has spurred the export growth of Southeast Asian countries to the PRC. Exports of the subregion to the PRC accounted for 6.4% of exports and expanded by an average 59.1% in 2003.

GDP projections for Southeast Asia indicate an acceleration in growth to 5.7% in 2004, moderating somewhat to 5.4% in 2005. Prospects for all countries will improve, as in addition to domestic factors, the global outlook will be the most favorable in many years, benefiting the export-oriented economies of the subregion, though robust growth will largely emanate from the two best performers in 2003, namely Thailand and Viet Nam. The Lao PDR and Malaysia will also grow at just above the subregional average. A firm recovery should take hold in Singapore as

Table 6. Contribution to Growth, Southeast Asia, 2003-2005 (percentage points)

Item	2003	2004	2005
Indonesia			
GDP Growth	4.1	4.5	4.5
Total consumption	3.6	6.0	4.1
Private consumption	2.8	5.4	3.6
Government consumption	0.8	0.6	0.5
Total investment	-0.2	-1.6	0.2
Net exports	0.7	0.1	0.2
Malaysia			
GDP Growth	5.2	5.8	5.6
Total consumption	3.5	4.2	4.8
Private consumption	2.4	3.7	4.3
Government consumption	1.1	0.5	0.5
Total investment	-0.3	1.5	1.7
Net exports	2.0	0.1	-0.9
Philippines			
GDP Growth	4.5	5.0	5.0
Total consumption	3.8	4.4	4.4
Private consumption	4.0	4.3	4.3
Government consumption	-0.2	0.1	0.1
Total investment	1.1	0.9	0.9
Net exports	-3.8	-2.0	-2.2
Singapore			
GDP Growth	1.1	5.6	4.8
Total consumption	-0.2	1.3	1.4
Private consumption	-0.2	1.3	1.4
Government consumption	0.0	0.0	0.0
Total investment	-7.3	2.4	5.6
Net exports	8.7	1.9	-2.3
Thailand			
GDP Growth	6.7	7.2	6.2
Total consumption	3.6	3.6	3.3
Private consumption	3.5	3.3	3.0
Government consumption	0.1	0.3	0.3
Total investment	2.6	2.9	2.6
Net exports	0.5	0.7	0.5
Viet Nam			
GDP Growth	7.1	7.5	7.6
Total consumption	5.3	6.9	6.1
Private consumption	4.8	6.2	5.9
Government consumption	0.5	0.7	0.2
Total investment	4.8	4.2	3.0
Net exports	-3.0	-3.6	-1.5

Note: Figures may not add up due to statistical discrepancy.
Source: Staff estimates.

measures to reduce the cost of business and to improve productivity and competitiveness start to show an impact. However, despite some improvement, growth will remain subdued in the Philippines and more so in Indonesia.

Consumption, particularly private consumption, will strengthen its position further as the main driver of growth in all countries. Supportive macroeconomic policies pursued in 2003 are expected to continue in 2004–2005, mainly in the guise of accommodative monetary policies. Consumption will also be supported by the sustained per capita income growth since 2002 in most subregional countries as well as by high commodity prices, while spending for 2004 elections in Indonesia, Malaysia, and Philippines will provide a further boost.

The wide diversity in growth performances among the countries of Southeast Asia over the forecast period can be traced to significant differences in investment expenditures. As in 2003, investment performance, though improving somewhat, will remain relatively weak in Indonesia, Philippines, and, to a lesser extent, Malaysia in 2004–2005. This trend can be observed both from the contribution of investment to growth and from low or falling investment ratios in these countries.

As restructuring of its economy proceeds and its cost structure is reduced, Singapore should see a recovery in investment, particularly in 2005. Projections indicate continued strong investment activity in Thailand and Viet Nam. A stable policy environment and strong domestic and external demand will lead to continued expansion in private investment in construction and equipment in Thailand. In Viet Nam, the private sector will develop rapidly as reforms to further improve the business environment continue. An estimated 19,000 private enterprises have been registered annually over the past 4 years alone. Investment-to-GDP ratios are also forecast to rise well above 20% in Cambodia and the Lao PDR, as the former benefits from increased investment in tourism activities and an improved political environment, and regional investment from Thailand in particular increases in the latter.

A very mixed picture for 2004–2005 emerges from the external sector performance in Southeast Asia. After the recovery in exports in 2003, export growth will settle to somewhat lower rates in 2004 and especially 2005, despite bullish global prospects. (The PRC's import growth rate should also moderate from its surge in 2003..) In contrast, buoyant domestic demand should lead to higher import growth in 2004. The overall current account surplus for the subregion might increase marginally to around $60 billion in 2004–2005 but mainly as a result of a widening surplus in Singapore. Overall, the external sector is forecast to

contribute significantly to GDP growth in 2004 in Singapore and Thailand only. In all other countries, contributions will be negative (Philippines) or marginally positive.

