3 Economic trends and prospects in developing Asia

Subregional summaries

- Central Asia
- East Asia
- South Asia
- Southeast Asia
- The Pacific

Bangladesh
People's Republic of China
India
Indonesia
Malaysia
Pakistan
Philipppines
Thailand
Viet Nam

Economic trends and prospects in developing Asia

Subregional summaries

Central Asia

Subregional assessment and prospects

The *Update* revises upward the gross domestic product (GDP) growth projections included in April's *Asian Development Outlook 2010* (*ADO 2010*) for four countries (Armenia, Georgia, Kazakhstan, and Tajikistan) of the eight in Central Asia. These four countries benefited from the recovery of the global economy through buoyant metal prices and the rebound of exports. Kazakhstan additionally benefited by stronger oil prices while the other three gained from a marked recovery in workers' remittance inflows.

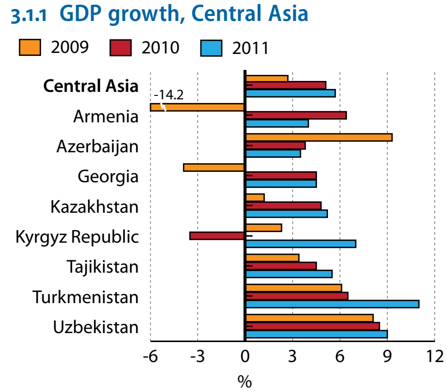
The *Update* maintains the GDP forecasts for Turkmenistan and Uzbekistan, while revising downward projections for Azerbaijan and the Kyrgyz Republic. Growth in Azerbaijan's oil production has slowed, and the Kyrgyz economy suffered from political unrest.

On balance, these developments contributed to a higher GDP growth forecast in 2010 for the subregion to 5.1% from 4.7% (Figure 3.1.1). In 2011, the GDP growth forecast for Central Asia is 5.7%, little changed from 5.9% expansion estimated in *ADO 2010*.

Economic indicators in the first half of 2010 signal that all economies that suffered from low growth in 2009 (except the Kyrgyz Republic) are experiencing higher growth following the recovery of the global economy. Exports have picked up in all countries. Particularly, buoyant gas and oil prices greatly benefit the four hydrocarbon exporters (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan).

In Armenia, Georgia, and Tajikistan, prices for their major exporting commodities, especially metals, increased, which helped to narrow their current account deficits. In the Kyrgyz Republic, the

3.1.1 GDP growth, Central Asia



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This chapter was written by Kiyoshi Taniguchi for Central Asia, Anthony Patrick for East Asia, Tadateru Hayashi for South Asia, Purnima Rajapakse, Aleli Rosario, and Anthony Patrick for Southeast Asia, and Stephen Pollard, Craig Sugden, Emma Ferguson, Dominic Mellor, Milovan Lucich, and Raquel Tabanao for the Pacific, with contributions from various ADB Resident Mission staff.

positive economic outlook of early 2010 was soured by widespread political instability and civil unrest in April and June. Largely as a result, that economy is now projected to contract by 3.5% in 2010. All these four countries (which are nonhydrocarbon exporters) are undertaking economic adjustment programs supported by International Monetary Fund (IMF) credit facilities.

The Russian Federation has been on a recovery path since the second half of 2009. Reflecting its extensive economic relations with Central Asia, trade, investment, and workers' remittances from that country to the subregion came back strongly. According to data from the central bank of the Russian Federation, aggregate remittances to the eight countries increased on an annual basis by about 16% during the first half of 2010. The increase in remittances was a main factor stimulating domestic consumer demand in recipient countries.

Until the global recession started, remittances were a leading factor boosting growth for Armenia, the Kyrgyz Republic, and Tajikistan for years. These economies were severely affected by the decline in remittances during the global recession. Armenia saw a sudden drop, which halted many construction projects. In the Kyrgyz Republic, though, in the first half of 2010, recovery of remittances boosted private demand and moderated the current account deficit. In Tajikistan, anecdotal evidence indicates that about half the labor force is working abroad, and one-third of them in the Russian Federation.

In Azerbaijan, the rapid expansion of oil production has been the main source of high growth. Since oil production is approaching a plateau, expansion in the non-oil sector will now largely dictate the pace of overall GDP growth.

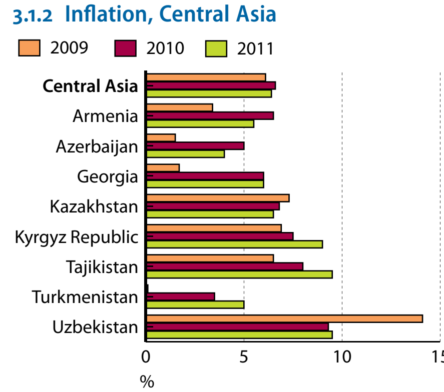
Due to the slow recovery of domestic demand, inflation in most countries will generally remain subdued in 2010–2011, and well below the double-digit levels experienced during earlier years of very rapid growth. In Armenia, inflation increased between the last quarter of 2009 and the first quarter of 2010 due to higher international commodity prices, pass-through effects from depreciation in early 2009, and the recovery of remittance-driven consumer demand. These factors have prompted an upward revision in the inflation forecast.

In Uzbekistan, the rapid growth of bank credit as well as pass-through effects from continuing local currency nominal depreciation induced inflation pressures and higher inflation is now forecast for 2011. Slower growth in Azerbaijan and the Kyrgyz Republic are mitigating price pressures and projected inflation.

Subregionally, the *Update* slightly reduces the inflation projections of *ADO 2010* from 6.7% to 6.6% in 2010 and from 6.6% to 6.4% in 2011 (Figure 3.1.2).

While energy exporters are exhibiting strong current account surpluses, energy importers will see pressures on their current account deficits. Exports from the four hydrocarbon-exporting countries grew fast between end-2009 and the first half of 2010 due to higher oil and gas prices and buoyant demand. Projections of current account surpluses have been raised for Azerbaijan and Kazakhstan. Export growth is picking up across the energy-importing countries in the subregion, though it is accompanied by higher import demand, thereby limiting improvements

3.1.2 Inflation, Central Asia



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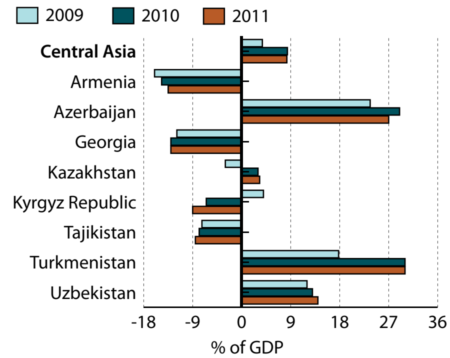
in current account deficits. The narrowing of the current account deficits in Georgia and Tajikistan from *ADO 2010* projections is mainly explained by the strong recovery of remittance inflows.

The subregion's current account surplus is projected to increase from 3.8% to 8.4% of GDP in 2010 and decline a touch to 8.3% in 2011 (Figure 3.1.3).

3.1.3 Current account balance, Central Asia



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Country highlights

Armenia

The economy is coming out of a severe economic downturn as the improved global economy has boosted major exports, such as copper, chemicals, and jewelry. Industry, construction, and services were the main drivers of the recovery in GDP growth to 6.7% in the first half of 2010. Domestic consumption also increased as remittance inflows picked up, particularly from the Russian Federation, the biggest source. Given the strength of the GDP rebound, the *Update* revises growth forecasts upward from 1.5% to 6.4% for 2010 and from 3.0% to 4.0% for 2011.

Inflation moved above the central bank's target band (4±1.5%), in part owing to the lagged pass-through of the large devaluation in 2009. Inflation in the first half of 2010 averaged 7.6%; however, it eased over the period in response to a tightening in monetary policy. The *ADO 2010* inflation forecast of 4.5% is revised upward to 6.5% in 2010, while the 2011 forecast is lifted from 5.0% to 5.5%.

Countercyclical fiscal policies as well as declining revenues in 2009 led to an increase in the budget deficit, which reached 7.9% of GDP. With recovery under way, the government responded with a 3-year medium-term spending program calling for the suspension of public sector salary increases (through 2013) and a cap on public spending. The budget deficit was reduced to 4.0% of GDP in the first half of 2010 and it is expected to narrow further as the plan is implemented.

Soaring international metal prices helped to push up exports by 57.4% in the first half of 2010 compared to a year earlier. Imports, though slower, still grew handsomely by 25.1% during the same period. However, because they are about four times as large as exports, the trade deficit widened in the first half of 2010, as did the current account deficit in the first quarter. The balance-of-payments adjustment was expected to be protracted as structural imbalances were large. In view of the unexpected strength of the rebound, the *Update* raises forecasts for the current account deficit to 14.7% of GDP in 2010 and 13.5% in 2011.

Azerbaijan

In the first half of 2010, GDP growth slowed to 3.7%. The oil sector (as recorded in national accounts rather than gross production, and accounting for about 55% of GDP), grew by only 2.3% despite higher global oil prices and improving external demand. After a 15% expansion in 2009, oil production is officially expected to grow by around 4% in 2010 as existing oil fields (except Azeri–Chirag–Gunashli) reach their production capacity.

The non-oil sector grew by 4.7% in the first half of 2010, mainly reflecting strength in manufacturing and construction, as output

contracted in the relatively small agriculture sector because of floods. Taking account of a leveling off in oil production and expected growth of the non-oil sector, this *Update* revises the growth forecast from 9.5% to 3.8% in 2010 and from 9.7% to 3.5% in 2011.

Despite the strong pressures stemming from depreciations in the country's major trading countries, the Central Bank of Azerbaijan successfully maintained the de facto exchange rate peg to the United States (US) dollar. Citing slowing inflation, it set an accommodative monetary policy in the early months of 2009 to bolster the non-oil economy, and has maintained this stance. The moderate expansion in credit, a stable exchange rate, and few commodity price pressures kept inflation at 4.9% in the first half of 2010. Reflecting moderation of domestic demand and commodity price pressures, this *Update* adjusts inflation forecasts down from 5.8% to 5.0% in 2010 and from 6.0% to 4.0% in 2011.

The current account balance ran a surplus of 32% of GDP in the first quarter of 2010. With higher oil and gas earnings than projected, the *Update* revises its current account surplus forecasts from 23.0% to 29.0% in 2010 and from 21.7% to 27.0% in 2011.

Georgia

Robust growth in key sectors such as manufacturing, transportation, and trade during the first quarter of 2010 pushed GDP growth positive at 4.5%, and preliminary estimates indicate a further strengthening in the second quarter to 8.4%. The global recovery substantially raised exports and remittance earnings, underpinning a strengthening in domestic incomes and demand. Given the strong rebound in the first half of the year, the *Update* revises the GDP growth forecast from 2.0% to 4.5% in 2010 and from 4.0% to 4.5% in 2011.

Due to stronger than expected economic growth, as well as to the anticipated passage of a new tax code in September 2010, fiscal revenue is projected to be above target in 2010. As a result, the government adjusted down the estimated fiscal deficit from 7.4% to 6.3% of GDP in 2010, and expects it to be under 5% of GDP in 2011.

Inflation was a low 2.8% through the first half of 2010, in part due to revision in the consumer price index methodology that gives less weight to food and non-alcoholic beverages. The National Bank of Georgia moved to tighten monetary policy by gradually increasing its policy rate by 150 basis points to 6.5% from June to August 2010, to stem the inflation impact from an expansion in the money supply and to reduce pressures in the foreign exchange market. Inflation is expected to pick up in the second half of the year due to the strong recovery in domestic demand and rising global commodity prices. However, there is no apparent need to revise the 6.0% inflation forecasts for 2010 and 2011.

The growing demand for and higher prices of the main export commodities—gold and base metals—as well as moderate import growth, are now expected to narrow the 2010 current account deficit to 13.0% of GDP from 14.0% of GDP given in *ADO 2010*. For 2011, a continued positive outlook for the Russian Federation, still the major source of remittances to Georgia, will likely allow the current account deficit to stay unchanged from 2010.

Kazakhstan

The economy rebounded with robust 8% growth in the first half of 2010. In addition to the low-base effect, the main drivers of strong growth include the oil and minerals sectors and international trade. However, construction registered a slight contraction. The launch of over 100 large-scale investment projects under a 5-year accelerated industrial and innovative program will expand diversification of the economy from its concentration in mining and hydrocarbon operations as well as provide medium-term stimulus.

Due to higher export demand, strong oil prices, and the increase in foreign direct investment, growth of the oil economy is projected to accelerate, while the non-oil economy will grow modestly. Limited credit availability due to the banking sector difficulties will damp domestic demand in 2010, though credit availability should improve somewhat in 2011 as banks have been making progress in strengthening their balance sheets. Overall, owing to a robust growth in the first half of 2010, and expected strong demand in 2011, the *Update* revises its growth forecasts upward from 2.5% to 4.8% in 2010 and from 3.5% to 5.2% in 2011.

Monthly consumer price index inflation for the first half of 2010 remained stable, ranging from 6.8% to 7.4% year on year. In September 2009, the National Bank of Kazakhstan reduced the refinance rate (its main policy rate) by 50 basis points to 7% (as inflation tumbled) as part of the efforts to strengthen the sagging economy. The central bank has kept it on hold since then. The exchange rate, too, has been stable.

Inflation is expected to remain at around 7%, within the government's defined inflation corridor of 6%–8%. The current monetary policy stance is expected to continue though the impact of drought in Kazakhstan and the Russian Federation on wheat prices could temporarily boost inflation pressures. Accordingly, the *Update* maintains its inflation forecasts of 6.8% for 2010 and 6.5% for 2011.

Fueled by an approximate 50% increase of oil and metals price indexes, exports registered about a 70% year-on-year increase in the first half of 2010. The upgraded Aktau International Sea Port facilitated a 77% increase in hydrocarbon and mineral exports. Imports were little changed during the same period due to weak domestic demand. A trade surplus of $16.5 billion in the first half of 2010 was registered, four times as high as the same period in 2009.

In 2011, import growth will narrow current account surplus as domestic demand is projected to gradually rise. The *Update* revises its current account surplus forecast for 2010 from 2.3% of GDP to 3.0% in 2010 but maintains its forecast of 3.3% in 2011.

Kyrgyz Republic

The positive outlook at the beginning of 2010 was clouded by widespread political instability and civil unrest in April and June. First quarter GDP growth rebounded to 16.4%, recovering from a depressed quarter a year earlier. The recovery was largely driven by strong gold production, a pickup in industrial production, and a step-up in construction activity. The civil unrest, however, has disrupted agriculture, trade, and other services. Agricultural output, particularly, is expected to suffer and decline by 12% due to insecurity in the south and lack of inputs.

The *Update* revises GDP growth forecast from an expansion of 5.5% to a contraction of 3.5% in 2010. However, a strong rebound to growth of 7.0% in 2011 is now forecast due to donor-supported reconstruction activities, some recovery in investor confidence, and resumption of trade with and growth in Kazakhstan and the Russian Federation, the main trade and financial partners. To assist the Kyrgyz Republic with the aftermath of the violence in the south, a donors' conference in July pledged $1.1 billion in grants and concessional loans.

As a result of the contraction of the economy in 2010 as well as the April reversal of an earlier increase in electricity tariffs, inflation is expected to be 7.5%, lower than *ADO 2010* projection of 8.5% for 2010. Toward the end 2010 and in 2011, higher domestic consumption demand because of improving remittances in the face of decreased production capacity due to the destruction will raise domestic prices. The *Update* maintains its inflation forecast of 9.0% in 2011.

The *Update* revises the current account deficit forecast from 12.0% of GDP to 6.5% of GDP in 2010, mainly due to the disruption in trade, services, and investment activities caused by the unrest. The current account deficit forecast for 2011 is also lowered from 12.0% to 9.0% of GDP given expected stronger grant and remittance inflows.

Tajikistan

Higher global prices for aluminum and cotton, 20% stronger remittance inflows, and an agriculture sector growing by 9.2% supported robust growth of 7.4% in the first half of 2010. Industrial output grew by 12% mainly due to higher aluminum production, the country's main export. With robust GDP growth in the first half of the year in part reflecting a depressed period a year earlier, the outlook for the remainder of 2010 nevertheless is cautiously optimistic. Therefore, the *Update* revises GDP growth projections in *ADO 2010* from 4.0% to 4.5% in 2010 and from 5.0% to 5.5% in 2011, anticipating that global prices for aluminum and cotton as well as remittance inflows will remain high.

Inflation remained moderate during the first half of 2010 at 5.3%, despite fast-growing remittances. In this period, many employees, particularly in the public sector, were required to purchase shares to fund restarting of the construction on the Roghun hydroelectricity project, which substantially lowered the disposable incomes of the population, though this policy was relaxed in the later part of the year. Reflecting these developments, inflation is projected to be contained, and the *Update* revises down the inflation forecast for 2010 from 10.8% to 8.0%. The 2011 forecast at 9.5% is maintained.

Exports registered a significant increase of more than 35% year on year during the first half of 2010 due to the recovery of aluminum and cotton export volumes and prices. Despite higher remittances, mainly due to disruptions with rail cargo transit through Uzbekistan, imports declined by 6.1% in this period. Trade disruption is expected to narrow country's trade deficit, and on this basis the *Update* reduces the 2010 projection of the current account deficit from 8.3% GDP to 7.8% of GDP. With normal transit conditions and the expected strengthening in growth in 2011, higher imports would boost the current account deficit, which the *Update* raises to 8.5% of GDP, from 7.1% in *ADO 2010*.

Turkmenistan

Economic growth in 2009 was robust despite the global recession. Even though a technical accident in the main gas pipeline to the Russian Federation in 2009 halted gas exports, the impact on the economy turned out not to be large because other gas export routes were expanded. In late 2009, the People's Republic of China (PRC) started to import gas from Turkmenistan through a newly constructed gas pipeline through Kazakhstan and Uzbekistan. Gas exports to the Islamic Republic of Iran also increased and a second new pipeline was opened in January 2010. The *Update* maintains the growth forecast in *ADO 2010*, of 6.5% in 2010 and 11.0% in 2011, which mainly reflected the phase in of higher hydrocarbon exports.

No change is made to the inflation forecasts of 3.5% for 2010 and 5.0% for 2011.

ADO 2010 estimated that the current account surplus narrowed to 17.8% of GDP in 2009 mainly due to a sharp decline in gas exports to the Russian Federation. As the global economy rebounded, energy demand in general increased in 2010 broadly in line with expectations in *ADO 2010*. Reflecting export earnings made possible by the newly opened pipelines, the April forecasts of the current account surplus of 30.0% of GDP for 2010 and 2011 are maintained.

Uzbekistan

The economy grew by 8.0% in the first half of 2010, with construction and services providing the main impetus. Favorable weather boosted agricultural growth to 6.9%. Construction benefited from increased public infrastructure investment undertaken as part of the anticrisis program. Foreign direct investment was buoyant in the first half of 2010, amounting to a record $1.6 billion—a 150% year-on-year increase. A one-third increase in bank lending, mainly to industrial enterprises and small and medium-sized enterprises (SMEs), helped to underpin the expansion. With the economy running according to plan, the *Update* maintains growth forecasts of 8.5% for 2010 and 9.0% for 2011.

The government reported inflation for the first half of 2010 at 4.0%, significantly lower than its announced target of 9.0% for the year, which has not been revised. Lower import prices of consumer goods and a government cap on utilities prices were major contributing factors containing inflation pressures. Given the increased pace of nominal depreciation of the local currency and an accommodative credit policy by the monetary authority, inflation pressures will build. The *Update* maintains the April 2010 inflation forecast at 9.3%, while edging up the 2011 projection from 9.0% to 9.5%.

Exports increased by 14.3% year on year in the first half of 2010 due to the economic recovery in the Russian Federation and strong global demand for metals. Imports were lower by 18.9% during the same period, as imports of machinery and equipment declined apparently reflecting completion of investment projects, however they are likely to rise in the second half of the year. Since growth in the economy and exports are in line with forecasts in *ADO 2010*, the *Update* maintains the earlier forecast of the current account surplus of 13.0% of GDP in 2010 and 14.0% in 2011.

East Asia

Subregional assessment and prospects

The forecast for aggregate economic growth in East Asia this year is raised to 8.6%, which if realized would make it the strongest expansion of any of the five subregions of developing Asia. In large part, this represents a rebound from a weak prior-year performance in four of the five subregional economies.

The export-oriented economies of Hong Kong, China and Taipei,China contracted last year owing to the global recession. Mongolia's GDP also declined in 2009, as global prices fell for its copper exports and foreign investment in mining dwindled. Trade-reliant Republic of Korea barely avoided a contraction last year—its GDP rose by just 0.2%.

These four economies were expected to rebound in 2010 as world trade recovered, but the first-half bounce was higher than anticipated. Taipei,China's GDP shot up by 13.1% year on year in January–June, propelled by surging demand for manufactured exports, particularly electronics. Benefiting from improved global demand for manufactures such as automobiles and semiconductors, the Republic of Korea's GDP rose by 7.6%. Hong Kong, China returned to growth with a 7.2% increase in GDP. This economy depends heavily on exports of trade-related and business services, as well as tourism, all of which have recovered this year from slumps. Mongolia's important mining industry benefited from the restoration of global investment flows in the first half, and from a recovery in prices for copper.

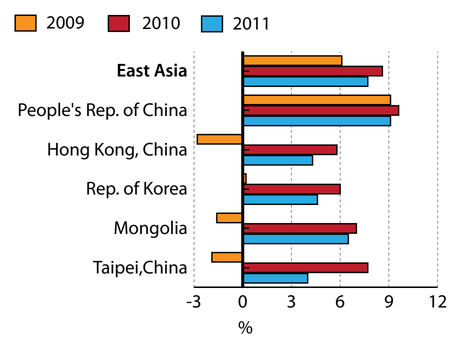
One reason for the sharp GDP gains was double-digit economic growth in the PRC, the major trading partner of the other four East Asian economies. PRC imports surged by 45.8% in the first 8 months of this year.

Rising exports prompted a burst of investment in Hong Kong, China; the Republic of Korea; and Taipei,China, so that investment contributed most of these economies' first-half GDP growth. That generated jobs, which supported higher rates of growth in private consumption. Forecasts for GDP growth in 2010 are raised for Hong Kong, China (to 5.8%); the Republic of Korea (6.0%); and Taipei,China (7.7%).

As for the PRC, its 11.1% pace in the first half of 2010 was underpinned by expansionary monetary and fiscal stimulus that kept it growing through the global recession in 2009, coupled with the recovery in world trade. The trajectory of the PRC economy has been broadly in line with *ADO 2010* expectations, and the GDP growth forecasts are unchanged (9.6% for 2010 and 9.1% for 2011).

The PRC's stimulus programs are being gradually withdrawn, and economic growth will moderate in the second half of 2010 and in 2011. Growth is expected to also slow in Hong Kong, China; the Republic of Korea; and Taipei,China in the second half of 2010 as export growth moderates, base effects from the slump in early 2009 fade, and some stimulus is unwound (particularly in the Republic of Korea). The subregional GDP forecast for next year is maintained from *ADO 2010* at 7.7%, with growth stepping down in all five economies from the speedy 2010 pace (Figure 3.1.4).

3.1.4 GDP growth, East Asia



Source: *Asian Development Outlook* database.
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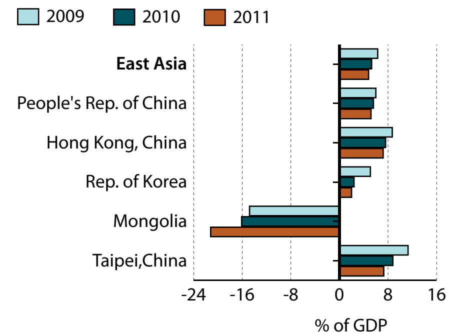
Current account surpluses in relation to GDP are projected to decline from 2009 levels in all economies through the forecast period (except in Mongolia, where imports of capital equipment for mining projects will widen its external deficit). Imports will likely rise in tandem with domestic demand and increases in oil prices, while export growth will moderate. The subregional current account surplus is seen moderating to 5.3% this year and 4.8% in 2011, little changed from *ADO 2010* (Figure 3.1.5).

Inflation in East Asia has generally been mild this year. The subregional forecast is trimmed to 3.0% in 2010 (Figure 3.1.6), mainly owing to a downward revision for the PRC. This rate is also projected for the subregion next year. Policy interest rates, lowered during the global financial crisis, have started to rise in the Republic of Korea; Mongolia; and Taipei,China.

Three economies have experienced steep increases in housing prices in major cities, in part a result of monetary stimulus and capital inflows. The authorities in the PRC; Hong Kong, China; and Taipei,China have taken steps to cool demand for housing (especially speculative demand), and to increase the supply of land for construction of apartments and, in some cases, low-cost housing.

3.1.5 Current account balance, East Asia



Source: Asian Development Outlook database.
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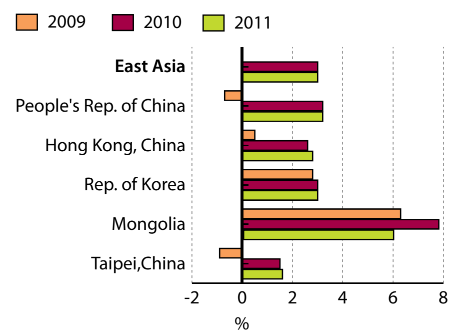
3.1.6 Inflation, East Asia



Source: Asian Development Outlook database.
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Country highlights

People's Republic of China

Expansionary fiscal and monetary policies, together with recovery in world trade, drove rapid economic growth of 11.1% in the first half of 2010. Investment, much of it funded by stimulus programs, increased at a strong pace and private consumption continued to grow, supported by a tightening labor market and rising incomes and subsidies. Net exports turned positive in the second quarter.

GDP growth moderated a little in the second quarter from the first, and is forecast to ease through the third and fourth quarters. Monetary officials started to rein in the expansionary monetary stance adopted during the global recession, in view of the strong economic growth, sharp rise in property prices, and risks that funds would be diverted into unproductive purposes. Among other measures, they raised the reserve requirement for banks three times and set monthly credit quotas for banks. New bank lending decelerated in the first 8 months of this year from 2009, although it remains well above 2007–2008 levels.

Fiscal stimulus is being phased down as well, and is expected to be fully disbursed by end-2010. Growth in government spending has pulled back this year compared with 2009. The budget deficit as a share of GDP will probably be smaller than targeted in 2010, and the deficit is likely to narrow further in 2011 in relation to GDP.

Consequently, growth in fixed-asset investment has moderated and this trend is expected to continue, tempering demand for industrial products. Government plans to reduce excess capacity in steel and to reduce carbon emissions will also cool growth of the industry sector through the forecast period. Export growth, too, is likely to ease owing to fading base effects from the slump in early 2009 and to more subdued demand from some export markets. Given that these developments are

broadly in line with *ADO 2010* expectations, the GDP growth forecasts are maintained at 9.6% for 2010 and 9.1% next year.

Merchandise exports rose by 35.4% in the first 8 months of 2010 and imports even more steeply, by 45.8%. Although the trade surplus narrowed, sizable capital account surpluses are still expected in the forecast period (5.6% of GDP this year and 5.2% in 2011). The authorities said in June that they would gradually allow greater flexibility in the yuan exchange rate against a basket of currencies. By mid-September, the yuan had appreciated by 1.5% against the US dollar from the start of 2010. The adjustment is unlikely to have much of an impact on trade flows in the near term.

Consumer prices have turned up, after declining for most of last year. Flooding in summer led to increases in food prices, but this impact is expected to be temporary. The forecast for average inflation in 2010 is trimmed to 3.2%, and that rate is also projected for 2011.

Housing prices, however, have climbed steeply in major cities, spurred by the expansionary monetary stance and investment demand. The government has taken steps to cool the property market. For example, it raised downpayments required for a second home and directed many central government–owned enterprises to stop participating in the property market. To increase supply, it increased the availability of land for residential purposes and the supply of low-income housing.

Hong Kong, China

Strong growth in external trade, linked to rapid expansion in the PRC and to the global recovery in trade, contributed to a stronger than expected 7.2% rebound in Hong Kong, China's GDP in the first half of 2010, from a contraction in the prior-year period. Increases in private consumption and investment also contributed to the expansion.

Merchandise exports in nominal terms rose by nearly 25% year on year in the first half. Exports of services increased by 28%, reflecting a rebound in trade-related and business services, as well as in inbound tourism, particularly from the PRC. An even stronger increase in imports (up by nearly 32%) more than offset the bounceback in exports, so that net exports fell.

Investment expanded by about 12% in real terms as business sentiment improved, and it made a major contribution to total GDP growth. Sharp rises were seen in private sector machinery and equipment investment and in public sector building investment. Private consumption spending rose by nearly 6%, sustained by a better labor market (the unemployment rate fell to 4.6% in April–June 2010 from 5.1% at end-2009).

GDP growth is likely to moderate in the second half, to about 4.5%, given base effects as well as a slower pace of growth in several major export markets, including the PRC. That would put full-year GDP growth at 5.8%, higher than was forecast in April. Growth is still expected to step down to 4.3% in 2011, taking into account base effects and the phasing out of stimulus policies this year in the PRC. Current account surpluses exceeding 7% are still expected for this year and next.

Inflation quickened to average 2.1% in the first 7 months of 2010 owing to the rebound in domestic demand and higher import prices. The full-year inflation forecast is raised to 2.6% and the 2011 projection

is maintained at 2.8%. The government has made further efforts to damp rapidly rising prices for housing, caused in part by ample liquidity and low interest rates associated with the Hong Kong dollar's link to the US dollar, coupled with some spillover from the PRC's expansionary monetary policy.

Republic of Korea

This economy rebounded by 7.6% in the first half of 2010, after contracting in the prior-year period. A surge in exports of manufactured goods such as automobiles and semiconductors drove the recovery; in the second quarter exports in nominal terms not only exceeded the prior-year period by nearly 35% but also exceeded exports in the second quarter of 2008, before the global recession.

Rising exports prompted a surge of investment in semiconductor manufacturing equipment and other machinery. Total investment contributed more than 5 percentage points of GDP growth in the January–June period. Most of the remaining growth came from private consumption, which got support from a stronger labor market (the unemployment rate fell to 3.7% in July from 5.0% in January 2010), offset in part by high household debt and a soft property market that weighed on consumer sentiment.

Based on this stronger than expected rebound, the growth forecast for 2010 is revised up to 6.0%. Growth will likely moderate to about 4.5% in the second half, as the low-base effect from 2009 fades and the government unwinds fiscal stimulus implemented during the recession. The leading composite index has decelerated from a peak reached early this year, which suggests an easing in economic activity. In 2011, the economy is expected to grow by 4.6%, still above trend, as the pace of equipment investment eases to more sustainable levels.

Merchandise imports, fueled by demand for investment equipment and consumer goods, rose by 42% in the first half of 2010, outpacing the 34% rise in exports. The surplus in goods trade fell from the year-earlier period and the deficit in services trade widened, contributing to a smaller current account surplus of $11.6 billion. For all 2010, the current account surplus is projected at $24 billion, or 2.4% of GDP, revised up from *ADO 2010* mainly due to the strong export performance and a likely moderation of import demand in the second half. The current account surplus is seen easing a touch to about 2% of GDP in 2011.

Inflation averaged 2.6% in the first 7 months of 2010, and is edging higher. Full-year inflation forecasts for this year and next are maintained at 3.0%. The Bank of Korea, after lowering interest rates during the global recession, has started to move rates back toward more normal levels. It raised the policy rate by 25 basis points in July to 2.25% and further gradual increases are expected. The won, which depreciated by 1.2% against the US dollar in January–August 2010, may well strengthen over the rest of the year, which would help to put some downward pressure on imported inflation.

Mongolia

GDP rose by 5.0% in the first half of 2010, coming out of a 1.6% contraction in 2009. Mining, construction, and services expanded in

the first half. Agriculture, however, which supports some two-fifths of the population, suffered from a very harsh winter that reduced livestock numbers by 8.8 million, or 20%, of the herd that consisted mainly of goats, sheep, and cattle.

Economic growth is getting a lift both from construction of the Oyu Tolgoi copper and gold project—which will be one of the world's biggest copper–gold mines when it starts production in 2013—and from increased public spending. Government outlays and net lending rose by 27% in the first 7 months of 2010, much of it channeled into subsidies and cash transfers. In July, Parliament approved budget amendments that allow for further spending hikes. The authorities also propose to raise state-sector wages and pensions this year.

The revenue side of the budget is being bolstered by the recovery in global copper prices. In June 2010, Parliament enacted a fiscal stability law that aims to improve the management of revenue inflows from minerals, so as to avoid boom–bust cycles in the budget and the economy.

Taking these factors into consideration, forecasts for GDP growth are maintained at 7.0% for this year and 6.5% for 2011.

Growth in the value of exports, including coal and copper, has been driven by strong demand from the PRC, Mongolia's major trading partner, as well as by higher global prices for copper and other commodities. Imports of capital equipment needed for mining projects will contribute to widening the current account deficit to a projected 16.1% of GDP this year, and to 21.2% in 2011. The gap is expected to be financed primarily by foreign direct investment, particularly in mining, and by official development assistance. International reserves, at $1.4 billion in June, were slightly above end-2009 levels.

Inflation accelerated to 9.8% year on year in July from 5.7% in January. Livestock losses pushed up meat prices, and prices rose for other food and for electricity. Stronger domestic demand and a surge in broad money (M2) supply (up by 41% year on year in July) contributed to inflation. In response to the price pressures, the Bank of Mongolia raised its policy interest rate in May to 11.0% from 10.0%. The inflation forecast is kept at 7.9% for this year and 6.0% in 2011.

Taipei,China

Surging demand for manufactured exports, particularly electronics products, propelled a 13.1% rebound in GDP in the first half of 2010, from a period of contraction a year earlier. Manufacturing generated most of the growth (about 9 percentage points) on the production side. This recovery prompted a 39% rise in private investment, so that total investment contributed over half the growth in GDP on the demand side. Private consumption picked up by nearly 4%, and net exports also contributed to growth.

Merchandise exports in US dollars surged by just over 47%, with shipments to the PRC and Hong Kong, China up by 62% in the first half. Imports, spurred by recovery in exports and investment, shot up by 61%. Nevertheless, the economic rebound has been uneven, and while the unemployment rate declined to 5.2% in July 2010, is was above trend. Delays in implementation of some government infrastructure projects early in 2010 likely hurt employment creation.

Economic growth is projected to moderate in the second half of 2010, reflecting fading base effects, slower expansion in the PRC (the biggest export market for Taipei,China), and the likelihood of only modest growth in industrial economies. The momentum of export orders and industrial production started to slow in mid-2010 as inventory rebuilding phased down both domestically and globally. For all of 2010, GDP is forecast to grow by 7.7%, revised up from April because of the stronger than expected expansion in the first half. GDP growth is seen moderating to about 4% in 2011, close to its trend rate.

Consumer prices, after declining in 2009, have edged up this year. The monetary authorities raised the policy interest rate by 12.5 basis points in June, to 1.375%, and issued certificates of deposit to drain liquidity from the financial system. The authorities are concerned about speculative capital inflows, which have put upward pressure on the NT dollar exchange rate (it appreciated by 1.0% against the US dollar in the first 8 months of 2010) and could spark asset price bubbles. In response, they have taken steps to curb bank lending for second homes and housing speculation.

Inflation forecasts for this year and next remain unchanged (at 1.5% and 1.6%, respectively). Strong demand for Taipei,China's exports has led to upward revisions in forecasts for the current account surplus, to 8.8% of GDP in 2010 and to 7.3% in 2011.

South Asia

Subregional assessment and prospects

South Asian economies are on the rebound. Robust and well-timed fiscal and monetary policies succeeded in sustaining growth at relatively high levels in 2009 and laid the basis for a solid recovery in 2010. While rising inflation and enlarged fiscal deficits are prevalent in South Asia, policy adjustments are already under way in most countries.

Over the first half of 2010, industrial production markedly increased in three of the four larger countries—India, Pakistan, and Sri Lanka. Activity in Bangladesh was crimped by weak activity in the large readymade garment sector. Moreover, credit to the subregion's private sector is staging a strong revival, as is business confidence, indicating that investment activity is beginning the transition to replace government spending as the mainstay for sustaining rapid growth. GDP grew by 7.1% and 8.5% in Sri Lanka, while India posted 8.6% and 8.8% expansions in the first 2 quarters of calendar 2010.

Since late 2009, inflation has crept into double digits in India, Nepal, and Pakistan, in part on rising food prices, especially in India where a weak monsoon depressed production. Bhutan and Nepal (countries with a pegged currency to the Indian rupee and close trade links with that country) endeavored to find a steady footing as inflation pressures mounted. In Afghanistan, Maldives, and Sri Lanka, inflation remained low. High food inflation in the subregion usually quickly translates into higher nonfood prices, as low wages prevail. Increases in energy prices (as governments struggle to lower heavy subsidies) and public sector wage hikes are significant inflation pressures.

Monetary authorities in high-inflation countries are facing the dilemma of either raising policy rates (to limit price increases) or, under strong pressure from the public, maintaining low interest rates (to stimulate growth). The Reserve Bank of India, for example, has as of mid-September increased its policy rate four times since mid-March. In August, Bangladesh Bank and the State Bank of Pakistan increased their rates. The Central Bank of Sri Lanka, in contrast, continued an accommodative stance in a context of declining inflation, reducing its policy rates in July and August.

The majority of South Asian economies are seeing better foreign exchange earnings. Exports in India, Pakistan, and Sri Lanka started expanding from late 2009, though Bangladesh's garment exports (about 75% of total exports) turned up only in March 2010. Tourist arrivals have also picked up, with India, Maldives, Nepal, and Sri Lanka posting double-digit growth in arrivals in the first half of 2010 relative to the same period in 2009.

Although the growth of net emigration has slowed, workers' remittance inflows remain strong, especially compared to other sources of foreign exchange. Albeit slower than the 20%–40% expansions in 2008, most subregional countries are seeing workers' remittances grow by 10%–20%. Remittances are sustaining private consumption in Bangladesh, Nepal, Pakistan, and Sri Lanka, while offsetting much or all of the trade deficits in these countries.

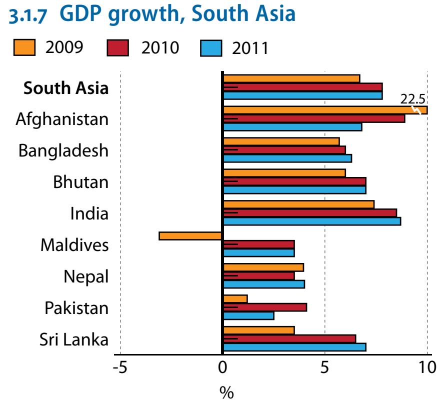
While expansionary fiscal policies were the key factor in mitigating the effects of the global economic crisis, South Asian authorities are now exploring the timing of withdrawal of fiscal stimulus measures to avoid an unsustainable buildup of public debt. India's government is targeting a gradual decrease in the federal fiscal deficit to 3.0% of GDP in FY2013 from 6.7% in FY2009. Maldives, Pakistan, and Sri Lanka have been implementing fiscal consolidation programs under IMF standby arrangements. In Pakistan, higher security-related expenditure, power subsidies, and transfers to provinces pushed out the deficit in FY2010; the budget plan for FY2011 is being adjusted in the face of challenges from devastating floods in August. In Maldives, a political stalemate may threaten to block further fiscal reform. Nepal's government, which approved a partial budget for the first 4 months of FY2011 following the prime minister's resignation, faces an uphill struggle to control fiscal spending due to the absence of clear policies to guide expenditures.

Generally across the subregion, fiscal consolidation needs to be accompanied by growth-oriented structural reforms, especially infrastructure development to remove bottlenecks to growth, particularly in the areas of energy and roads.

Reflecting upward revision in growth estimates for most countries, the South Asian GDP growth projection is revised to 7.8% in 2010 in this *Update* from 7.4% in *ADO 2010* (Figure 3.1.7). This in good part reflects improved growth prospects for India (which accounts for about four-fifths of GDP in South Asia), as India's growth projection was raised to 8.5% from 8.2%. South Asian GDP is forecast at 7.8% in 2011, slightly lower than the 8.0% projected in April, largely attributable to a slowdown in flood-ravaged Pakistan.

This *Update* revises up the inflation projection for South Asia to

3.1.7 GDP growth, South Asia



Source: Asian Development Outlook database.

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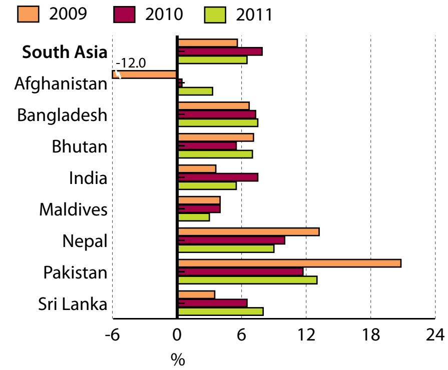
7.9% in FY2010, 1.9 percentage points higher than previously forecast (Figure 3.1.8). This change essentially reflects the revised upward forecast for India, since changes for other countries from *ADO 2010*'s forecasts were marginal. Inflation pressures are, however, expected to ease to 6.5% in FY2011, moderately above the 6.0% projection made in April, as comfortable domestic food supply is assumed due to normal monsoons. Higher inflation in Pakistan largely accounts for the revision. Moderation in global oil and food prices continues to underpin a positive outlook for keeping inflation in check.

The current account deficit for the subregion in 2010 is projected to widen to 2.2% of GDP from 1.5% given in *ADO 2010* (Figure 3.1.9). A wider current account deficit in India was partly offset by improved external positions projected in Bangladesh and Pakistan, owing mainly to lower than expected trade deficits and stronger remittances. The current account deficit is projected at a slightly wider 2.5% of GDP in 2011, with the change coming mainly from Bangladesh, Pakistan, and Sri Lanka.

3.1.8 Inflation, South Asia



Source: Asian Development Outlook database.
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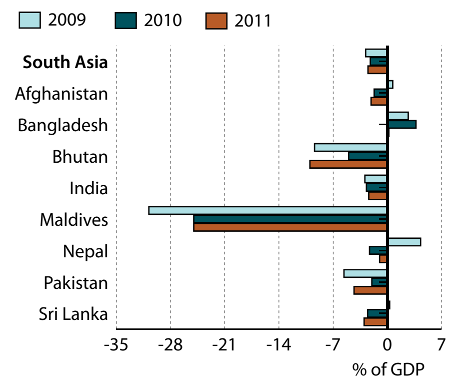
3.1.9 Current account balance, South Asia



Source: Asian Development Outlook database.
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Country highlights

Afghanistan

Economic growth in FY2009 (which ended 20 March 2010) was impressive, with GDP up by 22.5%. This happy outturn stemmed from a strong recovery in agriculture (following a drought the previous year), while heavy external assistance continued to underpin expansion in industry and services. Yet despite the strong economic rebound, prices tumbled during the year, reflecting lower global prices and the recovery in domestic crop production (food has a 61% weighting in the index). Large external trade and services deficits continued to be funded through grants and other non-debt-creating flows.

During the Kabul International Conference on Afghanistan on 20 July 2010, the IMF announced a staff-level agreement on a new 3-year economic program of $125 million under the Extended Credit Facility. But since then, the IMF has decided to review the proposed program, with an indicative date for the new program as end-2010. The program aims to keep inflation low, strengthen banking supervision and regulation, increase fiscal revenues, promote transparency in mining, and improve efficiency in the budget process and public spending—all while protecting the poor.

Given the strong economic momentum shown the previous year, economic growth in FY2010 is forecast to be 8.9%—higher than the 7.6% projected in April—and then moderate to 6.8% in FY2011. These forecasts are based on key assumptions that include continuance of reform in the fiscal, financial, and public enterprise sectors; maintenance of large development-partner funding; normal weather; and a gradual improvement in security. Inflation in FY2010 is revised down to 0.4% and to 3.4% in FY2011. As projected in *ADO 2010*, the current account deficit (after grants) is expected to be stable at about 2% of GDP in FY2010 and FY2011.

Bangladesh

GDP growth in FY2010 (ended 30 June 2010) is estimated at 6.0%, higher than the 5.5% projected in *ADO 2010*. Given the sharp decline

in the growth in exports and remittances, the better than expected performance stemmed from a boost in domestic consumption, which was underpinned by the rapid growth in credit to the private sector and by a rise in public sector wages.

On the supply side, higher growth in agriculture and services accounted for the expansion. Growth in industrial production was slightly lower than a year earlier but held up well given continued power shortages and weak garment exports.

Annual average inflation rose to 7.3% from 6.7% in FY2009 as pressures on prices intensified because of robust consumption demand. As import payments rose slightly more than export earnings, the trade deficit expanded only marginally. Remittance growth fell by nearly half from the previous year, mainly because of the continued decline in the numbers of workers leaving for jobs abroad. Still, with a limited expansion in the trade deficit, increased workers' remittances boosted the current account surplus to $3.7 billion, which, at 3.7% of GDP, was well above the *ADO 2010* projection of 1.8%

GDP growth in FY2011 is forecast at 6.3%, unchanged from that given in *ADO 2010*. Strong domestic demand supported by the ready availability of credit will again drive growth. Average inflation for FY2011 is projected at 7.5%, marginally lower than the 7.8% in *ADO 2010* because of the likely moderation in global oil and other commodity prices. Growth in imports and exports will rise, responding to some pickup in domestic and global demand. Expansion in workers' remittances will again slacken, and the current account surplus will fall to 0.2% of GDP.

Bhutan

Power production and export to India remain near capacity levels. Sales of industries (of which three-quarters is exported) such as cement, ferro-alloys, and chemicals, which had contracted earlier, surged in the last quarter of 2009. Credit to private sector is strong, expanding by about 20%. Moreover, revisions to the budget for FY2010 (ended June 2010) boosted capital expenditure substantially.

With these new developments, this *Update* revises estimated growth for FY2010 to 7.0% from 6.0% in April. With construction having started on a new hydropower project, growth momentum is expected to be sustained at 7.0% in FY2011.

The estimates for inflation have been marked up to 5.5% and 7.0% in FY2010 and FY2011, respectively, mainly owing to higher inflation in India, the dominant trade partner. Reflecting the expected stronger economic growth, the balance-of-payments current account is now projected to be in deficit by 5.0% of GDP in FY2010 and 10.0% of GDP in FY2011.

The government released its new Economic Development Policy in June 2010. The policy sets objectives for the country to become self-reliant and achieve full employment by 2020. It identifies areas of economic opportunities and proposes to promote these sectors with a package of incentives under the "Bhutan Brand." The initiative would reflect the values of Bhutanese society and history, as well as the philosophy of "Gross National Happiness."

India

The economy is on a path to impressive recovery. Growth data in the first quarter of FY2010 came in at 8.8%, the highest in more than 2 years. Macroeconomic management, however, has become more complex due to heightened inflation pressures and a strengthening in the real effective exchange rate. A gradual withdrawal from the expansionary monetary policy stance begun in early 2010 has been initiated and a series of upward revisions made to short-term policy rates.

This *Update* chalks up the forecast for average inflation in FY2010 from 5.0% to 7.5%. However, as nonfuel commodity prices slacken in FY2011 and domestic production and the stock of foodgrains remain comfortable, inflation is still expected to moderate to 5.5% in FY2011, as projected in *ADO 2010*.

With a somewhat stronger than expected recovery under way, projected growth for FY2010 is nudged up to 8.5% from 8.2%. Moreover, the key drivers of growth—consumer demand and private investment—are expected to remain buoyant in FY2011, pushing growth to 8.7% in FY2011 as forecast in *ADO 2010*, despite the slight moderation in growth in industrial economies envisaged in this *Update*.

Favorable developments on the export front are expected to help assuage some of the complexity of macroeconomic management. Trade flows in FY2010 will strengthen, primarily due to the pull factor originating from the buoyancy in world trade. Exports are projected to grow by 18.0% in FY2010 and 15.0% in FY2011. Sectors such as information technology (IT) and IT-enabled services, gems and jewelry, and agricultural and allied products are expected to post impressive export performance. Import growth will see strong performance of 20% in FY2010 due to robust domestic industrial production and investment before moderating to 18% in FY2011.

Taking account of developments to date, the current account deficit is revised from 1.5% to 2.7% of GDP in FY2010 and from 2.0% to 2.4% in FY2011.

Maldives

Affected by the global economic recession, GDP fell by 3.1% in 2009 as tourist arrivals dropped by 4.0%. Tourism, the mainstay of the economy, started to pick up from late 2009 and the country saw a 21% jump in tourist arrivals in January–July 2010 relative to a year earlier. The rebound was led by a surge in tourists from the PRC, though there was also a solid return of European tourists, who account for about two-thirds of all visitors.

Too-rapid fiscal expansion in recent years, combined with the drop in tourism earnings, has pushed the current account deficit to unsustainable levels and led to a marked fall in foreign exchange reserves. The government has, since December 2009, implemented an economic adjustment program supported by an IMF standby arrangement and its Exogenous Shocks Facility, and by an ADB Economic Recovery Program. A donor forum is also providing financial assistance that will underpin adjustment efforts and foreign exchange reserves.