Inflation in Southeast Asia will accelerate somewhat over the forecast horizon but remain relatively subdued at an average of 3.6% in 2004 and 3.8% in 2005. It is not a major concern except in Indonesia, Lao PDR, and Myanmar.

Fiscal deficits will remain high in the subregion with projections at 5.8% and 5.6% of GDP in 2004 and 2005, respectively. In most countries, fiscal deficits are a matter of concern and the scope for continued fiscal expansion will be limited over the next 2 years. Government debt levels are also high in Indonesia (55% of GDP), Malaysia (48% of GDP) and, particularly, the Philippines (77% of GDP). The window of opportunity given by a strong outlook should therefore be used by governments to ensure fiscal consolidation. This will better prepare these economies to withstand possible future economic shocks and slower economic growth, and to cope with higher interest rates.

The most worrisome feature of the outlook is the slow pace of business investment forecast for several countries of Southeast Asia at a time when these economies are expected to show more robust growth. These countries will need to substantially boost investment if they are to raise their potential growth rates and remain competitive in an increasingly integrated Asian region. They also need to position themselves to be able to compete with the PRC while also being able to export to that country. In all of these countries, policies to improve the investment climate will be of paramount importance over the forecast period. Broadly, these include continued financial sector and fiscal reforms, public administration, trade and labor market reforms, and the establishment of a simple and transparent FDI regime (see Part 3).

Finally, another main concern is that while the growth environment over the next 2 years will be one of the best in a long time, GDP forecast growth in several Southeast Asian countries remains well below their potential, and will be insufficient to generate employment for new labor force entrants. As a corollary, these growth rates will be too low to bring about a significant reduction in the incidence of poverty. Economic growth projections for both Indonesia and the Philippines are of particular concern. The combined population of both countries is significant at 320 million, and unemployment is high and well above the levels in other countries in the subregion. It is estimated that economic growth in these two countries would need to accelerate by 1.5–2 percentage points above the average performance in 2002–2003 to ensure a decrease in unemployment and a significant reduction in poverty. Economic growth

projections for Cambodia, too, are well below the pace required to generate sufficient employment in a country where the incidence of poverty is 35–40%. Unemployment is not a major issue in Malaysia, but the economy is forecast to expand below its potential, which is estimated at about 6.5–7%.

Hence, several subregional countries risk falling behind their competitors unless they aggressively pursue policies to improve productivity and competitiveness. The main challenge for them over the forecast period will be to raise investment substantially.

South Asia

The return of favorable weather conditions generally in South Asian countries in 2003 led to a marked recovery in agricultural output from the very depressed levels of a year earlier. With a relatively large share of agriculture in output and employment, GDP growth for the subregion rebounded to a record high of 6.9%, well above the 5.7% recovery projected in *ADO 2003*, with all countries achieving a more rapid expansion than had been projected (Table 7).

Table 7. Growth Rate of GDP, South Asia, 2001-2005, %

	2001	2002	2003	2004	2005
South Asia	5.2	3.9	6.9	7.0	7.2
Afghanistan	—	—	—	—	—
Bangladesh	5.3	4.4	5.3	5.7	6.0
Bhutan	7.1	6.7	6.5	7.0	8.0
India	5.8	4.0	7.3	7.4	7.6
Maldives	3.4	6.5	8.4	5.5	5.0
Nepal	4.6	-0.4	2.6	4.0	5.0
Pakistan	2.2	3.4	5.1	5.5	5.8
Sri Lanka	-1.5	4.0	5.5	5.0	5.5

Sources: Asian Development Outlook database; staff estimates.

In India (accounting for nearly 80% of the subregion's GDP output) the sharp turnaround in agricultural output (from a contraction of 5.2% to an estimated 7–8% growth in FY2003) combined with a continuing rapid expansion in industry and services pushed GDP growth to an estimated 7.3%. Growth in private consumption nearly doubled from a year earlier and contributed about two thirds of the increase in GDP; expansion of fixed investment continued to be relatively strong. Pakistan also saw a significant upturn in agriculture after 2 years of decline. GDP growth strengthened to 5.1%, the best outcome in 6 years, pushed by net exports

that accounted for more than three fifths of the expansion. Faster growth in Bangladesh at 5.3% in FY2003 also reflected a significant pickup in agriculture and private consumption. Despite gains in export-oriented manufacturing, the net foreign balance, generally a positive source of growth, turned slightly negative because of buoyant import growth.