As tourist arrivals are higher than expected in April, this *Update* revises the GDP growth projection for 2010 from 3.0% to 3.5%. Recent

political tensions between the ruling and the opposition parties, however, pose risks for the long-term growth perspective. Progress in some reform areas that need legislation, most notably expanding the tax base, has been slow. For example, a business profit tax has been discussed and debated in Parliament for more than a year, even though it is essential to fiscal adjustment and to long-term economic sustainability. Civil service restructuring may also be delayed.

Nepal

GDP growth decelerated to 3.5% in FY2010 (ended mid-July 2010) from 4.0% in FY2009, mainly due to the impact of inclement weather on agriculture. Industry saw a modest improvement, reflecting some easing of fuel and power shortages, although the difficult political transition continues to weigh on business confidence. Growth of services was supported by a sustained increase in tourist arrivals, which partly offset the impact of decelerating remittances. Average annual inflation remained in double digits, driven mainly by food shortages due to a poor harvest.

A lagged impact of the global economic crisis was seen in sharply decelerating remittances and a decline in exports. These factors resulted in an unprecedented current account deficit of 2.3% of GDP and a marked fall in reserves. Decelerating remittance inflows, coupled with aggressive lending by banks in real estate, triggered a liquidity crunch in the banking system, sharply driving up interest rates.

The economy is now expected to grow by 4.0% in FY2011, down from the 4.5% projected in *ADO 2010*. Assuming normal weather conditions, agricultural growth is expected to pick up in FY2011. With disruptive political strikes abating, industrial growth should maintain or improve its pace. The FY2011 monetary policy imposes restrictions on the entry of new banks, and this will crimp services expansion.

On the demand side, the major deceleration will be in consumption as remittance growth continues to slow. Although inflation is expected to fall in India, inflation in Nepal is unlikely to moderate to 8.0% as projected in *ADO 2010* and, in fact, will likely edge up to 9.0% given the lag in price transmission between the two countries and Nepal's expansive domestic policies.

Imports are gradually adjusting to the slower remittance inflows, but persistently weak exports will keep the current account in deficit, now estimated at 1% of GDP in FY2011, versus the 1% surplus projected in *ADO 2010*.

Political uncertainty associated with frequent changes of government and with a protracted constitution-drafting process remains a major risk to stronger growth in FY2011. For the third year running, a partial budget only was approved for FY2011 in the face of political disruptions. This risks curtailing the capital spending that is critical for a growth revival.

Pakistan

Pakistan enjoyed a modest rebound in FY2010, growing by 4.1% after negligible growth in FY2009. This upturn was supported by a continued buildup of foreign reserves and a steep drop in inflation. The current account deficit narrowed sharply, reflecting a modest rebound in exports

and lower imports, lower services and income deficits, and a strong expansion in workers' remittances. Inflation fell from the 20.8% average pace in FY2009, but remained high at 11.7%. Fiscal slippage in FY2010, however, was substantial as revenue fell short of target and current spending topped budget allocations due to higher security outlays and ballooning energy-related subsidies.

Prospects for FY2011 have been subsumed by the extensive damage from the devastating flooding in much of the country. The widespread damage to agriculture and key infrastructure has affected every sector of the economy and will pose significant challenges for growth in the short to medium term. As the supply and distribution of goods and services have been hit, the resulting shortages will exert significant upward pressure on prices.

Pressures on the current account deficit will also intensify, due to a higher than envisaged increase in food and material imports and lower than projected exports stemming from the losses in agriculture and manufacturing output.

Flood-related expenditure will alter the fiscal outlook relative to the preflood budgetary targets for FY2011. In this context, the urgency of reforms necessary to release fiscal space for reconstruction and development is greater than ever before.

Sri Lanka

The economy picked up strongly from the beginning of 2010. First-quarter growth was 7.1%, with all three major sectors of the economy (agriculture, industry, and services) registering significant growth. Inflation, which had climbed to 6.9% by February 2010, fell to 4.8% by June. Policy rates that had been slashed in February–November 2009 were cut yet again in July and August 2010. Credit to the private sector, which contracted during much of 2009 on weak demand and banks' cautious approach to lending, turned positive from March 2010 with the pickup in economic activity. The stock market is vibrant, reflecting strong confidence among both local and foreign investors.

The budget, which was postponed on account of two major elections held in early 2010, was presented to Parliament in June 2010. The fiscal deficit for the year is expected to be 8.0% (including grants), down significantly from 9.8% in 2009, narrowed mainly by expenditure rationalization. With satisfactory progress in the economic adjustment program, the IMF released funding under the country's standby arrangement and extended it for a year.

The current favorable momentum is expected to continue, and this *Update* upgrades the 2010 GDP growth forecast to 6.5%, from 6.0% in *ADO 2010*. Political stability, improved credit ratings, private sector revival, and government infrastructure investment underpin a strengthened economy. No change is made in projected inflation.

Imports have picked up, though the turnaround in exports is less significant. The withdrawal of GSP Plus by the European Union in August 2010 could affect export performance in the last quarter of the year. On these developments, the projected current account deficit is now expected to widen to 2.5% of GDP in 2010, from 2.0% given in *ADO 2010*. No change is made in the 2011 forecast (3.0% of GDP).

Southeast Asia

Subregional assessment and prospects

Aggregate GDP growth in the 10 Southeast Asian countries is now forecast to increase by 7.4% in 2010, faster than previously expected and a sharp rebound from growth of just 1.3% in 2009 (Figure 3.1.10). Better than expected performances in the first half of the year—driven by a strong recovery in global trade and a broad-based increase in domestic demand—are behind the upgrade.

The recovery in many Southeast Asia economies was initially driven by a pickup in both global and regional demand, particularly from the PRC. This caused a sharp recovery in exports of both manufactured goods and commodities. The resulting increase in manufacturing output, the firming up of labor markets, higher wages, and increased agricultural commodity prices led to higher urban and rural incomes and a rebound in private consumption.

Investment also surged as business sentiment improved on the back of stronger global and domestic demand. Economic stimulus programs introduced during the downturn in 2009 continued to exert a positive influence on domestic demand during the first-half of 2010 in a number of these economies.

Despite a sharp increase in subregional exports, the contribution of net exports to economic growth was generally modest, or negative in the case of Malaysia, as imports increased even faster due to the heavy dependence of most countries on imported inputs for manufactured exports.

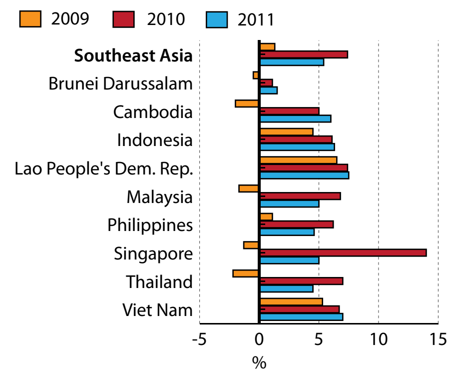
Growth forecasts for 2010 are revised up from April for all subregional countries, except Brunei Darussalam and Myanmar, with those most open to international trade—particularly Malaysia, Singapore, and Thailand—recovering the fastest. Singapore had the fastest year-on-year growth (17.9%) in the first half of 2010 as net exports contributed most to GDP growth, while investment and consumption powered GDP growth in Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.

In the more open economies of Malaysia and Thailand, the rebuilding of inventories, which were run down in 2009, contributed substantially to GDP growth, as did private consumption and fixed investment. Government consumption in these two economies remained at relatively robust levels owing to disbursements under stimulus programs. The main contribution to growth in Indonesia and the Philippines, which are less dependent on exports, was private consumption, followed by fixed investment.

Brunei Darussalam is still expected to experience a modest recovery in 2010, but will be held back a little by the government's decision to conserve the country's oil and gas reserves, and by limited progress in economic diversification. In Myanmar, foreign investment in the hydrocarbon sector, a modest recovery in agriculture, and an increase in election-related public expenditure will likely increase GDP, but not to the extent projected in April. Higher growth in Cambodia and the Lao People's Democratic Republic will be underpinned by rebounds in exports and tourism.

Growth in the subregion will likely slow in the second half of this year relative to the generally fast pace of the first 6 months, and the expansion is forecast to moderate in 2011. Various common factors will contribute to

3.1.10 GDP growth, Southeast Asia



Source: Asian Development Outlook database.
Click here for figure data

this slowdown. During the second half of 2010 and in 2011, the favorable base effect of a contraction in, or sharply slower, GDP growth in the first half of 2009 will play itself out. Moreover, with recovery now appearing to be firmly on track, fiscal and monetary authorities are likely to complete the unwinding of policy stimulus this year. Interest rates have been raised in Malaysia, Thailand, and Viet Nam, and other measures have been taken to contain emerging asset bubbles in some stock and property markets.

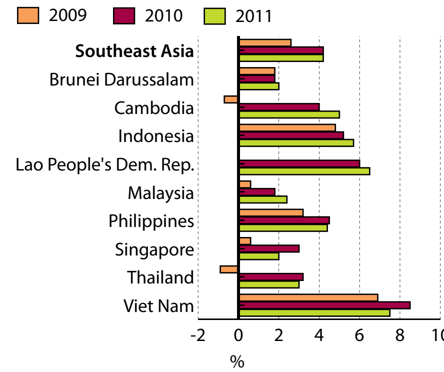
The world economy is experiencing considerable uncertainty, though, and there are signs that economic activity across Southeast Asia is starting to decelerate. Investment due to restocking is slowing in Indonesia, Malaysia, the Philippines, and Thailand, suggesting that the restocking cycles in both export and domestic markets are nearing completion. In several countries, net exports were beginning to exert a bigger drag on growth in the second quarter relative to the first, suggesting slowdown in demand for exports. GDP growth in Southeast Asia as a whole is now projected to moderate to 5.4% in 2011, bumped up a little from *ADO 2010*.

As economic recovery strengthened in January–June, inflation across the subregion edged up, but remained manageable. Aggregate inflation is projected to rise to 4.2% in 2010 (Figure 3.1.11), from 2.6% in 2009 when global food and fuel prices dropped in the wake of the global recession. In 2011, inflation for the subregion is also seen at 4.2%. Forecasts for both years are a shade lower than in *ADO 2010*. Inflation pressures have been kept subdued in several economies, including Malaysia, the Philippines, and Thailand, by the presence of output gaps, while a steady appreciation of the currencies of the bigger economies against the US dollar helped contain imported inflation. Inflation is expected to rise during the rest of 2010 as output gaps narrow.

In 2011, higher domestic demand, combined with a planned reduction in subsidies in some economies, will add to inflation pressures, offset to some extent by firming exchange rates and a forecast decrease in global food prices. Myanmar and Viet Nam will continue to post the highest rates of inflation during the forecast period (although forecasts for both are trimmed from April).

With some intercountry differences, the overall subregional current account surplus as a share of GDP is still forecast to decline to 5.7% in 2010, from 7.1% in 2009, and to remain at around 5.7% next year (Figure 3.1.12). Export growth is projected to moderate over the rest of this year and into 2011 owing to a less supportive external environment, the completion of inventory building in industrial economies, and lower prices for some commodities. Import growth is likely to remain robust, a result of buoyant domestic demand. Viet Nam's current account deficit is expected to narrow because of improvements in its trade account, remittances, and inbound tourism.

3.1.11 Inflation, Southeast Asia



Source: Asian Development Outlook database.
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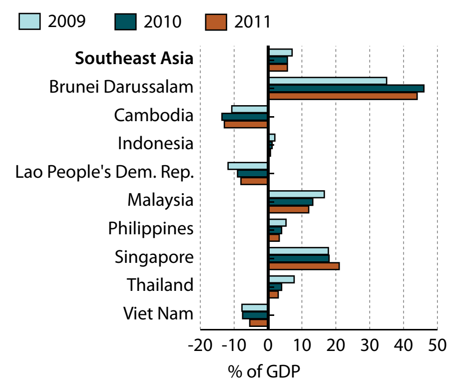
3.1.12 Current account balance, Southeast Asia



Source: Asian Development Outlook database.
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Country highlights

Indonesia

A welcome increase in fixed capital investment together with higher levels of private consumption drove 5.9% growth in GDP in the first half of 2010. Government consumption spending declined as the government

unwound its fiscal stimulus and as budget disbursement lagged behind schedule. The monetary authorities left the policy interest rate at low levels to stimulate growth in credit and in the context of modest core inflation and an appreciating exchange rate. On the production side, services contributed most to GDP growth, while manufacturing and mining expanded at a moderate pace. Agricultural output was affected by bad weather.

Investment is expected to gather momentum through the second half of 2010 and private consumption to grow at a healthy rate. Export growth will moderate, though. On balance, the forecast for full-year growth is raised from April to 6.1%, and for 2011 to 6.3%, owing to projections of further growth in private consumption and in private and public investment.

Inflation accelerated to just over 6% in July and August, fueled by higher prices for food (a result of bad weather) and an increase in electricity tariffs. Some of the pressures on prices were one-time and seasonal factors (which were expected to subside). Forecasts for year-average inflation of 5.2% in 2010 and 5.7% in 2011 are trimmed from those made in April. However, inflation could exceed these forecasts given the quickening economic growth, accommodative monetary policy, and possibility that bad weather could revive upward pressure on food prices.

While merchandise exports rebounded by 39% in the first half of this year, imports rose by nearly 50%, owing to the need to import materials for the export industries together with the demand for imported consumption and fixed capital goods. Current account surpluses are now forecast at 1.2% of GDP in 2010 (slightly lower than expected in April) and 0.7% in 2011.

Malaysia

First-half GDP growth was stronger than expected at 9.5%. Recovery in global trade and a broad-based increase in domestic demand drove the recovery. While the pace of growth will ease in the second half, private consumption is seen remaining robust, reflecting a firming labor market and higher incomes. Private investment in fixed capital and inventories is supported by a recovery in export-oriented manufacturing industries. Efforts to reduce the fiscal deficit are likely to damp public consumption and investment during the rest of 2010. Monetary stimulus, too, is being unwound—the central bank raised its policy interest rate three times from March to end-August 2010.

The slowdown anticipated in the second half is mainly due to base effects (the economy picked up from a slump in the second half of 2009) and slower growth in several export markets. Nevertheless, the forecast for growth in 2010 is raised to 6.8% on the basis of the powerful first-half recovery. For 2011, GDP growth is forecast to moderate to 5.0%, owing to less favorable base effects, unwinding of policy stimulus, and tamer growth in global and regional export markets.

Upward pressure on prices has been milder than anticipated, so that the 2010 inflation forecast is lowered to 1.8%. The continuing output gap, exchange rate appreciation (the ringgit strengthened by 8.8% against the US dollar in the first 8 months), and maintenance of price controls on some basic goods will keep inflation at low levels. In 2011, higher domestic demand combined with planned reductions in subsidies will add to

inflation, while the firming exchange rate and subdued global commodity prices will counteract some of that influence. Taking these factors into account, inflation is now forecast to edge up to 2.4% in 2011.

On the trade front, export growth is projected to moderate over the rest of this year and into 2011, due to a less supportive external environment, the completion of inventory buildups in industrial economies, and lower prices for some export commodities. Import growth is expected to remain robust owing to buoyant domestic demand. A narrowing of the trade surplus is likely to be reinforced by deterioration in the income balance because of increased outflows of profits and dividend payments. This narrowing should be partly offset by an improvement in the services account as inbound tourism picks up. Forecasts for the current account surplus are edged down to the equivalent of 13.2% of GDP this year and about 12% in 2011.

Philippines

Economic growth of 7.9% in the first half of 2010 was stronger than expected. Private consumption accounted for about half the total growth, supported by a near 7% gain in the US dollar value of remittances sent home by workers abroad. Investment contributed significantly to growth for the first time since 2007, with a 21% increase in fixed capital investment. Government expenditure also climbed, ahead of presidential and legislative elections in May and as a result of additional spending on conditional cash transfers to poor families and reconstruction of typhoon-damaged infrastructure.

On the production side, industry contributed most of the GDP growth as export-oriented manufacturing (particularly electronics) as well as construction and mine production rose steeply. Services grew, but agriculture contracted in the first half because of dry weather.

Growth is expected to decelerate in the second half as the low-base effect fades and inventory rebuilding levels off. For the full year, GDP growth is forecast to be 6.2%, revised up from April because of stronger than foreseen rebounds in trade and investment. In 2011, growth is seen easing to 4.6% as a consequence of base effects, reduced policy stimulus at home and abroad, and slower growth in world trade. The new government aims to rein in the fiscal deficit, but also to promote public–private partnerships to build infrastructure.

Inflation pressures have been milder than anticipated. Upward pressures on rice prices caused by the dry weather were countered by an increase in rice imports, and a 2.8% appreciation of the peso against the US dollar in the first 8 months helped to shield the economy against imported inflation. Inflation forecasts are trimmed to 4.5% in 2010 and 4.4% in 2011.

The external position strengthened in the first half of 2010. Merchandise exports rebounded by 38.5%, propelled by a surge in shipments of electronic products, and imports increased by 29.7%. The current account surplus rose, a result of a narrower deficit in merchandise trade (but a smaller surplus in services trade) and the substantial remittances. The overall balance of payments increased, lifting gross reserves to nearly $50 billion by August. Forecasts for the current account surplus are raised to 4.0% this year and 3.3% next year.

Singapore

Rebounding from last year's economic contraction, GDP surged by 17.9% in the first half of 2010. The export-led recovery spilled over into stronger private consumption and investment. Merchandise exports rose by 37.5% in US dollar terms in the first half, and imports by 34.6%.

Stronger external demand for goods such as chemicals, electronics, and pharmaceuticals drove a surge in manufacturing production. About 40% of Singapore's exports were destined for the PRC, and growth in that market helped to offset weakness in industrial countries.

Export-oriented services—finance, tourism, and trade-related—joined the recovery. Net exports of goods and services contributed more than half the total first-half increase in GDP.

Growth will decelerate in the second half, given base effects brought about by a pickup in the prior-year period, coupled with the impact of more moderate expansion in the PRC and several other export markets. The forecast for full-year growth is raised to 14.0% (and it could exceed that high rate) in light of the much stronger than expected outcome for January–June. For 2011, the growth forecast is maintained at 5.0%, in the context of subdued global growth. Large current-account surpluses are still projected for both years.

Inflation picked up from 0.2% year on year in January to 3.3% in August. The monetary authorities, starting to reverse an effective loosening of monetary policy implemented during the global financial crisis, in April this year raised the Singapore dollar's trading band and allowed the currency to appreciate. The forecast for average inflation in 2010 is raised to 3%, owing to higher than expected domestic demand. The government, concerned that a bubble might be inflating property prices, has taken steps to curb speculation in housing, and has said that it will increase the supply of public housing and land available for residential construction. Inflation is expected to slow to about 2% in 2011, in tandem with economic growth.

Thailand

Vigorous growth in the first half of 2010 pulled the economy out of the contraction experienced in 2009. Momentum was interrupted when political tensions broke out into violent demonstrations in Bangkok during April and May, though GDP still managed to grow by 10.6% in January–June.

Domestic demand contributed nearly all the GDP growth in the first half. Private consumption benefited from a firming labor market and higher farm incomes, as well as from fiscal stimulus measures initiated in 2009. Fixed capital investment rose significantly, with increases in investment in machinery and equipment as well as building. Delayed disbursement on government projects damped public investment, however. From the supply side, industry contributed nearly all the GDP growth. Services also expanded, but agricultural production fell slightly because of drought and pest infestations.

Growth in the second half of 2010 will decelerate markedly, as the base effect of the slump in the first half of 2009 fades and because of slowing growth in several major export markets. Monetary policy stimulus is being withdrawn—the Bank of Thailand started to raise its

policy interest rate in July. Nevertheless, the economy is now expected to expand by 7.0% in 2010, revised up from April because of the stronger than expected rebound in the first half. In 2011, growth will likely moderate to about 4.5%. A resurfacing of the domestic political tensions remains a risk to this outlook.

The baht appreciated by 5.3% against the US dollar in the first 8 months of 2010, which contributed to containing inflation (it averaged 3.4% year on year in that period). The full-year inflation forecast is trimmed to 3.2%. Price pressures are expected to ease slightly next year, along with economic activity.

Merchandise exports rose sharply from 2009's low levels, by 36.6% in the first half of 2010, and imports surged by 51.7%. Surpluses in the current and capital accounts pushed up international reserves to $151.5 billion by July. The current account surplus in seen at 4.0% of GDP this year and 3.0% in 2011.

Viet Nam

First-half economic growth of 6.2% was stronger than expected, with solid gains in the industry and services sectors and modest growth in agriculture. The rebound in world trade spurred manufacturing production, and a recovery in global travel lifted inbound tourism. Construction slowed early in the year when domestic credit was squeezed, but it then turned up strongly. Robust growth was recorded in utilities, transport and communications, and financial services. On the downside, production of crude oil resumed its decline.

Fiscal and monetary stimulus initiated during the global crisis sparked a near 40% surge in credit growth as 2009 progressed, putting upward pressure on inflation and eroding foreign exchange reserves. With macroeconomic stability at risk, the authorities started to withdraw the stimulus from late in 2009. Macroeconomic conditions improved in the second and third quarters. The current account deficit narrowed sharply in the first half of 2010 from the second half of 2009, and foreign reserves started to increase from low levels. Policy tightening and a good rice harvest pulled back inflation to 8.2% in July–August 2010, from 9.5% in March, although it increased to 8.9% in September.

The authorities devalued the dong exchange rate three times between November 2009 and August 2010, by a total of about 11% against the US dollar. The sizable trade deficits and relatively high inflation, coupled with residents switching from local-currency assets into US dollars and gold, had put downward pressure on the dong.

Assuming that macroeconomic stability is maintained in the forecast period, economic growth this year is projected at 6.7%, revised up from April in light of the stronger first-half performance and a quickening in growth anticipated in the second half of 2010. Growth is seen rising to 7.0% in 2011 as investor confidence improves, reflecting more subdued inflation and more robust external accounts.

Given that credit growth has moderated and macroeconomic conditions have generally improved, forecasts for inflation are shaved to 8.5% in 2010 and 7.5% next year. The current account deficit is seen narrowing to 7.5% of GDP and 5.4%, and foreign reserves are expected to increase modestly. However, a premature easing of policy, or a perception

of looser policy by financial markets and domestic investors, would risk derailing the stabilization efforts, putting inflation on an upward path and reserves on a downward one. That would likely require a more stringent policy tightening later, denting growth prospects in 2011.

Other economies

Brunei Darussalam

After contracting by an estimated 0.5% in 2009, this economy is forecast to stage a modest recovery and grow by 1.1% in 2010 and 1.5% in 2011. Growth will be underpinned by a small increase in oil and gas production as global demand and prices for hydrocarbons picks up with the recovering global economy. The start of production and exports of methanol in the first half of 2010 will provide a lift to growth.

Still, the hydrocarbon sector's contribution to growth will remain modest, given the government's decision to tap reserves sparingly to extend the life of energy production. Private consumption is likely to be tame this year a result of measures taken to prevent the buildup of a credit bubble through restrictions on lending and tighter regulations on credit card debt.

Inflation is set to edge up to 1.8% in 2010 and 2.0% in 2011, a touch higher than forecast in April. Its evolution depends largely on movements in prices of food, most of which is imported. Stability of the Brunei dollar against the US dollar and maintenance of an extensive array of government subsidies will hold inflation to low levels.

Forecasts for current account surpluses have been raised to 46% of GDP in 2010 and 44% in 2011. The surpluses are underpinned by higher oil and gas prices, a likely increase in tourist arrivals, and increased net income inflows with a recovery in prices of the country's assets abroad. Growth in imports, however, is projected to more than offset higher exports, reflecting increases in the machinery and equipment that are needed for oil exploration, together with growth in construction materials for government infrastructure projects.

Cambodia

Economic growth in 2010 is now forecast at 5.0%, upgraded from *ADO 2010* because of solid growth in garment exports and tourism arrivals. US Department of Commerce figures indicate that garment imports to the US from Cambodia in the first 7 months of this year increased by over 10% in US dollar terms, and by about 24% in volume terms, compared with the prior-year period.

Tourist arrivals rose by 12.4% in the first 6 months of 2010. However, growth in construction remains subdued and agricultural production is expected to be hurt by the late arrival of the rains this year.

Growth is projected at around 6% in 2011, reflecting forecast increases in garment exports and tourism receipts, an expansion of rice exports following a new rice production and export policy, and a pickup in nongarment manufacturing and some other services subsectors.

Inflation has been more muted than was expected in April, so that the full-year forecast for 2010 is trimmed to 4.0%. Next year, inflation is likely to edge higher to about 5%, in step with economic activity.

In the external accounts, preliminary data showed that merchandise exports grew by 6.1% in the first 6 months of 2010, a faster pace than for imports (4.8%). The recovery in tourist arrivals is expected to lift income from this source. The current account deficit, excluding official transfers, is anticipated to be narrower than forecast in April, at about 13.6% of GDP in 2010 and 12.9% in 2011. Gross foreign reserves edged up to nearly $2.5 billion in the first 7 months of 2010 from end-2009, equivalent to about 4 months of projected imports.

Lao People's Democratic Republic

Prospects have improved for this economy, and the forecast for GDP growth in 2010 is lifted to 7.4%. The industry sector, particularly minerals and hydropower generation, has continued to expand, and export orders for garments rose by about 15% year on year in the second quarter of 2010. Tourism arrivals have increased modestly. However, drought delayed planting of rice, which could dent growth in agriculture this year. The GDP growth forecast for 2011 is maintained at 7.5%.

Inflation has been higher than expected, accelerating to 6.8% year on year in July. The main factors were higher food and fuel prices, with the drought hurting food production and prices. Inflation is now projected to average 6.0% in 2010, quickening to 6.5% in 2011.

This year's start of large power exports from the Nam Theun 2 hydropower project and rising global prices for exports of copper, gold, and silver have improved the current account position. Forecasts for the deficit on that account are narrowed to 9.0% of GDP in 2010 and 8.0% in 2011.

Exports of electricity and minerals are set to increase further next year with the commissioning of more hydropower projects and expansion of two mines scheduled for completion by end-2010. The overall balance of payments will remain positive over the forecast period, supported by inflows of foreign direct investment.

Myanmar

GDP growth is expected to rise to 5.0% in FY2010 (ending 31 March 2011) and to 5.3% in FY2011, both forecasts lowered slightly from *ADO 2010*. The economy this year is expected to get a lift from foreign investment in two new gas fields and construction of an oil and gas pipeline to the PRC.

Private consumption will be supported by an increase in public sector wages announced earlier in the year, and higher rural incomes coming from a modest increase in agricultural commodity prices and a gradual increase in agricultural production. Public consumption and investment are likely to rise due to expenditure that is related to national elections announced for November 2010. In FY2011, agricultural output is projected to increase further, assuming that efforts to modernize the sector gain traction after the elections.

Inflation is forecast to quicken to 7.5% in FY2010 as prices for imported food and fuel rise from last year's low levels, and then move up by about 1 percentage point next fiscal year. Exports during the forecast period will be offset by imports due to higher prices for imported petroleum products and increased imports of capital equipment, construction materials, and consumer goods. The current account deficit is forecast to widen from 1.8% of GDP in FY2010 to 2.3% in FY2011.

The Pacific

Subregional assessment and prospects

The aggregate growth projection for 2010 is raised to 4.3% (Figure 3.1.13), mainly owing to upgrades in the growth outlook for the Solomon Islands and Timor-Leste, two of the larger economies. The Solomon Islands' revision is based on a stronger than expected rise in prices for some commodities, which will lift exports. For Timor-Leste, higher growth than previously expected in April's *ADO 2010* is driven by increases in government expenditure, funded by revenue from offshore petroleum production.

Solid growth in Papua New Guinea, the biggest Pacific economy, is a major contributor to the subregional aggregate projection. The forecast for this producer of agricultural commodities, metals, and energy is maintained at 5.5%.

However, the good prospects for these resource-driven economies mask the fact that the majority of Pacific economies are barely growing, and that forecasts for several are revised down. Tonga is now expected to join the Fiji Islands in facing a contraction of economic output this year. Tonga's downgrade is the result of delays in infrastructure investment coupled with weaknesses in remittances, tourism, and domestic demand. Forecasts also are lowered for the Cook Islands, Kiribati, Nauru, and Vanuatu.

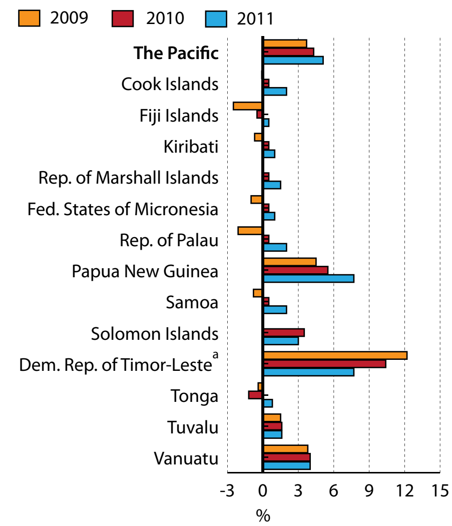
Growth in tourist arrivals in most destinations in the Pacific has slowed this year as the Fiji Islands regains some of the market share that it lost last year (partly on account of floods). But heavy discounting of tourism services in the Fiji Islands is expected to translate into minimal increases in tourism receipts.

Governments in the Cook Islands, the Republic of the Marshall Islands, Samoa, the Solomon Islands, and Tonga adopted programs of policy reform and public sector adjustment, assisted by development partners. These programs provide budget support to finance infrastructure upgrades and help to preserve priority expenditure on government services.

In 2011, subregional growth is expected to pick up to 5.1%, revised up slightly from the earlier forecast. The projection for Timor-Leste is raised to 7.7% because of higher levels of government spending, and Papua New Guinea is expected to grow at this rate, too, as investment accelerates in a large gas export project. The Fiji Islands and Nauru are likely to resume growth next year, supporting the increase in the subregional total. Growth forecasts are lowered a touch for Kiribati and Tonga, though. Excluding the two energy producers (Papua New Guinea and Timor-Leste), growth for the rest of Pacific subregion is forecast to remain low at 1.3%. Higher and sustained rates of growth there depend on further policy reforms.

Subregional inflation is projected to increase to 5.9% in 2010 (Figure 3.1.14), up from 2009 and faster than previously anticipated. Inflation has been driven by higher global prices for oil and commodities and by accelerating price pressures in some of the subregion's trading partners. Marked increases in inflation are now seen for the Fiji Islands and Timor-Leste. The projection for inflation in the Pacific in 2011 is maintained at 5.4%.

3.1.13 GDP growth, the Pacific

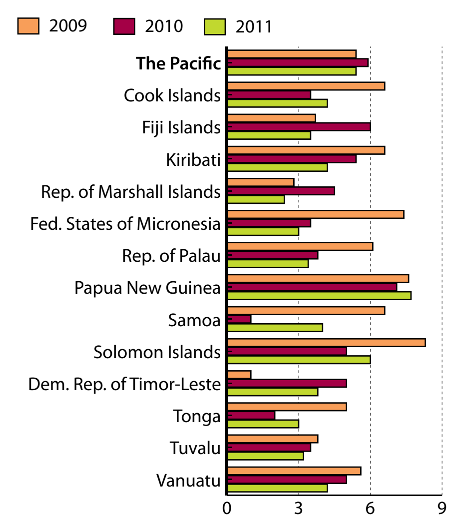


[a] non-oil GDP.

Source: Asian Development Outlook database.

Click here for figure data

3.1.14 Inflation, The Pacific

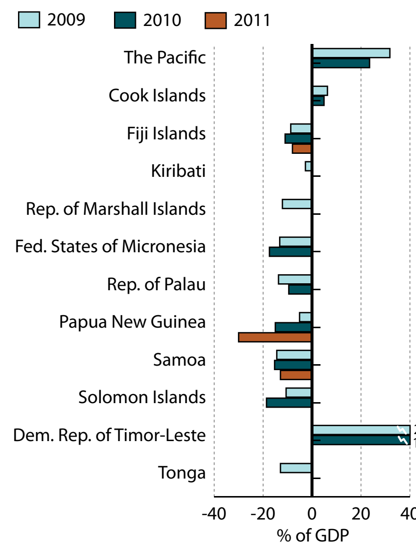


Source: Asian Development Outlook database.

Click here for figure data

As in previous years, large current account deficits are projected for 2010 in most Pacific economies. Current account deficits are expected to widen from 2009 for economies including Papua New Guinea, Samoa, and the Solomon Islands as growth in imports of goods and services outpaces that for exports. Timor-Leste's strong external position, a consequence of income from oil and gas extraction, puts the subregional total into surplus (Figure 3.1.15).

3.1.15 Current account balance, The Pacific



Source: *Asian Development Outlook* database.

Click here for figure data

Country highlights

Fiji Islands

The economy is forecast to contract by 0.5% in 2010, the fourth consecutive year of shrinking GDP. Sugar production is expected to fall from 2009 levels, due largely to dry weather, a declining area under sugarcane as farmers leave the industry, and poor mill performance. Tourist arrivals have picked up, but revenue has been dented by aggressive price discounting.

Fiscal constraints have damped government spending, although budget revisions at midyear allowed for a small net increase in spending to repair damage from cyclones in early 2010 and from widespread termite infestation this year. Consumer spending has been hurt by rising inflation and weakness in remittance inflows.

GDP growth is expected to resume in 2011, at the low rate of about 0.5%. The government that was installed after a military coup in December 2006 is taking action to overcome some of the difficulties (primarily concerning access to land) faced by the sugar industry. It is also discussing a standby arrangement with the IMF, which, if concluded, would likely improve business and investor confidence.

Inflation accelerated to 10.5% year on year in April 2010 due to the removal of some price controls, the impact of a devaluation of the Fiji dollar in April 2009, higher fuel prices, and increased liquidity in the banking system. Inflation is now expected to average 6% in 2010, revised up from April. By 2011, the impact of the devaluation and removal of price controls will have faded, so that inflation next year is forecast to decelerate to 3.5%.

The Reserve Bank of Fiji raised the reserve requirement for commercial banks in two stages during June and July 2010 to reduce excess liquidity in the banking system. However, growth in credit to the private sector has been below 1% in 2010, and credit fell in some months.

The external position is expected to remain fragile, with the current account deficit widening to 11.0% of GDP in 2010. Foreign exchange reserves at end-August 2010 were equivalent to 3.7 months of imports of goods and nonfactor services, but are inflated by restrictions on repatriation of bank profits and company dividends.

The Fiji Islands faces a large external financing gap in 2011 when a $150 million sovereign bond matures. The government's response has been to limit expenditure, and prioritize export promotion and import substitution. However, across-the-board cuts in government operations and in staffing have diminished its capacity to provide services. Measures to bolster revenue may be necessary.

Papua New Guinea

This resource-rich economy is benefiting from the recovery in global commodity prices, especially for copper, gold, and crude oil. However, as foreseen in April, some major resources projects have been delayed. Construction of a $16 billion liquefied natural gas (LNG) project has been held up by land access and compensation issues, as well as by a shortage of skilled labor. Startup of production at a new Ramu nickel–cobalt mine, originally scheduled for midyear, has been delayed until the end of the year by a dispute with a landowner group over environmental issues.

Other industries are performing strongly. In agriculture, production levels are expected to rebound from depressed levels in 2009, and an outbreak of cocoa pod borer disease has been contained. Construction activity has been boosted by new resource projects and demand for new commercial and residential properties, which are in short supply. Competition and expansion in the mobile telephone industry continues to stimulate services growth.

On the back of higher commodity prices and better agricultural production, the value of exports increased by about 37% in the first half of 2010 from the prior-year period. Private sector credit grew by 18% in the 12 months to June 2010. Public expenditure in real terms increased by about 2% in the 12 months to March 2010, even though revenue fell by 18%, as the government drew down about $700 million (equivalent to 9% of GDP) from trust funds established during times of very high commodity prices in the past.

Taking these factors into account, the GDP growth forecast for 2010 is maintained at 5.5%. Next year, growth is expected to accelerate to 7.7% as investment picks up in various projects, particularly the big LNG plant.

Inflation is seen remaining relatively high, averaging 7.1% in 2010 and 7.7% in 2011. Price pressure is being generated from high levels of private sector activity and public sector spending from trust funds.

The current account deficit is expected to widen sharply this year (to 15% of GDP) and next (to 30%), in large part a result of a surge in imported equipment required for the LNG plant and other projects. Foreign reserves totaled $2.8 billion at end-June 2010, sufficient for about 15 months of nonmineral import cover.

Democratic Republic of Timor-Leste

Growth in the preferred measure of this economy—GDP excluding offshore petroleum production—was revised up for 2009 from a preliminary estimate of 5.0% in *ADO 2010* to 12.2%. The upgrade was driven by a fourth-quarter surge in own-funded government expenditure, particularly on capital items, and a better than expected agricultural performance.

Growth forecasts for this year and next, too, are raised from April, to 10.4% and 7.7%, respectively, mainly owing to higher levels of government expenditure funded by the country's earnings from offshore oil and gas production. The original 2010 budget allowed for a small increase in own-funded government expenditure, but a supplementary budget approved in June 2010 increased expenditure by nearly 40%. Much of this is allocated for cash transfers (such as to war veterans) and for small-scale capital works, which will keep aggregate demand high.

Private construction, transport and communications, wholesale and retail trade, and agriculture are all expanding this year.

Inflation, which accelerated to 6.6% year on year in June 2010 from 1.6% at end-2009, is now expected to average 5.0% this year, higher than the previous projection. The gain reflects higher imported inflation and buoyant domestic demand. For 2011, inflation is projected to slow to 3.8% as growth in the domestic economy eases and global oil prices moderate.

Assets in the nation's Petroleum Fund rose to $5.9 billion in the first 4 months of 2010 and are projected to reach $6.4 billion by year-end. The savings are accumulating faster than expected, despite government withdrawals that substantially exceed estimated sustainable income. (That income figure—now 3% of the net present value of petroleum revenue—is that level of withdrawal that can be sustained indefinitely.) While the 2010 budget originally kept expenditure below estimated sustainable income ($502 million), the amount to be withdrawn is now budgeted to exceed it by $309 million.

Key issues for budget management are whether the higher levels of expenditure are fiscally sustainable, and whether implementation capacity has advanced so that additional budget allocations can be spent effectively and in a transparent and accountable manner.

In July 2010, Timor-Leste became only the third nation to comply with the Extractive Industries Transparency Initiative, an international agreement that aims to strengthen governance by improving transparency and accountability in the mining and oil industries. Compliance provides international recognition that Timor-Leste is accurately and fully disclosing the government revenue it receives from petroleum.

Small Pacific countries

Samoa

After 5 consecutive quarters of contraction, GDP grew by 0.7% year on year in the October–December quarter of 2009; slight 0.5% growth is still forecast for 2010. Post-tsunami reconstruction has stimulated growth (a tsunami battered coastal areas in September 2009). Inflows of remittances from Samoans working abroad rose after the tsunami. However, that increase has faded, in part because of weak labor markets in some source economies. Tourism, too, is subdued: visitor arrivals for the first 4 months of 2010 fell by 4.7% year on year.

The government plans to maintain an expansionary fiscal policy in FY2011 (ended 30 June 2011) through increased spending on education, health, and agriculture, coupled with tsunami-related expenditure. The budget deficit is set to widen to 9.4% of GDP in FY2011 from 7.6% in FY2010.

Economic growth is expected to pick up to about 2% in 2011, generated by government spending, reconstruction activity, and higher inflows from remittances and tourism as economies strengthen in source countries.

Inflation has been low so far in 2010; indeed the consumer price index fell by 0.3% year on year in June. Prices are expected to edge up later in the year because of higher costs of fuel and goods imported from New Zealand. On the basis of lower than expected inflation in the first half of 2010, the full-year forecast is lowered to 1.0%. Inflation next year is seen

accelerating to 4.0% in tandem with the pickup in domestic demand and rising prices for imported goods.

The FY2011 budget strategy statement acknowledges that fiscal consolidation may not be achievable until after FY2013, because of tsunami-related costs. The macroeconomic framework in the budget shows public debt peaking at 52% of GDP in FY2013 (in net present value terms).

Solomon Islands

A stronger than expected recovery in production of cocoa, fish, logs, and palm oil has prompted an upward revision to the 2010 GDP growth forecast, to 3.5%. Higher prices for most of these commodities stimulated output. However, the pickup in the economy from 2009, when GDP was flat, has been uneven. A survey of business expectations showed that 61% of businesses in June 2010 reported unchanged or declining sales compared with the same period in 2009 (though 56% expected sales to improve over the next 3 months).

Government finances remain strained. Revenue collections fell short of budget targets in the first 5 months of 2010, and payroll costs exceeded budget by about 10%. Development expenditure was below target levels.

Policy reforms aimed at strengthening fiscal operations and reducing the economy's dependency on logging and foreign aid are being implemented with assistance from development partners. The IMF in June 2010 approved an 18-month $18.3 million standby credit facility to support the reforms.

Economic growth is expected to moderate to 3.0% in 2011 as the decline in logging continues, a result of unsustainable harvesting of the native forest for over 20 years. Still, GDP growth could exceed this forecast if efforts to restart gold production at the Gold Ridge mine are successful. (The impact on government finances would be limited, though, due to generous tax breaks for mining.)

Inflation has been at modest levels so far in 2010, and the full-year forecast is lowered to 5.0%. Higher prices for imports, notably fuel and food, are expected to exert upward pressure later this year and in 2011 (when inflation is forecast at 6.0%).

The current account deficit is now expected to widen to nearly 19% of GDP in 2010, with imports of machinery and equipment (for mining and telecommunications) contributing to higher imports. Foreign reserves nevertheless rose to $1.5 billion in June 2010, equivalent to 6.7 months of imports of goods and nonfactor services. The increase was attributable to inflows from donors and the first tranche of the IMF credit.

Tonga

GDP declined by an estimated 1.2% in FY2010 (ended 30 June 2010), a worse outcome than projected in April. The contraction was the result of weakness in remittances from overseas workers and in tourism receipts, poor export performance, and delays in spending on public infrastructure.

Remittances fell by 11.6% from FY2009. Recent monthly data indicate that the decline is slowing. Nonetheless, high unemployment in major source markets, notably the US, suggests that remittances will remain relatively weak. Earnings from tourism fell by 14.8% in FY2010.

Credit to the private sector has contracted since banks tightened lending conditions when bad loans increased 2 years ago. The contraction in credit to businesses has been sharper than that to households.

GDP is expected to increase in FY2011, but the growth forecast is lowered to 0.8% in view of subdued remittances and tourism, credit constraints on the private sector, a weak business outlook, and fiscal constraints (giving the government little room to stimulate growth).

Government revenue fell short of the budget target by 20% in FY2010, requiring expenditure restraint and increased reliance on grants. A further decline in revenue is expected in FY2011. The net present value of public debt stands at 55.8% of GDP; more than 90% is external. The government intends to run primary budget surpluses in FY2012 and FY2013.

Inflation averaged about 2% in FY2010, lower than forecast. Price pressures will be a little stronger in FY2011 as the economy resumes growth and because domestic food prices are rising. The FY2011 inflation forecast is kept at 3.0%.

Both exports and imports declined in the year to February 2010, the weakness in imports reflecting the soft domestic demand. Foreign reserves have remained high, at the equivalent of 6.5 months of import cover in March 2010. In FY2011, exports are expected to recover slightly and imports to grow, widening the current account deficit. Foreign reserves are likely to remain at a comfortable level through FY2011.

Vanuatu

Projected economic growth in 2010 is revised down to 4.0%, primarily because of a weaker than expected performance in tourism, which contributes about 20% of GDP. After growing by 10.8% in 2009, tourist arrivals fell by 6.0% in the first 5 months of 2010, the result of vigorous marketing and heavy discounting by the tourism industries in the Cook Islands and the Fiji Islands.

Soft domestic demand is evident in slowing growth in both imports and private sector credit. Imports from Australia fell by 5.9% in the first quarter of 2010. Receipts from the value-added tax declined in January and February 2010 from prior-year levels.

Inbound tourism, particularly from Australia and New Zealand, is expected to be stronger in 2011 than in 2010, given the outlook for robust economic growth in those countries. However, tourism capacity constraints are emerging in Vanuatu, which could cap prospects for the industry. The GDP growth forecast for 2011 is maintained at 4.0%.

Inflation was 2.8% year on year in the first quarter of 2010, but is projected to accelerate and average 5.0% in 2010 due to the imposition of excise taxes on tobacco and beverages in March 2010 and higher prices for imported goods. Next year, inflation is expected to moderate to 4.2% as the effects of the introduction of the excise taxes fade.

Vanuatu's growth over the past 8 years has been based largely on private sector investment underpinned by policy reforms that improved the business environment. Maintaining solid GDP growth in the medium term is likely to require that reforms focus on state-owned enterprises. They earn very low returns on capital employed, divert government resources from social investments, and, as they are often the sole service providers, drive up costs of doing business.

A recent audit of one of the larger state enterprises showed that its accumulated losses totaled $20 million. Moreover, court rulings affirm that the government can be considered a guarantor of state enterprise debts. Of 14 state firms engaged in commercial activities, only four have reported commercially acceptable returns in the past 5 years.

Others

The Cook Islands' economy is expected to grow by 0.5% in 2010, downgraded from *ADO 2010*. Concerns over the level of public debt led to budget cuts, and some infrastructure projects have not proceeded as planned. Further, the tourism industry has performed poorly, despite heavy discounting. Cyclone Pat in February 2010 caused an estimated NZ$15 million damage on the island of Aitutaki, the second most visited location in the country.

GDP is forecast to increase by 2.0% in 2011 owing to a pickup in construction and improved external demand. Inflation is projected at 3.5% this year, rising to 4.2% in 2011 on the back of higher oil prices and the impact of higher inflation in the Cook Islands' major trading partner, New Zealand.

Kiribati is now forecast to grow by 0.5% in 2010, also revised down from April. Remittances have continued to decline and demand for copra is lower than was expected. The expected improvement in growth next year is downgraded a touch, too. Inflation forecasts are trimmed in view of the weaker domestic demand.

Nauru was expected to record slight growth in FY2010 (ended 30 June 2010), but its GDP is now estimated as flat, largely because storm damage at the port together with weak demand restricted exports of phosphate. Aid from the Russian Federation, amounting to about A$10 million, will be used mainly to repair mooring facilities. Together with a recovery in world phosphate demand, this should support a return to economic growth, of around 4%, in FY2011.

Growth projections for the Republic of the Marshall Islands, the Federated States of Micronesia (FSM), the Republic of Palau, and Tuvalu are unchanged from *ADO 2010*. The Marshall Islands and FSM are both seen growing by 0.5% in FY2010 (ended 30 September 2010), better results than in the previous fiscal year. For FSM, development partner–funded infrastructure activities will provide additional employment, support domestic demand, and increase government revenue.

Palau, too, is forecast to grow by 0.5% as fiscal tightening gets under way in an effort to stabilize government finances. In 2011, the growth performances of the Marshall Islands, FSM, and Palau are expected to improve along with continued global recovery.

For Tuvalu, economic growth of 1.6% is expected in 2010, supported by an increase in government expenditure. The outlook is similar for 2011, although there is a risk to the forecast if the number of Tuvaluan seafarers gaining employment continues to decline, given the significant contribution to the economy from their remittances.

Bangladesh

Growth in FY2010 was better than expected in April 2010, as a pickup in domestic demand neutralized the impact of weak expansion in exports. Inflation came in below the April projection, and the current account surplus was higher. For FY2011, this *Update* retains the outlook of a moderate uptick in growth, but with a slightly lower forecast for inflation and a larger fall in the current account surplus. To raise growth prospects, power and gas shortages need to be eliminated and reforms accelerated. More fundamentally, political stability will be critical to boosting growth.

Updated assessment

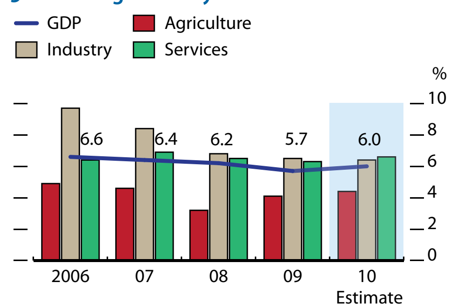
Ministry of Finance sources estimate GDP growth for FY2010 (ended June 2010) at 6.0% on a preliminary basis. This is higher than the projection of 5.5% in the *Asian Development Outlook 2010* (*ADO 2010*) released in April as well as the previous year's 5.7% (Figure 3.2.1). Given the sharp decline in the growth of exports and remittances—the economy's two traditional drivers—the better than expected performance stemmed from a boost in domestic consumption, which was underpinned by a strong expansion in credit to the private sector and a rise in public sector wages. Investment was reported to be unchanged at 24.4% of GDP.