The first rough estimates of GDP in Afghanistan indicate that the economy is likely to have grown by 20% in FY2003 after a 28.6% gain a year earlier. Following a 3-year drought, grain production increased by about 83% in 2002 and by 62% in 2003. This was a significant boost to welfare as agriculture accounts for about one half of GDP and four fifths of employment. The growth of the opium trade to about one half the size of the legal economy however, providing a large impact on domestic demand and incomes, is a major issue to be faced if Afghanistan is to become a truly secure and stable nation.

In the second year of the cease-fire agreement, Sri Lanka continued to recover from the 2001 recession with GDP in 2003 estimated to have grown by 5.5%. Tourist arrivals rose by over 27% to exceed 500,000, a record, supporting expansion in the services sector that accounted for about two thirds of the increase in GDP. Tourist arrivals also reached a record number of about 560,000 in the Maldives, where the economy grew by 8.4% after 2 tepid years stemming from the downturn in travel after the September 11 events. In Nepal, a cease-fire agreement with insurgents from January to August fostered a moderate economic recovery following the downturn of a year earlier. The trade and tourism sectors rebounded and manufacturing output strengthened, bringing GDP growth to 2.6% in FY2003. Bhutan's economy continued its steady development, growing at 6.5%, though this was a slight slowing from a year earlier mainly due to more moderate construction activity.

Growth in South Asia is projected to edge up from the record performance in 2003 to 7.0% in 2004 and to 6.9% in 2005 with virtually all countries boosting performance. This forecast assumes that the breakthrough cooperative efforts that India and Pakistan started in 2003 to assure peaceful relations are continued and that there is no deterioration in the security situations in Afghanistan, Nepal, and Sri Lanka.

India's GDP growth outlook is buoyant— 7.4% in 2004 and 7.6% in 2005. Agriculture is expected to return to trend (3.0%). However, a peaking of industry sector growth in 2004 would be offsetting while expansion of the services sector would continue and provide the fillip in 2005. Despite this remarkable overall performance and the fact that India is becoming one of the fastest-growing economies in the world, it appears that it will not quite achieve the 8% target that the Government has set for rapid poverty reduction.

Pakistan's outlook is also for stronger growth of 5.5% and 5.8%, respectively, in 2004 and 2005. Solid improvement in macroeconomic fundamentals and structural reforms that are boosting investment activity (e.g., to modernize the textile industry) underpin this outlook. The Bangladesh economy has been strengthened by the policies adopted in completing its first-year of the Poverty Reduction and Growth Facility (PRGF) program with the International Monetary Fund. Deepening of reform efforts that would foster greater investment and the availability of additional concessional aid has improved the outlook for growth, which is projected to increase to 5.7% and 6.0%, respectively, in 2004 and 2005. However, the outlook for the garment and textile industry and employment generally in the post-Multifibre Arrangement (MFA) environment is worrisome.

Economic prospects in Afghanistan are promising and annual growth of 15% in the medium term is certainly feasible, though this will require the commitment of the international community to meet the country's investment and security needs.

Sri Lanka's GDP growth is tentatively projected to be 5.0% and 5.5% in 2004 and 2005, respectively, rates somewhat below those set in the ongoing PRGF program. There are, however, major uncertainties, including the approach to economic policy by the new Government following recent elections, the evolution of the cease-fire and peace negotiations, and developments in the garment and textile industry post MFA. With a full recovery in tourism, growth in the Maldives is projected to moderate to 5.5% and 5.0% in the period ahead. The Government is seeking to expand its tourist marketing effort in new regions, find sources for economic diversification, and stimulate outer atoll development in an effort to reduce poverty.

Despite a breakdown in the cease-fire agreement in August 2003, the security situation in Nepal has remained relatively calm. On the assumption that this situation does not deteriorate, the outlook is for the economic recovery to continue with GDP growth increasing to 4.0% and then to 5.0% in 2005 based on further improvement in trade, tourism, and agriculture. Economic performance sufficient to substantially reduce poverty in the medium term, however, crucially depends on a lasting resolution of the insurgency as well as reconciliation between the Government and political parties over the dismissal of Parliament. In Bhutan strong growth is projected at 7.0% in 2004 and then 8.0% in 2005. A major hydropower project to be commissioned in September 2005 will provide a large step-up in export and budget revenues.

Balance -of -payments developments in South Asia continued to be strong in 2003 with all countries, except the Maldives and Sri Lanka,

achieving a current account surplus that for the subregion amounted to 1.1% of GDP. Exchange rates against the dollar were generally stable or slightly appreciated over 2003; foreign exchange reserves substantially strengthened. Reflecting the pickup in the global economy, most subregional countries in 2003 posted double-digit growth in exports and imports while tourism and worker remittances also registered large gains. The outlook is for continued rapid growth in trade and the maintenance by countries of their current account surpluses, though these are expected to moderate; for the subregion as a whole they are projected at 0.4% and 0.2% of GDP, respectively, in 2004 and 2005.