Growth in agriculture is estimated at 4.4% (4.1% projected in *ADO 2010*) as major crops performed better than forecast. The higher production was aided by continued government support (including subsidies on input prices), higher procurement prices, expanded credit, and better delivery of extension services. The services sector grew by 6.6% (as against 5.9% projected in *ADO 2010*), reflecting stronger than expected performances of wholesale and retail trade, and transport services.

Industrial growth of 6.4% came in slightly lower than a year earlier as power shortages continued. Still, it was higher than the *ADO 2010* projection of 5.6%, with domestically oriented manufacturing more than offsetting the effects of slower production for export. Robust growth of mining and quarrying and continued expansion of construction and the housing sector, especially in the second half of the fiscal year, also bolstered the sector's performance.

After decelerating in the previous year, inflation rose in FY2010, reaching a 9.1% year-on-year high in February 2010 from 2.3% in June 2009, then moderating through the end of the fiscal year (Figure 3.2.2). Annual average inflation edged up to 7.3% (marginally lower than the 7.5% projected in *ADO 2010*) from 6.7% in FY2009. With relatively benign global commodity prices, inflation pressures intensified, primarily because of demand pressures from the rapid private credit growth and a boost in public sector wages.

3.2.1 GDP growth by sector



Source: Ministry of Finance. *Bangladesh Economic Review 2010.*

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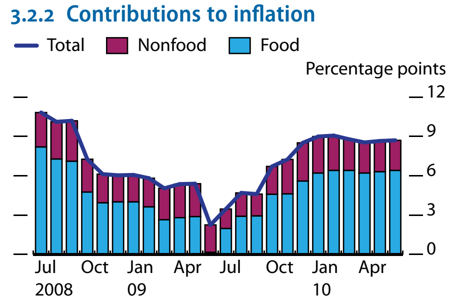
3.2.2 Contributions to inflation



Source: Bangladesh Bank. 2010. *Monthly Economic Trends.* July. http://www.bangladesh-bank.org

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This chapter was written by Mohammad Zahid Hossain, Shamsur Rahman, and Md. Golam Mortaza of the Bangladesh Resident Mission, ADB, Dhaka.

Money supply (M2) and private credit grew strongly year on year during FY2010 (Figure 3.2.3), exceeding their respective annual targets set in the monetary policy of Bangladesh Bank (the central bank). Net credit to the government, however, declined in this period, as strong revenue growth reduced the need for borrowing. Facing mounting inflation pressures, Bangladesh Bank raised commercial banks' cash-reserve requirement by 50 basis points to 5.5% in May 2010. In August 2010, the bank also raised the repo and reverse repo rates by 100 basis points.

The bank's Monetary Policy Statement (MPS), issued in July 2010, indicated that there may have been some diversion of private credit into consumer spending and into speculative investments in the stock market and real estate.

The lending rate declined slightly to 11.2% in June 2010 from the year-earlier level. But the contemporaneous decline in the deposit rate was greater, falling to 6.0%, and to a negative 1.3% in real terms.

To bolster growth, the government adopted an expansionary fiscal stance for FY2010. Expenditure expanded by 25.5% (raising its share in GDP to 16.0% from 14.3% in FY2009). Revenue collection during the year was buoyant: at an estimated 11.5% of GDP, it was up by 1.1 percentage points from FY2009 (Figure 3.2.4). The pickup in domestic economic activity, together with improvements in tax administration, contributed to the strong tax receipts.

Another year of underspending in the annual development program (4.1% of GDP, in place of the 4.4% originally planned) and the good revenue outturn contained the fiscal deficit to 4.5% of GDP (lower than the 5.0% budget target).

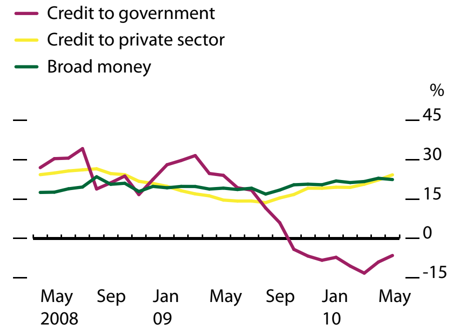
In FY2010, net losses of the 44 nonfinancial state-owned enterprises were estimated at $18.7 million, a marked switch from the net profit of $477.2 million in the previous year. A move back into loss of the Bangladesh Petroleum Corporation (BPC) (because no adjustment in the domestic administrative prices of petroleum products were made following the steep rise in global oil prices over the fiscal year), a much worse loss of the Bangladesh Power Development Board (BPDB), and weaker net income of the Bangladesh Telecommunication Regulatory Commission largely accounted for the sharp deterioration (Figure 3.2.5).

The government released $303.5 million (out of the $370 million earmarked in the FY2010 budget) to enable BPC and BPDB to settle part of their past liabilities to banks and other creditors. The 6%–7% rise in the power tariff, effective March 2010, aimed to reduce BPDB losses, though expected new generation (from rental diesel units under construction) will raise costs.

Export growth slowed to 4.2% from 10.1% in FY2009 (Figure 3.2.6) as readymade garment exports (knitwear and woven cloth products) grew by only 1.2%, dropping their share in total exports ($16.2 billion) from 79.3% in FY2009 to 77.1% in FY2010. Continued weak retail sales and low prices in the United States (US) and the European Union (EU), combined with domestic power outages and limited supplies of natural gas used in processing, contributed to the disappointing export performance.

In addition, frequent labor unrest for higher pay and better working conditions affected production. A new minimum wage of Tk3,000 a month (about $43) was set in June, a raise from Tk1,662 a month

3.2.3 Growth of monetary indicators



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. June. http://www.bangladesh-bank.org

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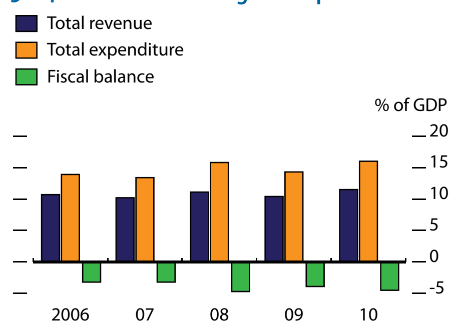
3.2.4 Government budget components



Source: Asian Development Outlook database.

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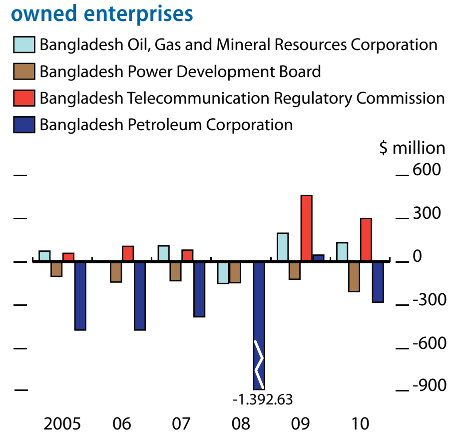
3.2.5 Profit and loss at selected state-owned enterprises



Source: Ministry of Finance. *Bangladesh Economic Review 2010*.

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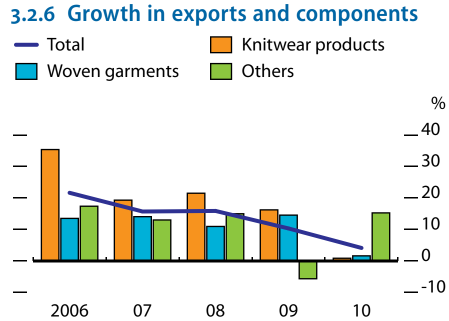
3.2.6 Growth in exports and components



Sources: Bangladesh Bank. *Annual Report 2008–2009*; 2010. *Major Economic Indicators: Monthly Update*. June. http://www.bangladesh-bank.org

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prevailing since 2006, however the new wage was less than the Tk5,000 a month that garment workers asked for.

Earnings from other products increased sharply by 15.2% but still accounted for less than one quarter of exports. Takings from jute and jute goods rose sharply, responding to the rising demand for these environment-friendly products. However, revenue from frozen foods, tea, and chemicals declined because of weak demand.

Imports rose by only 5.4% in FY2010 (Figure 3.2.7). Rice imports fell, following the good domestic production. The import of consumer and intermediate goods declined, and that of capital goods decelerated.

Remittance growth fell by nearly half to 13.4% from the 22.4% in the previous year, mainly because of the continued decline in the numbers of workers leaving for jobs abroad (Figure 3.2.8). Nevertheless, with a limited expansion in the trade deficit, increased workers' remittances boosted the current account surplus to $3.7 billion from $2.4 billion in FY2009 (at 3.7% of GDP, the surplus was well above the *ADO 2010* projection of 1.8%).

The deficit in the combined capital and financial account narrowed to $313 million in FY2010 from $374 million a year earlier, despite a marked decline in net foreign direct investment, reflecting larger capital transfers and lower net outflows of portfolio and other investment. Gross foreign exchange reserves of the central bank reached $10.7 billion at end-June 2010, up by about $3.3 billion from the previous year (Figure 3.2.9).

The exchange rate against the US dollar remained essentially stable at about Tk69/$1 in FY2010, as the central bank made large foreign exchange purchases in the interbank market to prevent nominal appreciation. Still, due to higher relative domestic inflation, the real effective exchange rate appreciated by about 5% during the fiscal year.

The Dhaka Stock Exchange general index rose steeply (Figure 3.2.10), as significant new involvement of institutional participants and retail investors helped the index to gain 105.8% in the year to end-June 2010. Low returns on bank deposits and ready availability of credit appeared to play a major role. Market capitalization also doubled during the year, reaching $38.6 billion (about 38.7% of GDP), primarily reflecting the stock price rise, though there were new listings.

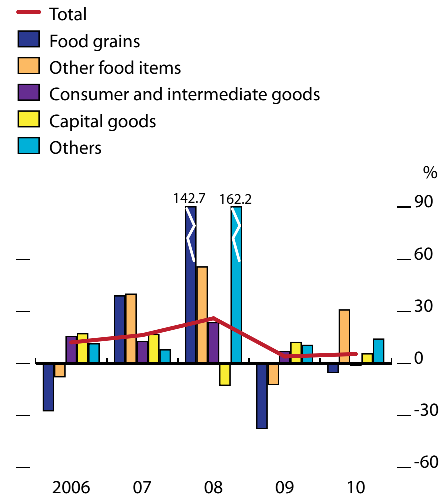
To limit exposure of banks and financial institutions to the stock market, the central bank restricted banks' exposure to no more than 10% of their liabilities. It allowed financial institutions to invest up to 25% of their paid-up capital and reserves.

Prospects

The forecast for FY2011 assumes that government policy will balance growth with containing inflation; that political stability will prevail; that progress is made on structural reforms; that planned additional rental power generation will reduce shortfalls; and that normal weather conditions will prevail.

GDP growth in FY2011 is forecast at 6.3% (Figure 3.2.11), unchanged from *ADO 2010*. The slow global recovery will prevent export and remittance growth from returning to their respective precrisis levels. Stronger domestic demand, supported by the ready availability of credit

3.2.7 Growth in imports and components



Sources: Bangladesh Bank. *Annual Report 2008–2009*; 2010. *Major Economic Indicators: Monthly Update*. June. http://www.bangladesh-bank.org

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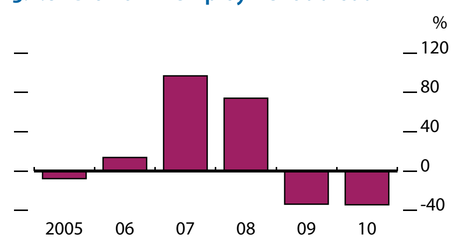
3.2.8 Growth in employment abroad



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. July. http://www.bangladesh-bank.org

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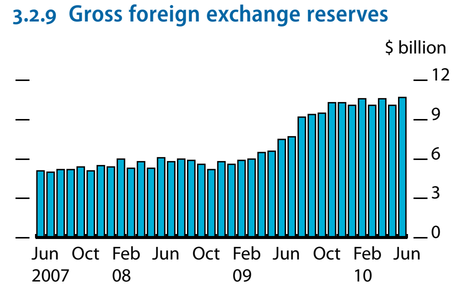
3.2.9 Gross foreign exchange reserves



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. June. http://www.bangladesh-bank.org

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for productive purposes and continued fiscal stimulus, will buttress the modest expansion.

As posited in *ADO 2010*, more robust industry performance of 7.5% growth is the main factor seen supporting overall GDP growth in FY2011. Some pickup in production for export, on the back of strong domestic demand and higher production by small and medium-sized enterprises and by agro-based industries, underlie the projection. The government's purchase of rental power and better demand management is expected to alleviate power shortages that have been a major constraint on industrial production.

Agriculture growth is expected to be 4.1%, slightly slower than in FY2010 but close to its historical average. Higher industry growth, alongside some revival of trade, is expected to push up expansion in services slightly to 6.7%.

The FY2011 budget continues an expansionary stance: public expenditure is projected to rise by 19.6% from the previous year. The budget included a $288 million–equivalent stimulus package for exporters to help them cope with the continued impact of weak global demand. Budget policy seeks to support a higher medium-term growth trajectory by boosting spending on infrastructure, especially additional energy sources. It also takes aim at social equity by strengthening safety net programs and making higher investment in health and education.

The budget deficit is projected to widen to 5.0% of GDP in FY2011, from 4.5%. Three-fifths of the deficit will be financed by domestic borrowing (a higher share than in FY2010) and two-fifths by external sources (Figure 3.2.12). Given the government's estimate of available nonbank financing sources, the bulk of the domestic financing increase will need to come from the banking system, potentially limiting private sector access to credit.

The FY2011 budget targets a 16.8% increase in revenue (about a 0.5% increase in the tax-to-GDP ratio), aided by widening the tax base, simplifying tax payment, and strengthening tax enforcement. About half a million new income tax payers are expected to be added to tax rolls during the year.

The budget provided several tax incentives for stimulating economic activity. It lowered duties on equipment for power and energy, industrial machinery, and selected industrial raw materials; cut domestic taxes applicable for small and medium-sized businesses and agro-based industries; and eliminated value-added tax on local production for selected items while keeping it unchanged on identical imported goods.

The government is giving priority to eliminating the growing power shortages through heavy investment in the sector. For the short term, it is putting in place a program of small (100 megawatt) rental generation units. Since over four-fifths of current power generation is gas fired, it seems open to addressing gas shortages by inviting international bidding for gas exploration. It is also seeking ways to diversify fuel sources through importing liquefied natural gas and coal for power generation.

Separately, a landmark agreement that was signed with India in August provides for a power transmission line to be built between the two countries. Power imports from India should be available by end-2012.

To boost infrastructure investment, the government issued new

3.2.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	5.5	6.0	6.3	6.3
Inflation	7.5	7.3	7.8	7.5
Current acct. bal. (share of GDP)	1.8	3.7	0.5	0.2

Source: ADB estimates.

3.2.10 Dhaka Stock Exchange indicators

Source: Bangladesh Bank. 2010. *Major Economic Indicators: Monthly Update*. June. http://www.bangladesh-bank.org
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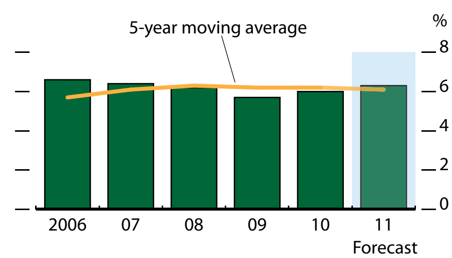
3.2.11 GDP growth



Sources: Bangladesh Bureau of Statistics. 2009. *National Accounts Statistics*. May; Ministry of Finance. *Bangladesh Economic Review 2010*.
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public–private partnership (PPP) guidelines and took steps to set up a Bangladesh Infrastructure Finance Fund to facilitate PPP in infrastructure. The government earmarked $430 million in the FY2011 budget to fund the new entity, adding to a reallocation of $230 million of unused resources for PPP projects included in the FY2010 budget. Bond issues are another likely source of funding.

This *Update* shaves the average inflation projection for FY2011 to 7.5% from the 7.8% in *ADO 2010* (Figure 3.2.13), in view of the likely moderation in global oil and other commodity prices. Still, expected adjustments in domestic power and gas tariffs, demand-side pressures from higher public expenditure, and the lagged effects of strong money-supply growth will sustain inflation at close to the FY2010 rate.

Compared with projections in this *Update*, the MPS aims at higher growth (6.7%) and lower inflation (6.5%) for FY2011. However, with the central bank alert to unproductive and speculative use of credit, the MPS projects that the year-on-year growth in money supply will slow from 18.8% in FY2010 to 15.2% in FY2011, while private credit growth will decline from 21.1% to 16.0% over the same period.

Imports are forecast to grow by 11.0% in FY2011, reflecting a rise in domestic demand for imported raw materials and capital equipment. Exports—continuing the rising trend seen in the fourth quarter of FY2010—are expected to grow by 8.0%, largely in response to the moderate expansion in global demand (and reflecting the previous year's low base).

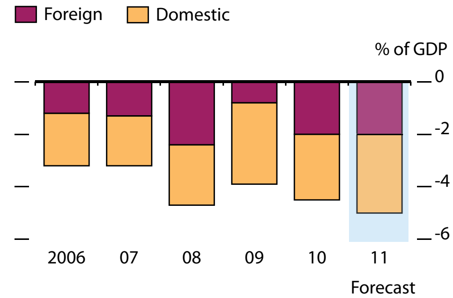
The country's market share for readymade garments in the US rose marginally to 4.3% in FY2010, although it declined slightly in the EU to 8.5% in the third quarter of FY2010.

Bangladesh stands to gain if the People's Republic of China sheds some part of the readymade garment market because of its rising labor costs. In addition, if the government's plans for improving power and gas supply and transportation facilities come to fruition—and so take off some of the costs that the industry currently has to shoulder—the competitive edge of Bangladesh vis-à-vis other developing-country producers in this market segment will be honed.

Slower growth of 8.0% in workers' remittances is foreseen because of the continued decline in the outflow of migrant workers. Nevertheless, remittance receipts will offset the modestly larger trade deficit. The current account surplus is estimated to fall sharply to 0.2% of GDP (Figure 3.2.14).

Several downside risks could prevent these projections from being realized. A waning recovery in the US and EU would likely result in weaker retail sales and lower demand for Bangladesh's exports. Inability to reduce power and gas supply shortages as planned would constrain growth. Finally, political instability or natural disasters would also undermine the forecast expansion.

3.2.12 Deficit financing



Source: Asian Development Outlook database.

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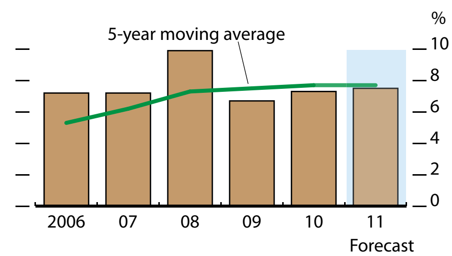
3.2.13 Inflation



Source: Bangladesh Bank. 2010. *Monthly Economic Trends*. June. http://www.bangladesh-bank.org

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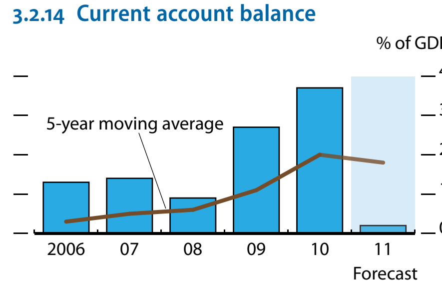
3.2.14 Current account balance



Source: Bangladesh Bank. *Annual Report 2008–2009*. http://www.bangladesh-bank.org

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People's Republic of China

Fiscal and monetary stimulus, coupled with recovery in world trade, drove double-digit growth in the first half of 2010. As the stimulus phases down, GDP growth is seen easing in the second half. The full-year forecast is kept at the 9.6% given in April. GDP growth is anticipated to step down by a half percentage point in 2011 from 2010, assuming the absence of stimulus programs and subdued industrial-country growth. Lower than expected inflation this year has prompted a slight downward revision to the 2010 forecast. Looking further forward, rebalancing the sources of economic growth remains imperative.

Updated assessment

GDP growth moderated to 10.3% in the second quarter of 2010 from 11.9% in the first (Figure 3.3.1), putting the expansion in January–June at 11.1%. While investment and consumption continued to drive growth from the demand perspective, the contribution of net exports turned positive in the second quarter for the first time since the onset of the global recession.

With the impact of the government's aggressive fiscal and monetary stimulus programs starting to recede, growth in nominal fixed-asset investment pulled back to 24.8% in the first 8 months of 2010 from the very high rate of 33.0% in the prior-year period. Growth of industrial output eased to 16.0% in the second quarter from 19.6% in the first, reflected in a marked slowing of growth in power generation and the production of automobiles, cement, and steel (Figure 3.3.2). The purchasing managers' index for manufacturing output declined from 55.8 in January to 51.7 in August (Figure 3.3.3).

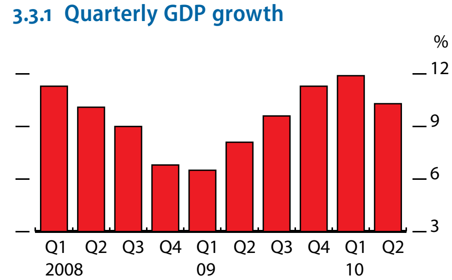
Retail sales, a proxy for consumption, held up well, increasing by 18.2% in nominal terms in the first 8 months from 15.1% a year earlier. Private consumption was supported by higher than expected employment generation and increased salaries and pensions, which lifted real incomes in urban and rural areas by 7.5% and 9.5%, respectively, from January to June. Sales of household appliances also benefited from government subsidies on these items.

By sector, industry grew by 13.2% and services by nearly 10% in the first half, both benefiting from the stimulus programs. However, drought in the south and northeast regions led to a decline in the summer harvest, so that agricultural output rose by a modest 3.6%.

Consumer prices, after falling for most of 2009, have edged higher this year (Figure 3.3.4), bumped up by low-base effects from the prior year, higher food prices caused by the bad weather, and excessive liquidity from the monetary stimulus. However, upward pressures were modest, and for the first 8 months of 2010 inflation averaged 2.8% year on year.

The government moved to curb sharp rises in prices of residential

3.3.1 Quarterly GDP growth



Source: CEIC Data Company (accessed 16 September 2010).
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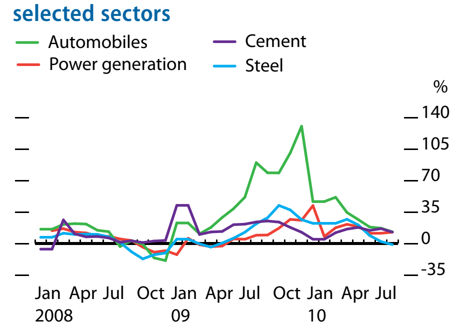
3.3.2 Growth in industrial production, selected sectors



Source: CEIC Data Company (accessed 16 September 2010).
Click here for figure data

This chapter was written by Yolanda Fernandez Lommen and Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

property spurred by investment demand and the expansionary monetary stance. Price increases for new housing in 70 major cities accelerated to 15% year on year in April. From May, though, policies to cool the market started to have an impact (Figure 3.3.5). Government actions included increasing downpayments on second homes (from 40% to 50%) and raising mortgage interest rates to at least 1.1 times the benchmark rate set by the central bank. In the main coastal cities, banks were encouraged to temporarily refuse loans for third homes.

At the same time, the government increased the availability of land for residential purposes and the supply of low-income housing. Further, the authorities directed 78 enterprises that are owned by the central government and whose core business is not property focused to stop participating in the property market. Their privileged access to bank loans under the stimulus package apparently was adding to land and housing price pressures.

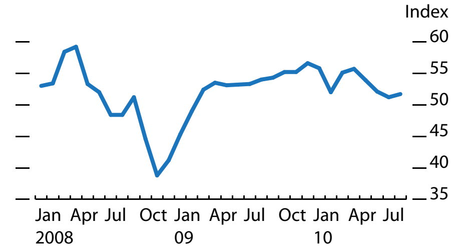
Merchandise trade has staged a vigorous recovery (Figure 3.3.6), after diving at the start of the global recession. Exports in nominal terms rose by 35.4% in the first 8 months of 2010, and imports by 45.8%. Imports decelerated in April–July, reflecting a slowdown in the fiscal stimulus and fewer infrastructure project startups. The trade surplus of $104.5 billion for the first 8 months was considerably less than for the same period in 2009. Net exports made a slight contribution to GDP growth in the second quarter.

Foreign direct investment (FDI) in the first 7 months increased by about 20% to $58.4 billion, illustrating the continued appeal of the burgeoning economy to international companies. Reflecting official efforts to combat pollution, new guidelines to encourage investment in what the government considers to be environmentally sound projects (such as high-tech industries, certain services, and energy-efficient technologies) have been written. A ban was imposed on foreign investment in polluting and energy-intensive projects, and in sectors suffering from overcapacity. Outbound investment, primarily directed at manufacturing and mining, increased by about 24% to $5.65 billion.

After 2 years of a de facto peg of the yuan to the US dollar, the central bank (the People's Bank of China) in June 2010 said that it would gradually allow greater flexibility in the exchange rate against a basket of currencies for the PRC's main trading partners. By mid-September, the yuan had appreciated by 1.5% against the US dollar from the start of 2010 (Figure 3.3.7). The real effective exchange rate appreciated by 2.4% in the first 7 months of the year. Foreign reserves rose to $2.45 trillion at end-June, the pace of reserves accumulation slowing mainly as a consequence of the smaller trade surplus.

Monetary officials started to rein in the very expansionary monetary stance adopted during the global recession, in view of the strong economic growth, sharp rise in property prices, and risks that funds would be diverted into unproductive purposes. The target for new lending in 2010 was pared back to CNY7.5 trillion (actual lending in 2009 totaled an exceptional CNY9.6 trillion), and the authorities set monthly credit quotas for banks. New bank lending decelerated to CNY5.7 trillion in the first 8 months of this year (still well above levels in 2007 and 2008—Figure 3.3.8) from CNY8.2 trillion in the prior-year period.

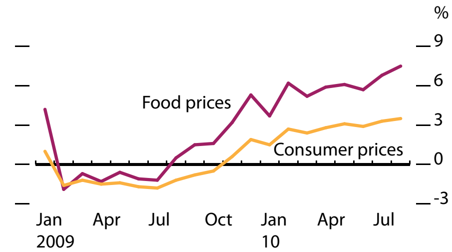
3.3.3 Purchasing Managers' Index



Source: CEIC Data Company (accessed 16 September 2010).

Click here for figure data

3.3.4 Monthly inflation



Source: CEIC Data Company (accessed 16 September 2010).

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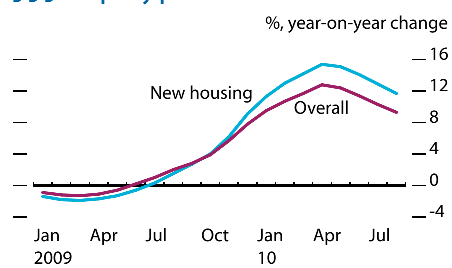
3.3.5 Property prices



Note: Overall property prices cover both residential and nonresidential buildings.

Source: CEIC Data Company (accessed 16 September 2010).

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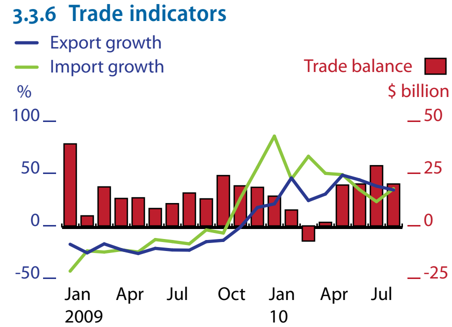
3.3.6 Trade indicators



Source: CEIC Data Company (accessed 16 September 2010).

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Tightening measures also included 3 half-percentage point increases in the banks' reserve requirement ratio (to 17% for large banks) and open-market operations by the central bank to absorb liquidity. M2 money supply growth moderated to 19.2% in August from 27.7% at end-2009 (Figure 3.3.9).

Share prices have declined, partly because of the clampdown on the property market and concerns over possible further tightening measures. The Shanghai Composite Index fell by nearly 20% in the 8 months through August. However, the market's decline did not stop Agricultural Bank of China from raising almost $22 billion in August through an initial public offering in Hong Kong, China and in Shanghai, the largest in the world to date.

Fiscal stimulus, too, is phasing down. Total government spending in 2010 is budgeted to increase by 11%, about half the pace seen in 2009. An 8% budgeted increase in revenue looks conservative, and the fiscal deficit for this year will likely be narrower than 2.8% of GDP, the official target.

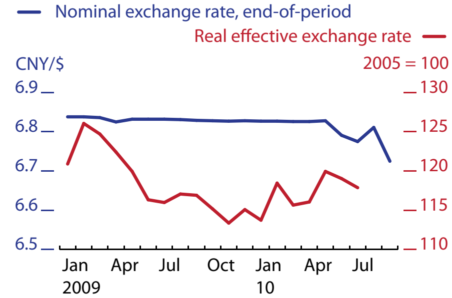
Local governments have used their off-budget investment arms to tap into the flood of bank lending unleashed during the stimulus programs, and have channeled those funds into local infrastructure projects, not all based on solid commercial foundations. An investigation of this practice by bank regulators found that, of CNY7.7 trillion disbursed by banks to local government investment arms, perhaps one-fifth is at risk of becoming bad loans. The regulators, while tightening guidelines for such lending, maintained that the banking sector is secure because the ratio of nonperforming loans was just 1.3% at midyear and the average provisioning ratio was 186%.

Another outcome of the massive stimulus programs that have been conducted mainly through state-controlled banks and enterprises has been to increase state ownership and control of the economy. The government has issued guidelines that, it has said are aimed at redressing this development, opening to private investment some previously closed industries, including public utilities, rural financial services, telecommunications, low-income housing, and science and technology ventures.

Rapid economic growth generated 6.4 million new jobs in urban areas in the first half, and more than 3 million laid-off workers were rehired. The national jobs-to-applicants ratio exceeds 1, signaling more vacancies than job-seekers. The stimulus programs fostered employment in central and western regions, attracting back a large number of migrant workers from coastal cities. The tightness of the labor market prompted higher wages and, in some cases, better working conditions (as well as a few strikes), contributing to the increase in consumer spending.

Senior government officials have highlighted the benefits of urbanization as a means to strengthen domestic demand, enhance services delivery, and reduce income inequality. In this connection, a new residence permit system has been adopted in 10 cities to reform the household registration (*hukou*) system and foster urbanization. The new permit grants to migrant workers the same social benefits as to those registered in the cities. Permit holders can later apply for the urban hukou if they meet certain conditions. The system is expected to result in migrant workers progressively becoming permanent urban residents,

3.3.7 Exchange rates

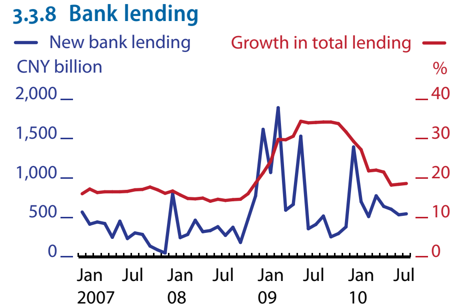


Note: Latest data for nominal exchange rate are as of 15 September and for real effective exchange rate as of end-July.

Source: CEIC Data Company (accessed 16 September 2010).

Click here for figure data

3.3.8 Bank lending



Source: CEIC Data Company (accessed 16 September 2010).

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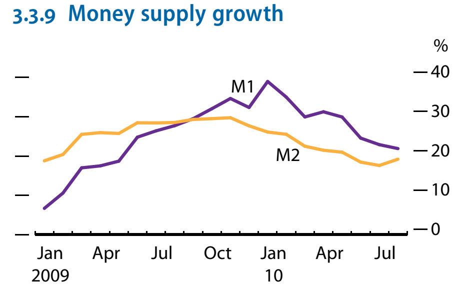
3.3.9 Money supply growth



Source: CEIC Data Company (accessed 16 September 2010).

Click here for figure data

enhancing mobility of labor and raising migrant workers' disposable incomes.

Addressing the issue of environmental damage inflicted by decades of heavy investment in industry and the economy's low-energy efficiency, the government plans to include low-carbon targets in the Twelfth Five-Year Plan (2011–2015). It is drawing up fiscal incentives and supportive policies to promote the use of renewable energy (wind, solar, biomass, and geothermal), and to increase the use of nuclear power. New anti-pollution taxes, too, have been proposed and, if approved, will likely be tried in one or two provinces later this year.

3.3.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	9.6	9.6	9.1	9.1
Inflation	3.6	3.2	3.2	3.2
Current acct. bal. (share of GDP)	5.7	5.6	5.3	5.2

Source: ADB estimates.

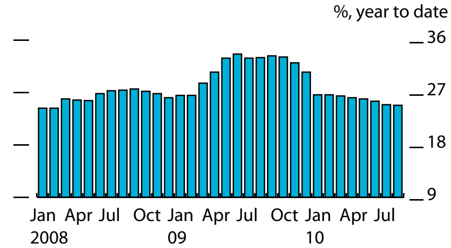
Prospects

The forecasts assume that the planned fiscal stimulus programs will be fully disbursed through the second half of 2010, and that no new stimulus measures will be introduced. As noted above, the fiscal deficit in 2010 is likely to be narrower than the budgeted deficit of 2.8% of GDP, mainly because of stronger than projected growth in revenue. In 2011, fiscal policy is assumed to be less stimulatory than 2010 and the deficit will narrow further from this year's level in relation to GDP.

On monetary policy, the outlook assumes that tightening measures taken this year to stem the flood of bank lending will rein in money supply and credit growth toward government targets.

Growth in fixed-asset investment has pulled back steadily this year (Figure 3.3.10) and is expected to moderate further as the impact of the fiscal and monetary stimulus wanes. This deceleration will temper demand for industrial products, such as cement, during the forecast period. A government plan to cut excess production capacity in the steel industry, by as much as 300 million tons, or about half 2009's steel output, will also cool growth in the industry sector. Furthermore, determined efforts to reduce carbon emissions and other environmental damage will likely crimp growth in some industries. The PRC has become the world's largest energy consumer, which adds some urgency to efforts to raise energy efficiency and reduce polluting emissions.

3.3.10 Growth in fixed asset investment

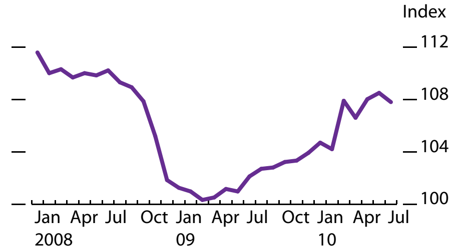


Source: CEIC Data Company (accessed 16 September 2010).
Click here for figure data

Private consumption is projected to remain brisk, underpinned by growth in employment and incomes, which in turn is helped by a trend to relocate labor-intensive industries to central and western areas and by policies to improve conditions for migrant workers. Government incentives to buy automobiles and household electrical appliances also favor consumption growth. Consumer confidence has continued to recover from low levels in the first half of 2009 (Figure 3.3.11).

Growth in merchandise exports is expected to decelerate in the second half of 2010, owing to the base effect as exports moved higher in the prior-year period, more subdued demand from some export markets, and the expiration of PRC tax rebates. Import growth, too, will soften, given the high import component of PRC exports (about 50%) and more restrained industrial production. The central bank's June adjustment to exchange rate policy is unlikely to have much of an impact on trade flows in the near term.

3.3.11 Consumer confidence



Source: CEIC Data Company (accessed 16 September 2010).
Click here for figure data

GDP growth is forecast to step down to about 9% in the third quarter of 2010 and to 8% in the fourth, so that full-year growth is 9.6%

(unchanged from the *Asian Development Outlook 2010* forecast in April). Taking into account the phasing out of stimulus policies in 2010 and expected subdued growth in industrial economies next year, the GDP growth forecast for the PRC in 2011 is maintained at 9.1% (Figure 3.3.12). Sizable current account surpluses are still projected—5.6% of GDP for this year and 5.2% for 2011.

Flooding in the summer raised prices of food and some other items, though this effect is expected to be temporary. Price increases that were anticipated this year for water, natural gas, and electricity have been postponed until next year. Average inflation for 2010 is forecast at 3.2%, trimmed from April, in light of lower than expected price pressures in the first half. Inflation in 2011 is forecast to be the same as this year's average (Figure 3.3.13).

Downside risks to the outlook mainly relate to the fragility of external demand, exacerbated by European fiscal and debt concerns this year. A weakening of the euro could exert appreciation pressures on the yuan's real effective exchange rate, hurting exports to the European Union, the PRC's largest trading partner. There is a risk of a worse than expected deterioration in PRC bank asset quality, a consequence of the flood of bank lending that in some cases has been diverted into unproductive purposes. That risk would be heightened if measures to cool the property market have a more severe impact than currently anticipated.

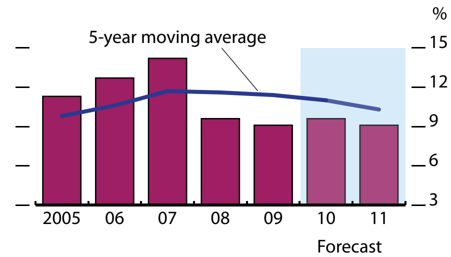
GDP growth would be more rapid than forecast if the domestic slowdown prompts the authorities to implement new fiscal or monetary stimulus. A stronger economic recovery in Europe that caused the euro to appreciate would likely spur PRC exports and GDP growth.

Longer term, failure to decisively implement the agenda to rebalance the PRC economy risks jeopardizing the sustainability of growth. A greater emphasis on private consumption demand, as against the current investment-driven economic growth model, would promote longer-term growth and raise living standards. Growth in consumption has been limited by the declining share of household income in total income, while the shares of enterprises and the government have increased.

From the production perspective, services have huge potential to contribute toward sustainable growth, since they account for only a relatively small proportion of GDP.

Finally, fiscal policy can play an important role in promoting a more consumption-driven and services-oriented economic model, particularly if it is complemented by other mutually supportive and consistent policies (Box 3.3.1).

3.3.12 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

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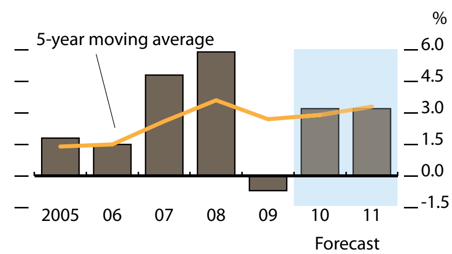
3.3.13 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

Click here for figure data

3.3.1 Fiscal policy's role in rebalancing the economy

The following fiscal goals could be pursued, within a broader overall policy environment, to support rebalancing and income redistribution.

Shift the emphasis of public spending from investment to public services and redistribute more corporate profits to social spending. Public expenditure on education, health, and social security combined amounts to only 6% of GDP, compared with an average of 28% in industrial economies. Allocating more fiscal resources to public services would raise the disposable income of households and thus reduce precautionary savings and encourage consumption. Further, strengthening the social safety net to protect the poor and the vulnerable promotes consumption (as well as equity), since those groups tend to spend more and save less. Rising profits earned by state-owned enterprises are generally not redistributed to the community because these enterprises seldom pay dividends to the state. A dividend stream from state enterprises to the government could fund additional social spending without straining public finances.

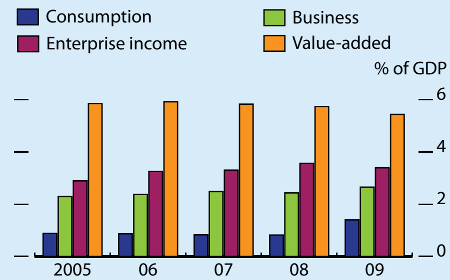
Strengthen automatic stabilizers. These mechanisms are taxes and transfers that adjust automatically to temper business cycles. For example, the amount paid out on unemployment benefits automatically increases in a recession when the labor market weakens, and such transfers contract as the economy turns up. Further, developing automatic stabilizers in the PRC would mitigate the risk and uncertainty households face in economic downturns, and thus encourage private consumption.

Increase the supply of low-income housing. Expanding such housing would increase the disposable income of poorer households. The government could establish municipal housing authorities to construct low-income housing and introduce fiscal incentives to attract private sector developers into this less profitable segment of the market. On the demand side, consumers could benefit from tax exemptions, cash subsidies or housing allowances, and capital grants on low-income housing. Further, provision of state guarantees or public mortgages, or both, would mitigate credit rationing that makes it difficult for poorer households to obtain housing finance.

Introduce property taxes. The government plans to pilot-test a property tax targeted at luxury residences in four cities, as part of its aim to curb property speculation. The expansion of the tax to all houses in urban areas, based on their value, could provide a substantial and steady source of revenue to fund public goods and services. This would in turn reduce precautionary saving and enhance consumption, contributing to rebalancing.

Subject services to value-added tax (VAT). VAT is the single largest source of tax revenue in the PRC, amounting to just over 5% of GDP in 2009 (Box figure). The central government gets 75% of the revenue and provincial governments 25%. VAT is levied only on manufacturing, while services are subject to a business tax that raises a much smaller amount. Given local governments' heavy dependence on VAT revenue, they have a strong incentive to promote manufacturing rather than services. Rebalancing the economy could thus be advanced by including services in the VAT base, a measure that likely would also raise the revenue of local governments, increasing their capacity to provide public services.

Sources of tax



Source: CEIC Data Company (accessed 16 September 2010).

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Strengthen fiscal transfers to provinces. In both magnitude and timing, the flow of fiscal transfers from the central government to the provinces is unpredictable, constraining the capacity of local governments to provide public services. One approach would be to transfer a larger share of tax revenue, such as VAT, to provinces. Alternatively, the central government, while maintaining its decentralized arrangement for provision of social services, could increase its share in their financing. This could be achieved through redistributive and equalizing mechanisms to support poorer provinces. Otherwise, interprovincial disparities in social spending per person will remain, constraining consumption in the central and western provinces.

In this regard, a 5% resources tax on oil and gas has been introduced in Xinjiang Uygur Autonomous Region as part of a pilot project. It is expected to increase the region's revenue by the equivalent of 25% of its total 2009 revenue. This approach is intended to promote the efficient use of natural resources, as well as to bolster finances in less developed provinces, so reducing regional disparities.

Source

Donghyun Park and Yolanda Fernandez Lommen. 2010. The Role of Fiscal Policy in Rebalancing the People's Republic of China. *ADB Briefs.* Asian Development Bank, Manila.

India

The economy is making a strong recovery from the slowdown in FY2008. Still, to return to the high-growth plateau of precrisis years, successful resolution of several macroeconomic management and reform challenges is needed. These include maintaining export competitiveness by ensuring the right balance between the exchange rate and inflation, continuing the fiscal consolidation, improving agricultural productivity, addressing infrastructure bottlenecks, and sustaining investor confidence. For the current fiscal year, this *Update* slightly lifts the forecast for GDP growth, but raises the estimate for inflation and widens the forecast for the current account deficit. In FY2011 these variables are expected to improve relative to FY2010.

Updated assessment

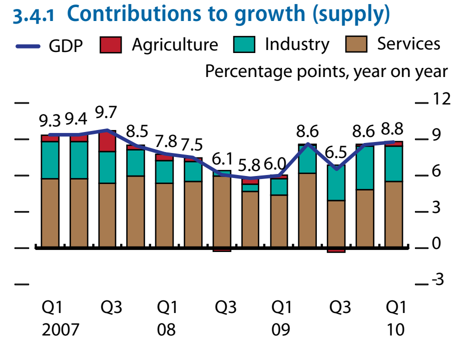
The complexity of macroeconomic and monetary management has become knottier since the publication of *Asian Development Outlook 2010* (*ADO 2010*) in April this year. Strong, well-timed macroeconomic policies cushioned the impact of the global downdraft and must now be wound down without their endangering the robust recovery that took hold this year. However, high headline inflation (triggered by high food prices due to structural supply constraints) and a strengthening rupee in real terms (mainly driven by relative prices), posed problems for monetary management.

Moreover, the rapid pace of the recovery has driven imports up and the trade deficit out. But capital inflows have been buoyant, and therefore policy needs to take into account their possible volatility, stemming from a sudden rise in risk aversion in global markets as well as any sustained erosion in India's export competitiveness.

GDP growth of 8.8% in the first quarter of FY2010 (ending March 2011) and 8.6% in the last quarter of FY2009 signaled a strong and (so far) durable recovery, primarily led by a healthy expansion in industry and buoyancy in services (Figure 3.4.1). Moreover, the performance of agriculture was reasonable in the first quarter, after a negligible expansion in FY2009 due to a poor summer monsoon. The subsectors that registered impressive growth included mining and quarrying; manufacturing; electricity, gas, and water supply; construction; and trade, hotels, transport, and communications.

From the demand perspective, investment took over as the major driver of growth in the second half of FY2009, from government consumption expenditure in the first. Indeed, investment contributed nearly one-half of GDP growth for the second half of the fiscal year. This revival was primarily due to an improved overall business outlook and the desire for greater production capacity following slow investment the previous year. Rapid growth in investment likely continued in the

3.4.1 Contributions to growth (supply)



Note: Fiscal quarters.

Source: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 31 August 2010).

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This chapter was written by Hiranya Mukhopadhyay of the South Asia Department, ADB, Manila.

first quarter of FY2010 (though preliminary GDP expenditure data are indeterminate because of a very large unclassified item).

Monthly manufacturing output data supplement the first-quarter GDP data to reveal the pattern of current expenditures (Figure 3.4.2). The bulk of improvement in manufacturing growth came from the capital goods and consumer durables goods sectors in FY2009, and this trend continued in early FY2010. Robust pickup in capital goods (apart from a revival in private sector investment) was in part attributable to higher spending on infrastructure. Automobiles, consumer electronics, home appliances, and other household products led the impressive performance of consumer durables.

Persistent high inflation somewhat mars the economic landscape. The year-on-year rate picked up to 11.0% in April 2010, and subsequently moderated to 8.5% in August (Figure 3.4.3). While initially bumped up by a surge in food prices reflecting a poor harvest, high food inflation appeared to be seeping through to wages and then to prices for manufactured goods, where inflation climbed to 6.4% in April, but subsequently slowed to 4.8% in August as monetary tightening gained traction.

Food price inflation stayed high at 14.6% in August 2010—despite record levels of government food stocks and a good spring harvest—adding further to popular discontent over continued high prices. (A June revision in domestic prices of petrol, diesel, cooking gas, and kerosene, while a welcome step in reducing high subsidies, has also nudged up overall inflation.)

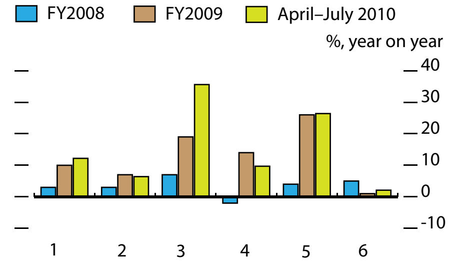
Still, the government expects inflation to moderate in the second quarter of FY2010 and beyond because this year's summer monsoon rainfall has been above average and a bumper agricultural outturn is expected to bring down food prices. The Reserve Bank of India (RBI), the central bank, expects that overall inflation will moderate to 6% year on year by end-March 2011.

In the context of the strong domestic recovery and inflation pressures, the RBI began a gradual withdrawal from its earlier expansionary monetary policy stance. It raised both the repo and the reverse repo rates by 125 and 175 basis points, respectively, from January to mid-September this year (Figure 3.4.4). It lifted the cash-reserve ratio by 100 basis points in the same period. In announcing the September decision to adjust rates (the first mid-quarterly policy review undertaken to better guide market participants), the central bank noted that India's recovery was rapidly converging to its trend rate of growth.

Strong momentum in industrial production, buoyant services sector indications, a favorable outlook for agriculture, and fiscal consolidation on its targeted path underpinned this assessment. Inflation remained the dominant concern and the upward rate adjustment would contain it and anchor inflationary expectations without disrupting growth.

On the external front, the central bank noted that the continued sluggishness of the global economy was constraining export growth, while the strong domestic recovery was pushing imports and the trade deficit higher. However, improved global investor sentiment was resulting in increased capital inflows and, if it continued, it would abate concerns even if exports remained sluggish.

3.4.2 Growth in manufacturing (use based)



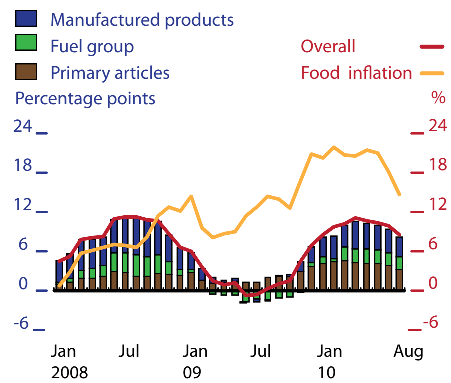
1 = manufacturing; 2 = basic goods; 3 = capital goods; 4 = intermediate goods; 5 = consumer durables; 6 = consumer nondurables.