Average subregional inflation increased to 4.9% in 2003 from 3.5% a year earlier, reflecting an edging up in prices in Bangladesh, India, and Nepal. Policies in Pakistan and Sri Lanka aimed at limiting inflation scored successes. While not at excessive levels, inflation in the subregion is appreciably higher than in East Asia or Southeast Asia. The projections for 2004 and 2005 indicate little change in the country pattern or level of inflation at just under 5%. This suggests that monetary policies will have to be tightened if global inflation picks up, particularly if oil prices exceed forecast assumptions, as South Asian countries are heavily dependent on imports.

Orientation toward economic liberalization and great reliance on private sector development is now more strongly rooted in subregional country economic policies and this augurs well for strong growth in the medium term. However, the maintenance of outsized fiscal deficits and high levels of government debt in nearly all countries is a source of serious concern. The adoption of fiscal responsibility laws containing specific consolidation objectives in India, Pakistan, and Sri Lanka as well as medium-term fiscal objectives in PRGF programs in Bangladesh, Nepal, and Sri Lanka are important first steps. Firm implementation of fiscal consolidation will, though, be necessary to avoid risk of disruption to the present encouraging outlook for growth and poverty reduction.

Central Asia

GDP growth in 2003 in the six Central Asian republics (CARs) as a group is estimated to have been 8.4%, well above the 5.8% projection made in *ADO 2003* (Table 8). In all countries GDP grew by more than had been forecast. Most of underestimation, however, was due to unanticipated strength in the oil- and gas-producing countries—Azerbaijan, Kazakhstan, and Turkmenistan—but especially in Kazakhstan, which accounts for about 45% of subregional GDP.

Table 8. Growth Rate of GDP, Central Asia, 2001-2005, %

	2001	2002	2003	2004	2005
Central Asia	10.8	8.1	8.4	8.1	8.4
Azerbaijan	9.9	10.6	11.2	9.0	12.5
Kazakhstan	13.5	9.8	9.2	9.5	9.5
Kyrgyz Republic	5.3	0.0	6.7	4.1	4.5
Tajikistan	10.2	9.1	10.2	8.0	5.0
Turkmenistan	20.5	8.6	10.0	10.0	10.0
Uzbekistan	4.1	4.0	4.4	4.5	4.0

Sources: Asian Development Outlook database; staff estimates.

Higher than expected oil and gas prices boosted exports and economic activity in these three countries and the very rapid growth rates experienced in recent years were maintained. In Azerbaijan, investment in the oil sector was especially important, contributing just over one half of GDP growth of 11.2%. Kazakhstan saw some moderation in investment but exports were very strong and a sharp expansion in private consumption supported GDP growth (up by 9.2%) and the first signs of diversification in manufacturing production. Growth in Turkmenistan, where GDP rose by 10.0%, was largely due to continued expansion of energy production and exports.

Outside this group, the Kyrgyz Republic's economy rebounded to grow by 6.7% with a full recovery in gold production (following an accident at the large Kumtor mine in 2002 that stalled the economy that year). In Tajikistan, about two thirds of the economic expansion, where GDP posted 10.2% growth, came from outside the traditional economic pillars—cotton and aluminum—reflecting strong expansion in private consumption expenditure, spurred mainly by an upsurge in worker remittances. Uzbekistan maintained GDP growth at about only 4%, which was well below its potential.

The medium-term outlook—2004 and 2005—for the CARs is quite favorable though little change is expected in the subregion's high overall GDP growth rate—8.1% and 8.4%, respectively—from that in 2003, nor is great change foreseen in the country pattern of economic expansion. The oil and gas sector will continue to drive growth in the three hydrocarbon-producing countries. In Azerbaijan, growth is expected to moderate to 9.0% in 2004 before picking up to 12.5% in 2005 as output from ongoing oil and gas development investment comes on stream. In Kazakhstan and Turkmenistan, growth is expected to be maintained at about 9.5% and 10.0%, respectively. While some weakening in oil and gas prices is

foreseen in 2005, an expansion in production volumes should offset this. Kazakhstan will benefit by the phasing-in of production from large projects at Karachagan and Kashagan, while Turkmenistan's outlook is underpinned by new long-term gas contracts with the Russian Federation and Ukraine.

Due to declining gold production (in view of depleting ore reserves) and the absence of any compensating source of economic expansion, GDP growth in the Kyrgyz Republic is expected to slow to 4.1%%, but then lift a little to 4.5%, in 2004 and 2005. Tajikistan's GDP growth is expected to slow to 8.0% and then to 5.0% over these 2 years because of capacity limits to expansion in aluminum and cotton production. Growth in Uzbekistan is expected to continue to be relatively low at about 4.5% and 4.0% in 2004–2005, respectively; however, if policy reforms that have begun are accelerated, the outlook could brighten.

Inflation is no longer a central policy issue in the CARs, except for Tajikistan and Uzbekistan. It moderated in four of the six countries with the subregion's average rate declining to 6.9% in 2003 from 10.9% a year earlier, despite upward pressure in the year caused by weather-related poor subregional grain harvests. An unintended loosening of monetary policy was the main reason for a planned reduction in inflation in Tajikistan not being realized. Over 2004–2005, inflation is projected to be moderate in all CARs except Uzbekistan where inflation rates of 20.0% are forecast due the expected unwinding of the macroeconomic imbalances created in 2003 by the extensive ad hoc measures to stabilize the exchange rate.

In recent years, appropriate macroeconomic and structural policies in most CARs have maintained stability among balance-of-payments outcomes that were responsive to underlying economic forces, except in Turkmenistan and Uzbekistan that extensively relied on direct controls. In 2003, the subregional current account deficit averaged 2.5% of GDP, essentially unchanged from a year earlier. All countries recorded increases in foreign exchange reserves. The subregional current account deficit is projected to increase to about 4% of GDP in 2004–2005, but is expected to be fully financed by capital flows.

The CARs, all of them countries in transition to market economies, have made varying degrees of progress in their reform efforts. Kazakhstan, with a per capita GDP of $1,510, has made the greatest progress in the transition by early adoption of structural reforms and sound macroeconomic policies. In 2003, it adopted an Industrial and Innovation Strategy to 2015 that targets 8% growth in manufacturing activity that will help deepen economic diversification and maintain growth momentum. Agriculture is one of the priority sectors in the strategy and large planned

budget allocations for the sector (2–3% of GDP in 2004–2005), in combination with a recently passed Land Code, are expected to have a favorable impact on employment and poverty reduction.

Azerbaijan (per capita GDP $710), Kyrgyz Republic (per capita GDP $290), and Tajikistan (per capita GDP $180) have all now formulated medium-term poverty reduction and growth strategies that include broad structural and institutional reform agendas. The countries have PRGF economic programs with the International Monetary Fund and their development efforts are being supported by ADB, the International Bank for Reconstruction and Development, and bilateral donors.

Azerbaijan has enjoyed impressive oil-led economic growth in the past 5 years, though this resource is limited and it will be essential to translate oil-boom savings into sustainable economic growth and poverty reduction. Good progress has been made in fiscal and monetary reforms and macroeconomic performance has been strong. However, actions are still needed to implement the second phase of agricultural reform and to overcome obstacles to development of the non-oil private sector, including enhancing competition, enforcing property rights, and ending cumbersome licensing procedures.

The Kyrgyz Republic has also achieved macroeconomic stability and put in place a broad range of structural reforms to lay the basis for a market economy. A sustained farm sector-led expansion since 1996 has significantly reduced poverty, based on mutually reinforcing agriculture sector reform and a high level of public investment. Even though 2003 saw completion of bilateral negotiations under Paris Club understandings, external debt at about 100% of GDP poses a significant constraint on development. Growth that is sufficiently high to reduce poverty significantly will require new sources of growth, improved public resource management, easing of trade barriers, and enhanced subregional cooperation to diversify exports and, probably further external debt restructuring.

In the 6 years since the agreement that ended its civil war, Tajikistan has recorded strong growth based on recovery in cotton and aluminum production, though weak institutional capacity, deficiencies in the legal structure, and an underdeveloped financial sector are among the constraints that hamper investment and private sector development. Moreover, a large external debt has meant that public sector investment is limited and must be entirely financed by concessional assistance. Despite daunting reconstruction and development obstacles, policy efforts are focused on strengthening fiscal performance and reducing the quasi-budget deficit in the energy sector, containing inflation, and pursuing needed structural reforms.

Turkmenistan has relatively high income (per capita GDP $1,200) largely due to energy production and export. Poverty is limited as the Government guarantees employment and can subsidize or freely provide many basic consumer items. The Government also maintains highly centralized economic management, resulting in limited private sector activity. Although immediate growth prospects are good, investment resources are being put into projects of questionable economic and social value, and strains in the economic system are apparent—such as little diversification of production, deterioration in the education and health care systems, and a highly depreciated black market exchange rate.

Uzbekistan (per capita GDP $450) is largely dependent on its agriculture sector, especially cotton production. Economic reform has been limited and gradual while growth and investment have been sluggish. The Government achieved current account convertibility in 2003 as part of its medium-term effort to attract greater FDI and liberalize trade; however, significant economic imbalances were built up in stabilizing the exchange rate. Reforms to date in agriculture are expected to underpin growth of about 4% in the period ahead; though implementation of announced policies, including withdrawal of government participation in the economy, could raise long-term growth rates to 7–8%.