Note: Revised series adopted 14 September 2010, with base year = 2004–2005.

Source: CEIC Data Company (accessed 13 September 2010).

Click here for figure data

3.4.3 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 September 2010).

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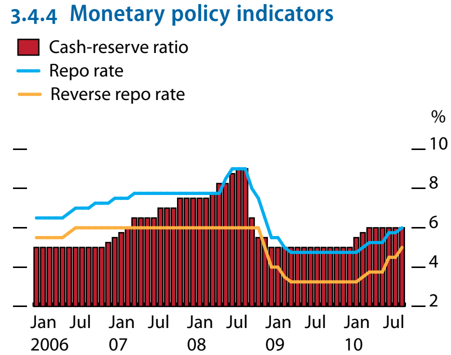
3.4.4 Monetary policy indicators



Source: CEIC Data Company (accessed 16 September 2010).

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In its statement, the RBI also indicated that policy adjustments over the year had brought back the high expansionary stance of policy to a more neutral position. With normalization largely complete, adaptations in central bank policies would now essentially be oriented to changing current and expected macroeconomic conditions.

The monetary measures have had a discernible effect on credit conditions. The call money market rate increased from a high of around 3.4% in December 2009 to 6.1%–9.0% by end-July 2010. Despite firming interest rates, the recovery in growth in bank credit to the commercial sector that began in November continued to be strong through August 2010 (Figure 3.4.5).

The key features of India's balance of payments during FY2009 were a slightly lower trade deficit (though it expanded over the year as the return to rapid growth sucked in imports); a weakening in the invisibles account surplus (because of slower growth in business processing services); and a marked widening in the current account deficit to $38.4 billion (to 2.9% of GDP) (Figure 3.4.6).

An encouraging development was the burgeoning of net capital inflows during the year, as risk appetite returned with the upswing in growth in major industrial economies. The capital surplus more than covered the current account deficit and helped to rebuild foreign exchange reserves following the large loss in FY2008. India's external debt, as of 31 March 2010, was at $261.4 billion (18.9% of GDP).

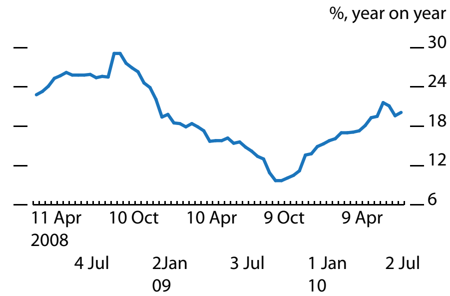
Balance-of-payments data for the first quarter of FY2010 are not yet available. Exports accelerated their post–October 2009 revival, surging by 34.4% in the first quarter of FY2010 (Figure 3.4.7), though this steep gain was partly due to the previous year's low base. The first quarter's stars were petroleum products (up 80%), gems and jewelry (36%), textiles (30%), and engineering goods (16%). Imports also leaped, registering growth of 35% in the first quarter. Data through August, however, indicate a marked slowing in exports versus an accelerating import pickup, widening the trade deficit.

Foreign exchange reserves fell slightly in the first fiscal quarter but subsequently advanced to show roughly a $4 billion gain over the first 5 months of FY2010, to total about $258 billion at end-August (Figure 3.4.8). This increase in reserves (though less than the $20 billion in the period a year earlier), suggests that, in the face of a growing trade deficit, net capital inflows stayed strong. Indeed, portfolio investment by foreign institutional investors amounted to $12.2 billion in the first 5 months of FY2010, some 20% above the prior-year level.

Despite some moderation in capital inflows in the first quarter of FY2010 (especially in May), and consequent nominal depreciation of the rupee against the dollar, the pressure on the rupee to appreciate has reemerged due to strong capital inflows in the second quarter. Indeed, the Indian currency appreciated by more than 11% in real terms between August 2009 and August 2010 (Figure 3.4.9). This was mainly attributable to high inflation (relative to trading partners). The authorities are keen to push growth to 9%–10% over time, and so may want to resist any appreciation in the exchange rate and to this end the expected reduction in inflation over the coming months will be beneficial.

Given the volatile nature of capital inflows in reaction to external

3.4.5 Credit growth to private sector



Source: Reserve Bank of India. http://www.rbi.org (accessed 13 September 2010).

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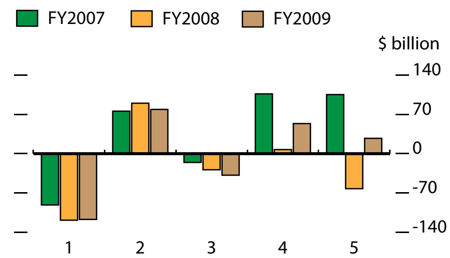
3.4.6 Balance-of-payments indicators



1 = trade balance; 2 = invisibles balance; 3 = current account balance; 4 = capital account balance; 5 = change in reserves including valuation changes.

Source: Reserve Bank of India. http://www.rbi.org (accessed 11 September 2010).

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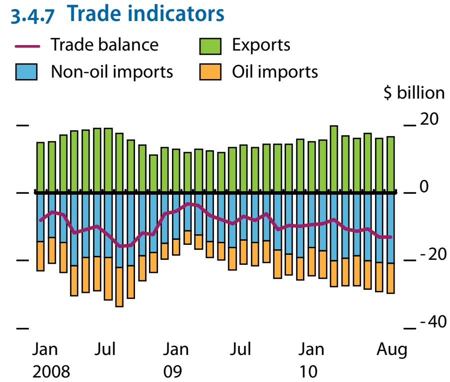
3.4.7 Trade indicators



Note: Total exports and imports based on customs data.

Source: Ministry of Commerce. http://commerce.nic.in/index.asp (accessed 16 September 2010).

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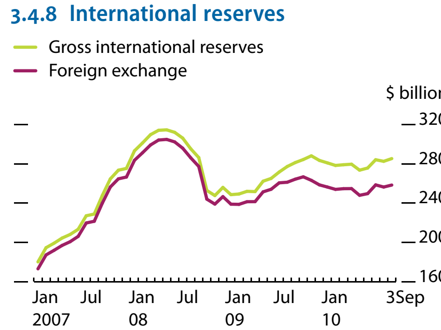
3.4.8 International reserves



Note: Gross international reserves includes gold and SDRs.

Source: CEIC Data Company (accessed 15 September 2010).

Click here for figure data

events, striking the right balance among growth, inflation, and competitiveness objectives will be a delicate maneuver. A continued stable recovery in the industrial world should sustain positive global investor sentiment, and hence capital inflows to India.

Amid uncertainties about global recovery, the central government's FY2010 budget deficit was set to decline to 5.5% of GDP, about a 1.2 percentage point reduction as part of a multiyear plan for winding down the large fiscal stimulus provided earlier (Figure 3.4.10). Receipts from the sale of bandwidth for mobile telephony and wireless broadband in auctions turned out to be almost three times the budgeted amount; however, the additional funds were largely offset by a Rs.546 billion supplement to the budget that raised total expenditure by about 5%. Data through August show buoyant revenue collection, such that the deficit target should be readily met.

The June 2010 the government's decision to decontrol gasoline (petrol) prices—allowing them to adjust to global prices—as well as raising administered prices for diesel, cooking gas, and kerosene was a step in the right direction. While further actions are needed, the changes were an important start to reducing excessive subsidies and rationalizing incentives for energy use and production.

The introduction of a comprehensive, integrated (federal and state) goods and services tax (GST) to replace a myriad of indirect taxes is also a crucial reform both for achieving fiscal consolidation as well as minimizing distortions in the economy. It was expected to take effect from April 2011; however, it has been delayed as procedural requirements were not completed in time. Moreover, the revised version of the direct tax codes, approved by the Cabinet recently, appears to be a missed opportunity for fundamental reforms in the direct tax system. That version, too, will not take effect in April 2011 as originally planned.

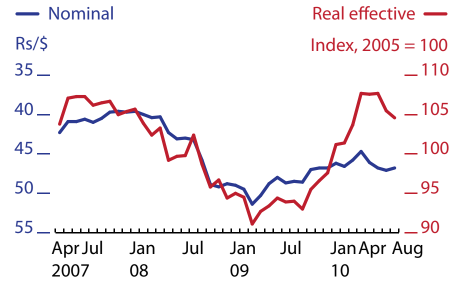
Despite renewed buoyancy in revenue stemming from higher growth, greater rationalization in expenditure will be needed to achieve the fiscal consolidation roadmap proposed by the 13th Finance Commission. That document envisaged the central budget deficit shrinking to 3.0% by FY2013 and the general government debt to 68% of GDP (from 80% at end-FY2009).

The Sensex, the main index of the Bombay Stock Exchange, saw a remarkable runup from March 2009 that has continued through August 2010 (Figure 3.4.11). The upturn was part of a general worldwide rally in stock prices. The Sensex has substantially outperformed a general index of emerging Asian stock markets—the Morgan Stanley Capital International All Country Asia Pacific (excluding Japan)—whereas they had often moved in virtual lockstep before.

Prospects

ADO 2010 forecasts for FY2010 and FY2011 were based on six key assumptions: monetary and fiscal stimuli would be withdrawn gradually over the next 2 years; the domestic food supply position would be comfortable because of normal monsoons; international oil prices would average about $80 per barrel in 2010 and $85 in 2011; domestic fuel prices would be revised upward; industrial economies would show modest

3.4.9 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org (both accessed 13 September 2010).

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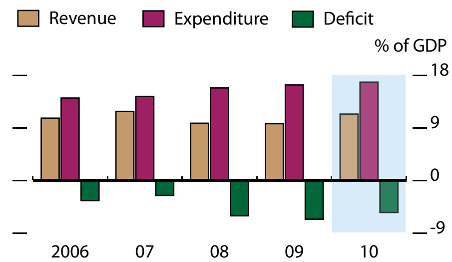
3.4.10 Central government budget indicators



Note: FY2010 is an estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 16 September 2010).

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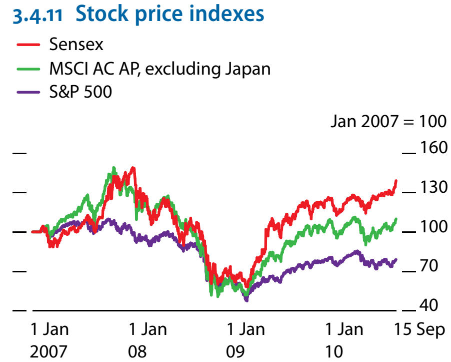
3.4.11 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 15 September 2010).

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3.4.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	8.2	8.5	8.7	8.7
Inflation	5.0	7.5	5.5	5.5
Current acct. bal. (share of GDP)	-1.5	-2.7	-2.0	-2.4

Source: ADB estimates.

recovery in 2010 followed by further acceleration in 2011; and world trade would grow by 7%–8%. The main differences in assumptions between this *Update* and *ADO 2010* are moderation in growth in industrial economies in 2011; and faster growth in world trade in 2010 (9.5%) followed by a deceleration in 2011 (to 8.1%).

The positive response to monetary policy accommodation and fiscal stimulus are still boosting growth prospects in FY2010. The improved business optimism is reflected in several business confidence surveys (Figure 3.4.12, for example). Similarly, despite some moderation in the 50th round of the Industrial Outlook Survey of RBI for the assessment quarter (April–June 2010) as well as expectations for the July–September 2010 quarter, growth impulses remained very strong. Moreover, the HSBC Markit Purchasing Managers' Index for manufacturing has since January 2010 been sustained at a relatively high level (Figure 3.4.13).

Sustained business optimism and rebounded corporate earnings in the second half of FY2009 are likely to support new investment, despite a hardening of interest rates in recent months. Profit after tax of nongovernment, nonfinancial, listed companies increased by 44% in the last quarter of FY2009 as against a decline by 20% in the same period of FY2008. Strong private investment demand is corroborated by the commissioning of new projects. Industries like construction, road infrastructure, shipping, automobiles, cement, paper, and fertilizer are expected to see substantial project commissioning in the current fiscal year. This will generate demand for capital goods.

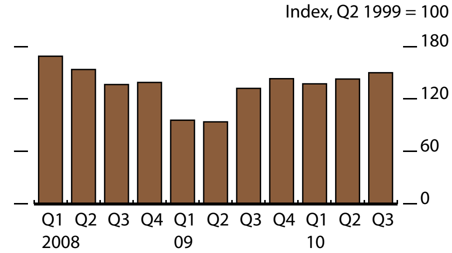
As argued in a recent RBI report, a buoyant stock market can also be conducive for domestic investment and growth. For example, rising asset prices (originating from rising stock price) would lead to improvement in the balance sheets of firms and banks, and hence easier access to funding at lower cost. The wealth effect could also exert a positive influence on private consumption.

Revival in private consumption is critical to maintaining the appetite for private investment demand. Higher disposable incomes (after an announcement of increased personal income tax limits in the last budget) will boost private consumption and the demand for consumer durable goods. Buoyancy in corporate wages will also boost urban consumption, while normal agricultural growth, expansion of the National Rural Employment Guarantee Scheme, and a higher minimum support price for pulses will strengthen rural demand for consumer durable goods and automobiles.

Despite a pickup in exports, the positive contribution of net exports that resulted from the sharper import decline in FY2009 will revert to the normal negative pattern in FY2010 as domestic demand and imports strengthen. The overall growth outlook, thus, will essentially be shaped by the renewed buoyancy in domestic absorption in FY2010. The overall GDP growth rate is expected to be 8.5% during FY2010, a touch stronger than the 8.2% projected in *ADO 2010*. The growth momentum is expected to carry on in FY2011 despite slight moderation in growth in industrial economies and world trade. In view of these developments, the growth forecast for FY2011 remains unchanged at 8.7% in FY2011 (Figure 3.4.14).

In contrast, the inflation forecast for FY2010 is raised substantially. Running against expectations in *ADO 2010*, inflation pressures did not

3.4.12 Dunn and Bradstreet optimism index



Note: The index is calculated as the ratio of the positive responses for six selected parameters (or "subindexes") for the period under review to the positive responses in the base period (Q2 1999).

Source: Dunn and Bradstreet India. http://www.dnb.co.in (accessed 31 August 2010).

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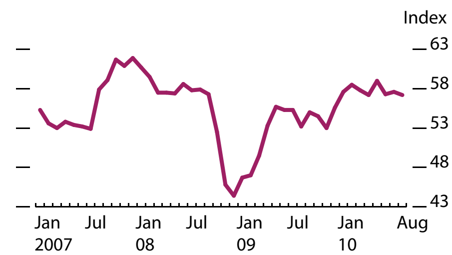
3.4.13 HSBC India manufacturing purchasing managers' index



Source: Bloomberg (accessed 10 September 2010).

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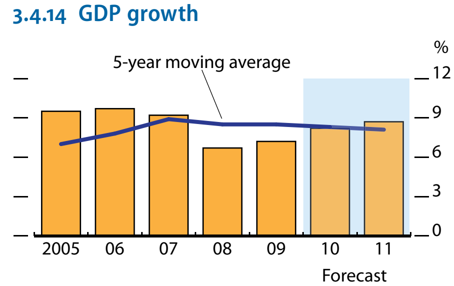
3.4.14 GDP growth



Source: Asian Development Outlook database.

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ease after the winter crop (harvested in April–June 2010), and the second-order impact of higher food and fuel prices remains an issue. However, overall year-on-year inflation is expected to decline by March 2011 due to a recovery in summer sown crops in 2010 (harvested in September–October), and the favorable impact of a high base in the second half of FY2009.

Nevertheless, projected average inflation will remain elevated at 7.5% in FY2010 despite sequential falls in the year-on-year rate. As nonfuel commodity prices slacken in 2011 and domestic production and stock of foodgrains remain comfortable, overall inflation is expected to moderate to 5.5% in FY2011 (Figure 3.4.15).

As forecast in *ADO 2010*, trade flows in FY2010 and FY2011 will strengthen, though less quickly than before the global slowdown, primarily due to the pull factor originating from the buoyancy in world trade and domestic growth. Exports are projected to grow by 18.0% in FY2010 and 15.0% in FY2011. Imports will maintain a relatively stronger growth (20%) in FY2010 due to buoyancy in investment and domestic industrial production before moderating to 18% in FY2011.

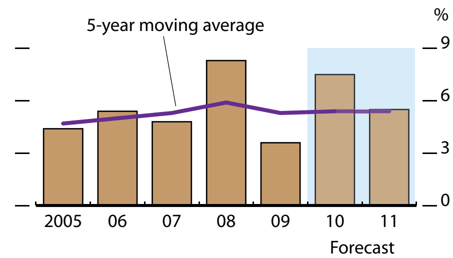
Sectors such as information technology (IT) and IT-enabled services, gems and jewelry, and agricultural and allied products are expected to post impressive export performance in the forecast period. Overall, the current account deficit as a share of GDP will remain relatively high at around 2.7% in FY2010 and 2.4% in FY2011 (Figure 3.4.16).

The possibility of surging capital inflows and, consequently, an excessive surplus in the capital account cannot be ruled out. This would pose a challenge for macroeconomic management in the coming months. Prolonged low interest rates in the major industrial economies could exacerbate the flow of short-term capital to India, leading to a complex balancing act between inflation and the nominal exchange rate. If Indian inflation does not abate as expected, the RBI would find it difficult to intervene in the foreign exchange market to damp rupee appreciation, due to limited options for sterilization.

A well-grounded, robust recovery will depend on the ability of the various levels of policy makers to coordinate effectively among themselves and achieve macroeconomic stability. There are two interrelated threats to stability: continued appreciation of the rupee as well as high actual inflation and inflation expectations. The former could jeopardize recoveries in many labor-intensive export-oriented industries, and the latter could force the central bank to take a sharply tighter credit policy, stunting growth.

The other downside risk to the growth forecasts is that the recovery in industrial economies will stall or an event that may shock global credit markets. Clearly, any renewed weakness in the external environment would deflate current positive trends.

3.4.15 Annual inflation



Source: Asian Development Outlook database.

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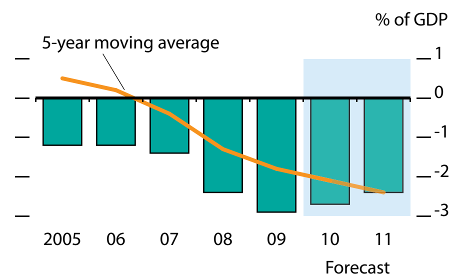
3.4.16 Current account balance



Source: Asian Development Outlook database.

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Indonesia

Stronger than anticipated economic recovery in the first half of 2010 was driven by growth in private consumption and private investment, gains that more than offset reduced government spending. GDP forecasts for this year and next are revised up from those made in *Asian Development Outlook 2010* in April. Inflation has been more subdued than expected, but there is a risk of price pressures building. The current account is projected to remain in surplus through the forecast period.

Updated assessment

GDP growth accelerated to 6.2% year on year in the second quarter of 2010 from 5.7% in the first (Figure 3.5.1.), putting the first-half expansion at 5.9%. The main drivers of growth on the demand side were private consumption and a welcome boost in investment.

Private consumption, supported by a firmer labor market, rising wages, and relatively high prices for agricultural commodities, grew by 4.5% in the first 6 months from the prior-year period and contributed nearly half the total GDP growth. By contrast, government consumption spending, which had expanded at double-digit rates from late 2008 through late 2009, fell by 8.9% in the first half of 2010 as the government unwound its fiscal stimulus and as budget disbursement lagged behind schedule.

A 7.9% increase in fixed capital investment (Figure 3.5.2) was a particularly beneficial development, contributing to the economy's productive capacity and adding 1.8 percentage points to first-half GDP growth. Investment in machinery and transportation equipment rebounded (it had contracted in the year-earlier period), while investment in buildings (including infrastructure) was maintained at a solid pace.

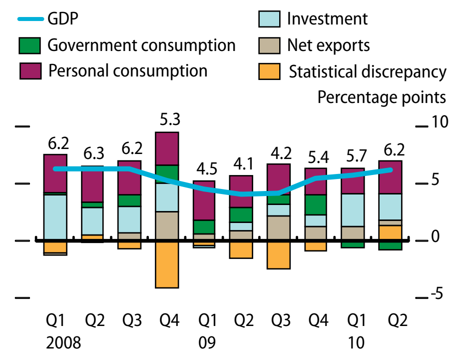
Investment was supported by a 4% appreciation of the rupiah against the US dollar in the first 8 months of 2010 and by a pickup in credit to the private sector. Net foreign direct investment inflows rose by about 45% to $4.9 billion in the first half, suggesting consolidating international confidence in the economy.

The contribution of net exports to GDP growth was just under 1 percentage point in January–June, similar to the same period of the previous year.

Among production sectors, services grew by 8.3% (Figure 3.5.3). Double-digit expansion was recorded in telecommunications services as well as wholesale and retail trading. Services contributed more than half of total GDP growth (3.7 percentage points) on the supply side. Industry expanded by 4.4%, with a moderate recovery in manufacturing (output up by 4.0%), in part reflecting the recovery in export demand. The

This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

3.5.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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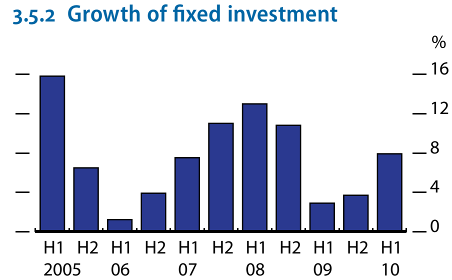
3.5.2 Growth of fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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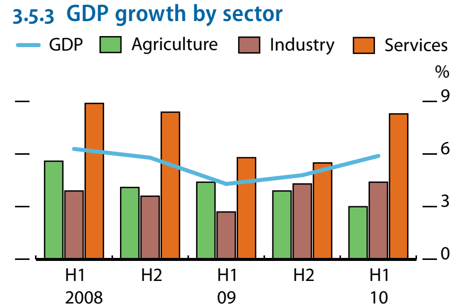
3.5.3 GDP growth by sector



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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manufacturing production index edged higher during the first 6 months (Figure 3.5.4). Growth in mining was slightly ahead of the year-earlier period, at 3.4%. Industry as a whole contributed 1.8 percentage points to GDP growth.

Agriculture, however, recorded its weakest performance for 3 years due to bad weather. Production in this sector rose by 3.0%, and made only a small contribution to GDP growth.

The rebound in world trade propelled merchandise exports by 39% in nominal US dollar terms during the first half, with notably strong gains in exports of oil and gas as well as rubber. Imports surged even faster than exports (Figure 3.5.5), at nearly 50%, in large part reflecting the need for imported inputs for manufactured exports and increases in capital equipment imports. The half-year trade surplus rose by just over 14% to $17.4 billion. After taking into account deficits in services trade and the income account, the outcome for the current account was a surplus of $3.9 billion (equivalent to 1.2% of GDP).

At $12 billion, the surplus in the overall balance of payments was more than double that of a year earlier (Figure 3.5.6), driven by increasing foreign investment in Indonesian bonds and short-term debt securities, coupled with the increase in foreign direct investment. Significant volumes of capital flowed out of the country in May, triggered by a rise in global risk aversion during the Greek sovereign debt crisis, though inflows resumed in June. International reserves in the first 8 months of 2010 rose to $81.3 billion, equivalent to 6.1 months of imports and government foreign debt payments. This strong external position contributed to the rupiah's appreciation against the dollar.

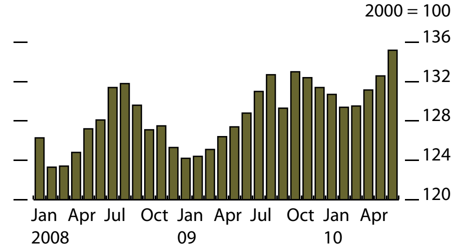
Higher levels of short-term capital inflows over the past 18 months have increased the country's exposure to the risk of a sudden reversal in these sometimes volatile capital movements. To temper that risk, the authorities have built additional foreign reserves and adjusted policies to check short-term flows. For example, Bank Indonesia has imposed a minimum 30-day holding period for central bank certificates, has issued longer-dated certificates, and has introduced a new term-deposit facility for commercial banks.

Robust economic growth helped to trim the rate of unemployment, to 7.4% in February 2010 from 8.1% in February 2009. About 2.9 million jobs were generated in that 12-month period, mainly in industry, domestic trade, and construction. Poverty incidence, as measured by the national poverty line, was 13.3% in March, down about 2 percentage points over 2 years.

Inflation, subdued at below 4% year on year since mid-2009, accelerated to just over 6% in July and August 2010 (Figure 3.5.7). That increase was fueled by a surge in the price of rice and some other food, in part a result of the bad weather, and higher electricity tariffs. For the first 8 months of this year, inflation averaged 4.6%. (Bank Indonesia's inflation target is 4%–6% for 2010–2011.)