The Pacific

The economic performance of the Pacific subregion in 2003 was generally good, as the aggregate GDP growth of the Pacific DMCs (excluding the Republic of Palau, which joined ADB on 29 December 2003) was an estimated 2.7%, with increases ranging from 0.1% (Federated States of Micronesia) to 5.0% (Fiji Islands and Samoa) (Table 9). Only Timor-Leste registered a contraction (3.0%), which resulted mainly from drought and the scaling down of the postconflict international presence. Growth in the Pacific DMCs also benefited from high international prices for their primary commodity exports.

Papua New Guinea especially, benefited from higher oil, gold, and copper prices. Primary production grew rapidly in Solomon Islands, which emerged from 4 consecutive years of contraction, as the arrival of a multicountry regional assistance mission in July 2003 helped restore law and order. Tourism bounced back across the subregion, stimulating the services sector and investment in infrastructure, particularly in the Fiji Islands. The weak international financial markets resulted in fluctuating returns for the Kiribati and Tuvalu trust funds, although a certain strengthening was registered toward the end of the year. In line with faster

Table 9. Growth Rate of GDP, The Pacific, 2001-2005, %

	2001	2002	2003	2004	2005
The Pacific	0.6	0.8	2.7	2.9	2.4
Cook Islands	4.9	3.9	3.1	2.7	2.9
Fiji Islands	3.0	4.1	5.0	3.9	3.0
Kiribati	1.8	1.0	2.5	1.8	1.5
Marshall Islands, Rep. of	-1.5	4.0	3.0	2.0	3.0
Micronesia, Fed. States of	0.5	0.9	0.1	-1.5	2.2
Nauru	—	—	—	—	—
Papua New Guinea	-2.3	-0.8	2.0	2.8	1.7
Samoa	6.2	2.8	5.0	4.0	3.5
Solomon Islands	-10.1	-4.0	3.8	4.5	4.5
Timor-Leste, Dem. Rep. of	17.0	-1.1	-3.0	1.0	3.0
Tonga	0.8	1.6	1.9	2.6	2.8
Tuvalu	4.0	2.0	3.0	3.0	—
Vanuatu	-2.1	-2.8	1.6	2.1	2.6

Sources: Asian Development Outlook database; staff estimates.

economic growth and increase in domestic demand, labor market conditions generally improved and inflation accelerated to an average 7.4% in the subregion.

Fiscal outcomes varied considerably among countries. In Papua New Guinea, revenue collection was on target, but expenditure restraint was required to minimize the need for domestic borrowing and the consequent pressure on interest rates. The fiscal deficit exceeded the budget in the Fiji Islands, due to unanticipated expenditures and a failure to realize planned asset sales, despite strong revenue collection. Expenditures were uncontrolled and misallocated in Solomon Islands, but a considerable effort to regain control was made with the arrival of an Australian budget stabilization team in the latter part of the year.

External accounts showed substantial variation in 2003. While export growth was generally positive, import growth was erratic; currency trends and earnings from tourism determined disparate outcomes in the accumulation of international reserves.

Political uncertainty and poor governance continued to hamper growth in several countries. The Pacific Islands Forum, the main regional cooperation body, is paying increasing attention to ways of pooling resources in the areas of governance, air transport, security, and international crime. A gradual move toward freer trade in the subregion occurred with the entry into force in April 2003 of the Pacific Islands Countries Trade Agreement, signed by 14 members and covering a 10-year implementation period.

At the national level, the main policy focus in the majority of countries was on maintaining macroeconomic stability through sound fiscal management as a key condition to encourage private investment and economic growth. Efforts to consolidate gains from implementation of economic and public sector reforms varied in intensity and effectiveness.

Based on further improvements in the tourism sector and continued strong commodity prices, economic growth is forecast to continue at a relatively fast pace in 2004 and 2005, at least by historical standards. GDP in the subregion is expected to increase by 2.9% in 2004 and by 2.4% in 2005, while inflation is projected to slow to 5.6% but then increase to 6.0% over this period. These trends are essentially determined by projections for Papua New Guinea, by far the largest economy in the Pacific. While expected medium-term growth and inflation rates represent improvements from the trends of the last few years, creating jobs in the formal sector will remain a major concern, as almost all economies are unlikely to be able to absorb the net increase in labor market entrants, with high youth urban unemployment leading to potential social unrest. Aside from adverse external shocks, the main risk to the growth forecasts rests with the evolution of the internal political conditions and the capacity of local institutions to build up a climate of stability to boost business confidence.

With regard to policies, all Pacific DMCs are struggling with fiscal governance and public administration reform issues, the need to create an environment enhancing private sector development, and the necessity to improve local capacity and institution building. A prerequisite for attracting investment and boosting the private sector is bringing about an effective system for land-titling registration, which, given the general shortage of land and customary traditions in the Pacific, is not easy to achieve. External assistance, with an increased focus on participation and self-reliance, continues to play a crucial role for economic development and poverty eradication in the subregion.

Part III

FOREIGN DIRECT INVESTMENT IN ASIA

In exploiting the opportunities offered by globalization, technological advancements, and increased competition, foreign direct investment (FDI) has an important role to play in developing Asia. FDI enhances the productivity of immobile factors of production in the host (recipient) country. The capital stock is augmented, productivity rises, and some (often much) of the increase is appropriated by domestic factors of production. These benefits appear to be especially important in connecting to the global economy, and in the area of technology transfer.

Since countries face the same international commercial environment, their domestic policy regimes, institutional capacities, and infrastructure availability are the key determinants of the volume and composition of their FDI inflows. Consequently, notwithstanding their diversity, almost all developing Asian economies have adopted progressively more open policies toward FDI during the past decade or two, and this trend appears likely to continue. This more open posture has been accompanied by the adoption of more liberal trade regimes, a process that has had profound implications for the motives for, and impact of, foreign investment.

An upsurge in FDI to developing countries in the 1990s followed unilateral liberalization of their FDI policies and regulatory regimes. Theoretical and empirical evidence provides strong support for the proposition that neutral policies designed to enhance the efficiency of investment are better suited to attracting foreign investment and enhancing its contribution to development than interventionist methods.

Still, investment measures have long been a feature of the regulatory framework governing FDI in most host countries. Most measures were designed to transfer benefits from the operations of foreign firms to the local economy and to promote development objectives. In essence, the

primary objective of these measures is for host countries to obtain the maximum possible share of the gains from FDI. However, such regulations distort trade and investment and impose welfare losses. The various regulations used may in fact have weakened, rather than enhanced, the contribution of FDI to national development objectives. In terms of incentives, there is some evidence that incentives play a relatively minor role in multinational enterprises' (MNEs') decisions about where to locate relative to other location-based considerations. Moran (2002) has provided much evidence to show how counterproductive and damaging domestic content requirements and joint-venture requirements can be for host country development. He also demonstrates just how beneficial a policy-of allowing subsidiaries that are wholly owned and unfettered by local content mandates-can be for host country growth and development.

The core of the debate on the use of these policies is typically referred to as the "development dimension." In this context, the term development includes elements of self sufficiency, national pride, and, perhaps most importantly, employment. It also has a technology transfer dimension, where FDI is supposed to induce technology transfer into developing countries.

However, investment measures have frequently turned out to be costly and inefficient. One key feature of the use of policies, such as local content schemes and export performance requirements, is that they are becoming less popular. Therefore, the appropriate question to ask is whether or not there are reasonable grounds for adopting or maintaining such policies. The most frequent answer to this question is that these policies are required to "develop" specific industries in order to compete in an open trading environment. Protection may induce expansion of output and employment in certain sectors, although this expansion often carries a substantial cost for the society implementing such a policy.

A central issue is whether investment measures actually alter the allocation of resources in production and trade or merely affect the distribution of rents between firms and host countries. Both suppliers and recipients of FDI gain from the liberalization of investment measures. Foreign investors may benefit from new investment opportunities resulting from liberalized investment regulations, while host countries may benefit from increased FDI inflows and greater market discipline resulting from this. Since many developing countries compete with one another to offer foreign investors generous fiscal, infrastructure, and financial incentives, the scaling down of investment incentives could yield additional revenue for the host country governments.

The international benefits of FDI appear to be highly uneven. For some countries the benefits of an MNE presence are clear, while for others

the impacts are ambiguous or possibly negative. Since all countries face the same international commercial environment, the presumption is that host country conditions are the deciding factors of these differences. Seven relevant policy issues are:

Flexible and Adaptable Regulatory Environment. A major challenge for policy makers is keeping up with a rapidly changing international commercial environment. The calculation for mobile, export-oriented, foreign investors differs from that for investors in the import substitution era. The quality of incentives, institutions, and infrastructure matters more than before.

Unfinished Reform Agenda. Significant obstacles to FDI are still in place, and these are typically more substantial than trade barriers. Many of them are concentrated in services industries, notwithstanding the significant liberalizations of the past decade. In fact, countries with a tradition of openness toward merchandise trade have often been quite restrictive on services trade and FDI in services sectors. It needs to be recognized that, for all the rhetoric of "open borders", major commercial barriers still exist.

Different Countries, Different FDI Issues. Different host countries have diverse expectations for FDI. For late reformers, a major objective is simply entering the international commercial mainstream. Thus "bagging the first contract" is a prime objective. For resource-rich economies, taxation and environmental arrangements, and the rate of resource depletion, feature prominently. For low-wage, densely populated economies, export-oriented labor-intensive FDI can be crucial. By contrast, as host economies lose their comparative advantage in the latter, attention shifts to how FDI may play a role in the process of upgrading to more technology-intensive activities. Where there already exists a strong domestic R&D base, policy makers can seek to build on these strengths through joint ventures with MNEs.

The key point, therefore, is that while the notion of one size fits all may apply at the general level to the adoption of open trade and investment regimes, there is in addition much scope for specific micro interventions to maximize the benefits of the foreign presence. Also, the types of FDI and related policies may differ for the same country at different stages of development.

Toward a Unified Investment Environment. A major challenge for policy makers is the introduction of a unified investment regime that confers national treatment on foreign investors, except when they deem domestic ownership to be essential (on the basis of carefully articulated national interest arguments). Foreign and domestic investors are generally concerned with the same set of policy issues-including the tax regime, labor relations, the quality of human capital and infrastructure, and

adequate legal protection. There is therefore little point in attempting to devise different policy regimes for foreign firms. Invariably, MNEs are attracted to a commercial environment that domestic firms find conducive.

FDI and Trade Issues, Again. Foreign investors have changed orientation from rent seeking to efficiency seeking. Underpinning this transformation in Asia has been trade liberalization, which has been primarily unilateral in nature and supported by a conducive multilateral environment. Now the momentum for multilateral trade reform appears to have slowed down, especially with the disappointing results at the Cancun WTO meeting in 2003. Bilateral and regional preferential arrangements, discriminatory in nature, are proliferating. There is a danger that a world of "hubs and spokes" may emerge, under which trade barriers between the spokes could increase, a reversal from the postwar trend toward a more liberal global environment. It would frustrate the emergence of the global factory phenomenon, and the capacity of MNEs to source globally at the lowest cost. It is therefore possible that, if the current predilection for preferential trading arrangements intensifies, MNEs will be forced to incorporate discriminatory trade barriers in their location decisions. For host economies, being a predictable and efficient production site would thus be a necessary but not sufficient condition for attracting FDI.

FDI in Decentralized Policy Environments. Over time, the power of central governments in many countries is likely to diminish, as authority devolves to the regional level. In transitional economies such as the PRC and Viet Nam, this process is an inevitable outcome of the shift from the planned to the market economy. In Thailand, the process is a deliberate one, as a major decentralization program was introduced in 1993. India and Malaysia are already federal entities. As this process takes root, it is possible that energetic local governments within a country will begin to compete among themselves to seize business opportunities, in the process bypassing cumbersome national agencies. The challenge for national governments will be to encourage this competitive potential, while ensuring that it operates in a manner consistent with national development objectives.

Fiscal Incentives. Fiscal incentives are a risky and generally costly means of attracting MNEs. They are invariably second best in nature, when a first-best approach would be to address at source the unattractive features of the host economy environment. If granted on a large scale, there is a risk that they will undermine the government's fiscal base. Foreign firms are attracted to commercially profitable and politically stable environments. Surveys of MNEs invariably record these features as the major determinants of their location decisions when investing abroad.

Fiscal incentives are also corruption prone. Government officials can treat these "rents" as bargaining tools for corruption. It is quite common for up to half of their nominal value to be dissipated in this manner. In addition, they may be employed as a de facto instrument of industrial policy by agencies without the analytical capacity to devise and implement such programs.

There may be a case for distortions of these kinds in special circumstances. For example, investment incentives may be a useful signaling device in cases where governments are seeking to press their reform credentials in international business circles. In such cases, the key is to ensure that these are time bound, transparently costed, and transitional. To prevent vested interests from proliferating around these initiatives, they should desirably contain clearly defined and nonnegotiable sunset clauses. However, the political economy of reforming these incentives is complex.

Individual countries can adopt a policy framework that is beneficial to both foreign and domestic investors, as well as to recipient economies as a whole. Basic components of such policies would include transparency about investment rules and regulations, with clear identification of agencies responsible for issuing relevant licenses, permits, and approvals. With efficiency-seeking FDI, a liberal trade regime, and a competitive commercial environment, FDI can remain a win-win proposition for developing Asia.

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PREVIOUS *ASIAN DEVELOPMENT OUTLOOK* THEME CHAPTERS

1989	The Development of Human Capital
1990	Informal Finance in Asia
1991	Environment and Development In Asia
1992	Rural Poverty in Asia
1993	Asian Economies in Transition
1994	Urban Poverty in Asia
1995 and 1996	The Financial Sector and Asian Development: Historical Experiences and Prospects
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