The central bank left its policy interest rate unchanged at 6.5% through September 2010 to stimulate growth in credit and in the context of modest core inflation (4.2% in August) and an appreciating exchange rate. (The monetary authorities had cut the policy rate by 300 basis points to 6.5% between October 2008 and August 2009 to support growth during

3.5.4 Manufacturing production index



Source: CEIC Data Company (accessed 15 September 2010).

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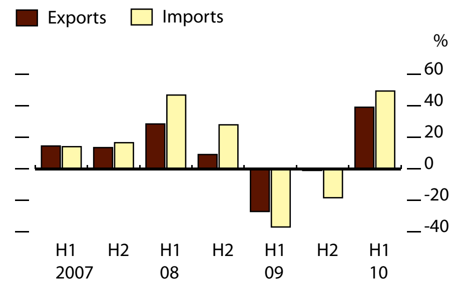
3.5.5 Merchandise trade growth



Note: Based on balance-of-payments data.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 September 2010).

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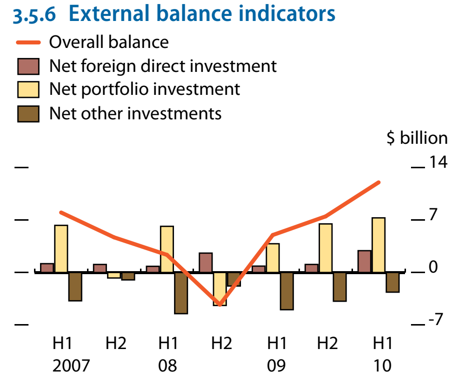
3.5.6 External balance indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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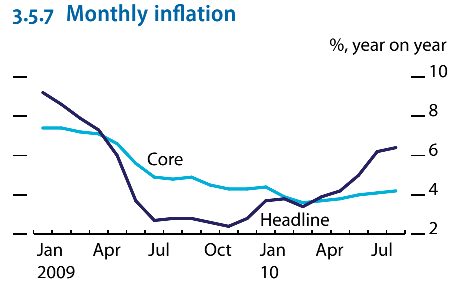
3.5.7 Monthly inflation



Sources: CEIC Data Company (accessed 3 September 2010); *Asian Development Outlook* database.

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the global recession.) Bank Indonesia, did, however, opt to raise the primary reserve requirement ratio for banks, effective 1 November 2010, to drain some of the considerable excess liquidity in the banking system. The central bank also took steps to encourage banks to spur sluggish lending, with the result that credit to the private sector started to pick up in the second quarter and was running at about 19% in July.

Domestic financial markets were generally buoyant. The Jakarta Composite Index of share prices climbed by nearly 22% in the first 8 months of 2010 (Figure 3.5.8). Yields on 5-year government local-currency bonds fell by 132 basis points to 7.7% during that period.

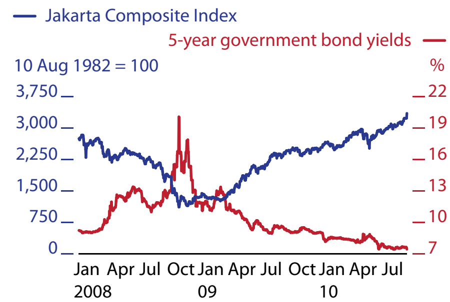
Revisions to the 2010 budget approved by Parliament in May widened the budget deficit target to 2.1% of GDP. These changes take into account higher international oil prices than originally expected, so that the amount allocated for energy subsidies in 2010 was increased to the equivalent of $15.7 billion. The revised budget includes a provision to raise retail fuel prices if international prices exceed the projected price in the budget ($80 per barrel) by 10%. Electricity tariffs were raised by an average of 10% from July.

The revised budget also allocated additional spending for physical infrastructure, poverty reduction, education, and reconstruction of earthquake damage. However, the budget outturn in the January–June period showed a surplus of Rp46 trillion, or 0.7% of GDP, instead of the budgeted deficit. Only about 35% of the 2010 budget spending was disbursed in the first half, mainly owing to delays in executing budget projects, a perennial problem (the equivalent spending figure a year earlier was 37%).

On the receipts side, higher domestic oil prices and production, an improved performance by state-owned enterprises, and the higher levels of business activity underpinned growth in government revenue.

Indonesia's debt-to-GDP ratio fell to 26% in August 2010 (preliminary data for national government debt), maintaining a decline that has seen the ratio fall by more than half over the past 6 years.

3.5.8 Financial market performance



Source: Bloomberg (accessed 15 September 2010).
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Prospects

The basis for the projections assumes that the government will implement the major policies formulated in the National Medium-Term Development Plan, which targets raising average annual GDP growth to 6.3%–6.8% in 2010–2014, and lowering the poverty incidence to 8%–10%.

Fiscal deficits are projected through the forecast period. Government spending will accelerate in the second half of this year, following the slow start to budget disbursement, although the targeted budget deficit of 2.1% of GDP for this year seems unlikely to be achieved (a deficit of about 1.5% seems in prospect, close to the 2009 deficit). Next year, the government is projecting a fiscal deficit of 1.7% of GDP. Deficit spending, together with some improvement in budget execution and increasing allocations for infrastructure, will support economic growth.

Monetary policy is assumed to be generally accommodative. The monetary authorities have indicated that they are inclined to adjust bank reserve requirements before they start to return the policy interest rate to more normal levels.

3.5.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	5.5	6.1	6.0	6.3
Inflation	5.6	5.2	6.2	5.7
Current acct. bal. (share of GDP)	1.4	1.2	0.6	0.7

Source: ADB estimates.

Investment is forecast to gain momentum through the second half of 2010 and in 2011, underpinned by prospects for growth in exports, improved credit availability, and efforts by the government to accelerate disbursement on capital works. A survey by Bank Indonesia in the second quarter of this year showed that 81% of respondents believe 2010 to be a good time to invest. International investor sentiment toward Indonesia, too, is improving. Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's revised its rating outlook in June from Ba2 stable to Ba2 positive.

Private consumption is expected to be robust, backed by rising real incomes, a public wage increase, and growth in employment. The index of consumer confidence dipped in July and August when inflation accelerated (Figure 3.5.9), but it still suggested growth in consumption.

The pace of growth in exports will likely moderate in the second half of 2010, given the base effects from an upturn in exports late last year.

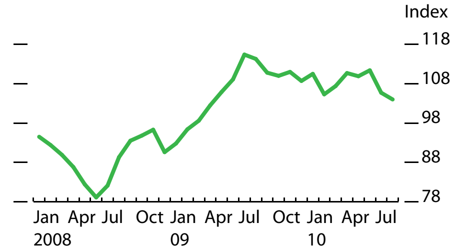
Taking these factors into consideration, GDP growth in the second half is projected to remain around the 6.2% rate recorded in the April–June quarter. The full-year 2010 forecast is revised up to 6.1% (Figure 3.5.10), in light of the upgrading of the projection for growth in world trade, and the stronger than expected, broad-based expansion of the Indonesian economy in the first half. GDP growth next year is seen at 6.3%, slightly higher than in 2010 owing to projections of continued growth in private consumption and in both private and public investment.

The surge in imports spurred by the stronger than expected domestic demand will trim the current account surplus from the level anticipated in April. Current account surpluses now are forecast at the equivalent of 1.2% of GDP this year and 0.7% in 2011.

Some of the upward pressures on prices in July–August were one-time and seasonal factors that are expected to subside. For the full year, inflation is forecast to average 5.2%, accelerating to 5.7% in 2011 (Figure 3.5.11) as domestic demand continues to strengthen. These forecasts are trimmed from April's on the basis of lower than expected inflation in the first half of 2010 and the pickup in investment, which will help to ease capacity constraints.

Still, there is a risk that inflation could exceed the forecasts, given the outlook for quickening economic growth and still low interest rates. Further bouts of bad weather would be reflected in higher prices for rice and vegetables, and global wheat prices have been under upward pressure. A return to high levels of inflation would dent private consumption and reduce room for accommodative monetary policy, hurting investment.

3.5.9 Consumer confidence index



Source: CEIC Data Company (accessed 15 September 2010).

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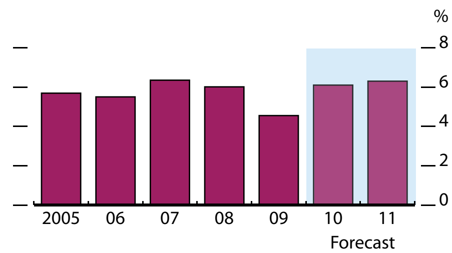
3.5.10 GDP growth



Source: Asian Development Outlook database.

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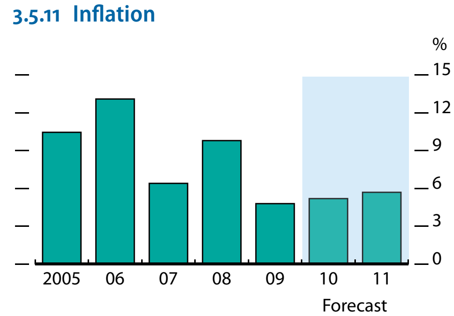
3.5.11 Inflation



Note: 2005–2007 base year = 2002; 2008 onwards base year = 2005.

Source: Asian Development Outlook database.

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Malaysia

Rebounding from contraction in 2009, GDP rose at a faster rate than anticipated in the first half of 2010. Exports recovered strongly, sparking a broad-based increase in domestic demand that powered the growth in GDP. The pace will slow in the second half, but the 2010 full-year forecast is raised from that presented in April. In 2011, the economy is expected to return to growth at a touch above trend level. Inflation has been milder than expected, and is forecast to remain low. Substantial current account surpluses will likely continue to underpin a firming ringgit.

Updated assessment

Recovery in global trade and a broad-based increase in domestic demand drove a stronger than expected economic rebound in the first half of 2010. GDP rose by 10.1% year on year in January–March (Figure 3.6.1), easing a shade to 8.9% in April–June. That put the expansion for the first 6 months at 9.5%, a turnaround from the year-earlier period when the economy contracted by 5.1%.

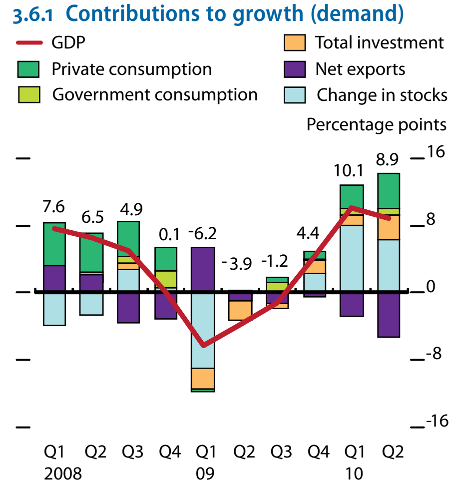
On the demand side, growth was underpinned by a robust 6.5% increase in private consumption in the first 6 months, reflecting renewed consumer confidence and rising incomes, which resulted from a lift in manufacturing output and wages coupled with higher agricultural commodity prices. Private consumption contributed 3.5 percentage points of total GDP growth in the first half. Government consumption spending increased by 6.6%, as disbursements of fiscal stimulus measures implemented in 2009 quickened.

Fixed capital investment rebounded by 9.4% owing to the recovery in world trade, while inventories posted their first increase in over 3 years. Total investment accounted for 2.0 percentage points of GDP growth. The large contribution of domestic demand to GDP growth was partially offset by net exports (in volume terms), which contracted from year-earlier levels as robust growth in exports of goods and services was offset by an even faster rise in imports, due to Malaysia's dependence on imported inputs for its manufactured exports.

In terms of supply, growth was spearheaded by a buoyant performance in manufacturing and services (Figure 3.6.2). Manufacturing, which accounts for around 25% of GDP, expanded by 16.4% in the first half, on account of the rebound in world trade. Production of electronic and electrical goods, which account for around one-third of total manufacturing, shot up by 32.8% owing to greater industrial-country demand to replenish depleted inventories.

Construction picked up by 6.3%, reflecting the impact of the fiscal stimulus on nonresidential and civil engineering activity. The services sector, which accounts for close to 60% of GDP, expanded by 7.9% in

3.6.1 Contributions to growth (demand)



Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 8 September 2010).

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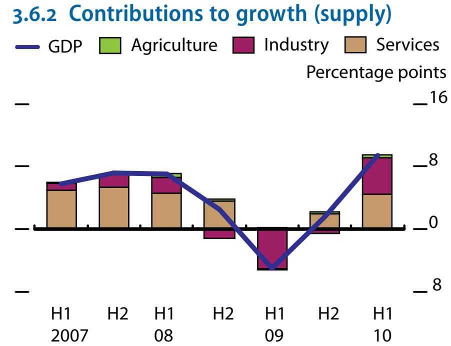
3.6.2 Contributions to growth (supply)



Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 8 September 2010).

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This chapter was written by Purnima Rajapakse of the Southeast Asia Department, ADB, Manila.

the first half, underpinned by growth in wholesale and retail trade and financial services.

Agricultural output also gained in the first half, by 4.5%. Production of natural rubber climbed steeply early in the year, then moderated owing to seasonal factors and bad weather. The weather problems, and replanting, meant that palm oil production rose only slightly.

Mirroring the economic recovery, the number of job vacancies in the first 6 months went up from prior-year levels, with the highest increases in manufacturing and services, and the number of layoffs fell. The unemployment rate was little changed at 3.7% of the labor force at end-June compared with the start of 2010.

Year-on-year inflation edged up to 1.9% in July 2010 from 1.1% in December 2009 (Figure 3.6.3), in tandem with rising global commodity and food prices. Prices of food and beverages rose by 2.9%, reflecting the stronger domestic demand and supply constraints due to the bad weather.

The current account surplus for the first half declined to a still substantial $14.1 billion (12.6% of GDP), from $16.5 billion a year earlier. Wider deficits in the income and transfer accounts, and a reversal in services from a surplus to a deficit, more than offset a trade surplus. The rebound in global trade pushed up merchandise exports (Figure 3.6.4), by 38.1% in US dollar terms in the January–June period.

Electronic and electrical products (about 40% of total exports) led the recovery as industrial countries restocked after running down inventories for much of 2009. Exports of palm oil and liquefied natural gas also rose strongly, owing to gains in both volume and prices. Strong demand from the People's Republic of China (PRC), now Malaysia's biggest trading partner, supported the export rebound. Higher exports were accompanied by a 44% leap in imports, mainly intermediate goods used in the manufacture of electronic and electrical goods for export. However, given the considerably higher export base, the surplus in the trade balance increased.

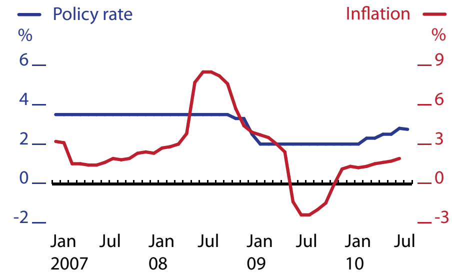
Deterioration in the services account stemmed mainly from higher payments on transportation as the volume of external trade picked up, and on other services such as insurance and finance, reflecting the bounce in economic activity. The wider deficit on the income account reflected higher outflows of dividends and interest from foreign companies operating in Malaysia than the equivalent inflows from Malaysian firms' investments abroad. The transfer account moved further into deficit due to higher remittances by foreign workers in Malaysia.

The lower current account surplus was accompanied by a significantly reduced deficit in the financial account due mainly to a reversal in portfolio flows from an outflow to an inflow. In part, that switch illustrated increased risk appetite for emerging market debt securities. Net foreign direct investment (FDI) recorded an inflow in the first half, compared with an outflow in the last 3 quarters of 2009.

Other investments, however, continued to register a large outflow. International reserves at mid-August 2010 amounted to $95.1 billion, sufficient to cover 7.8 months of retained imports and 4.3 times short-term external debt (Figure 3.6.5).

Having run a budget deficit of 7.0% of GDP in 2009 (widened by spending on two fiscal stimulus packages), the government aims to rein

3.6.3 Inflation and policy interest rate



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 8 September 2010).

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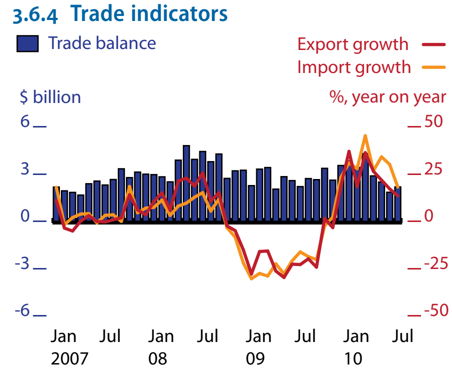
3.6.4 Trade indicators



Source: CEIC Data Company (accessed 8 September 2010).

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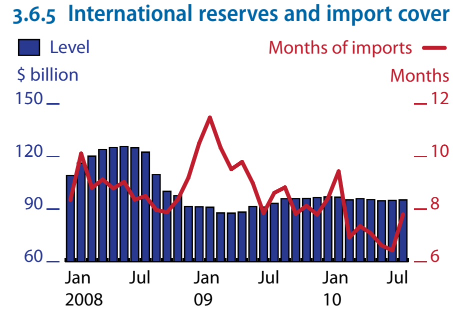
3.6.5 International reserves and import cover



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 10 September 2010).

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in the deficit to 5.4% of GDP in 2010, mainly from the expenditure side. During the first half of 2010, revenue collection came in at 43.7% of budgeted receipts, while operational and development expenditures were 46.7% and 36.2%, respectively, of budgeted amounts. The fiscal outturn in the second quarter showed increases in indirect taxes, export duties, and nontax revenue owing to higher levels of economic activity and higher prices for petroleum, which is produced domestically. Development spending also picked up in the second quarter. At midyear, the 2010 fiscal deficit target appeared to be within reach (Figure 3.6.6).

Federal government debt at end-July 2010 was the equivalent of 53.2% of GDP, up from 41.4% at end-2008. Although this increase is of some concern, it is manageable in the context of a government commitment to fiscal consolidation over the medium term. Moreover, most public sector debt is domestic and the share of short-term debt is low.

Monetary stimulus, too, is being unwound this year. Bank Negara Malaysia, the central bank, increased its policy interest rate three times between March and end-August 2010, by a cumulative 75 basis points to 2.75% (Figure 3.6.3, above). (The policy rate had been cut to record lows during the recession.) The reserve ratio for banks was left at just 1.0%.

In response to the increase in the policy rate, the average overnight interbank rate has firmed, while the average lending rate of commercial banks edged up to 5.05% in the 2 months to end-June 2010, from 4.93%. Reflecting the rebound in economic activity, growth in bank lending picked up over the same period to 12.5% from 10.0%. Bank soundness indicators remain healthy: At mid-2010 the risk-weighted capital-adequacy ratio was 14.8% and net nonperforming loans were 2.2% of totals loans.

Yields on 10-year sovereign bonds had declined to 3.7% at end-August from 4.3% at the beginning of 2010, reflecting the upbeat outlook for the economy, a strengthening of the ringgit (it appreciated by 8.8% against the US dollar in the first 8 months of 2010—Figure 3.6.7), and moderate inflation. The Kuala Lumpur Composite Index of share prices rose by 12.5% in the same period on the back of the domestic and regional economic recoveries.

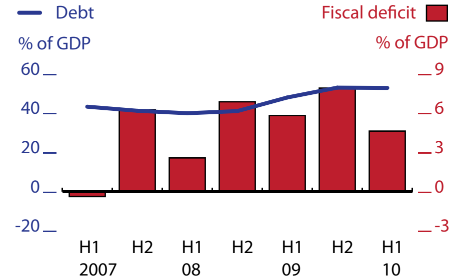
Prospects

With recovery now appearing to be firmly on track, the authorities are likely to complete the gradual unwinding of policy stimulus during the forecast period, though the economy will continue to benefit from fiscal stimulus this year. As of mid-August, 38% of the second stimulus package, which is to be fully disbursed by end-2010, had yet to be spent.

The government has signaled its intention to rein in the fiscal deficit over the medium term through subsidy reforms, streamlining the social safety net system, reviewing tax incentives to foreign and domestic companies, and rolling out a long-delayed goods and services tax. The fiscal deficit for 2011 is projected by the government's Economic Planning Unit at 3.8% of GDP, and according to the 10th Malaysia Plan (2011–2015) unveiled at midyear, the deficit is to be further narrowed to 2.8% by 2015.

Monetary policy is also likely to be tightened further. The central bank has flexibility as regards the timing and extent of interest rate rises,

3.6.6 Federal government fiscal indicators



Note: Federal government debt is based on rolling annual GDP.

Source: Bank Negara Malaysia. http://www.bnm.gov.my (accessed 16 September 2010).

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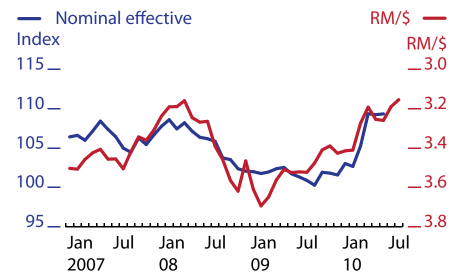
3.6.7 Exchange rates



Sources: Bank Negara Malaysia. 2010. *Monthly Statistical Bulletin*. July. http://www.bnm.gov.my; CEIC Data Company (both accessed 8 September 2010.)

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3.6.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	5.3	6.8	5.0	5.0
Inflation	2.4	1.8	3.0	2.4
Current acct. bal. (share of GDP)	14.0	13.2	13.8	12.0

Source: ADB estimates.

given a relatively large output gap and the strength of the ringgit, which is largely based on balance-of-payments surpluses. It can also raise its reserve ratio for banks as a way to tighten policy.

Even with the strong recovery this year, Malaysia's economic growth has slowed notably in the decade since the Asian financial crisis, with private investment declining to 9.5% of GDP in 2009 from an average of about 30% in the mid-1990s, and outward direct investment currently exceeding inward FDI. The economy lags behind some others in Southeast Asia in terms of growth, productivity, and investment rates.

The global competitive landscape, too, has become much more challenging with the country facing greater competition for FDI and exports in the context of likely slower growth in demand from industrial economies. It is widely accepted that the country can no longer rely on past strategies that drove growth, but needs a revamp to put greater emphasis on innovation, creativity, and high-valued-added industries.

The 10th Malaysia Plan suggests a new approach to structural reforms. It lays out the structural transformation needed if the country is to become a high-income nation by 2020 and focuses on, among other goals, improving the environment for private sector–led growth; moving toward inclusive socioeconomic development; developing and retaining a skills base as key to promoting productivity and innovation-led growth; and transforming the role of the government to become an effective facilitator in the transformation of the economy and to provide quality services.

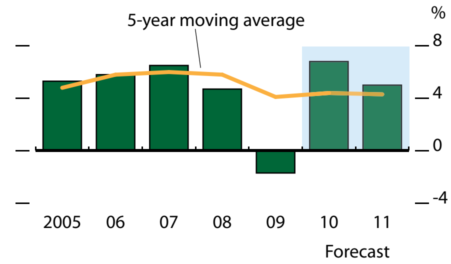
The new approach can be best illustrated by a comparison with some elements of the old: Growth through productivity (rather than growth through capital accumulation); private sector–led growth (dominant state participation in the economy); localized decision making (centralized strategic planning); cluster- and corridor-based economic development (balanced regional growth); favoring technologically capable industries and firms (specific industries and firms); a greater focus on Asian and Middle Eastern markets (an emphasis on being part of production chains to supply consumer goods and components to industrial markets); and policies to attract and retain foreign skilled professionals (restrictions on foreign skilled workers).

After consultation with the private sector, the government in September 2010 unveiled an Economic Transformation Program that further refines its plan to propel Malaysia toward developed-country status by 2020. The program is aimed at expanding higher-valued-added industries, such as energy, financial services, and public transportation to generate a greater number of well-paid jobs. It identifies 133 projects that would require investment totaling $444 billion over 10 years, mostly from the private sector (60%) and government-linked companies (32%), with the government to provide 8% of the funding.

The challenge is daunting and is likely to require difficult trade-offs, particularly in the context of tighter fiscal resources. Consensus will need to be forged, which suggests a measured pace of implementation over the 10th Plan period, with little impact this year or next on GDP growth.

In the light of the stronger than expected GDP rebound in the first half of this year, the full-year growth forecast is raised to 6.8% (Figure 3.6.8). Higher growth will narrow, but not close, the output gap. Private consumption is expected to remain robust due a firming labor

3.6.8 Annual GDP growth



Source: Asian Development Outlook database.

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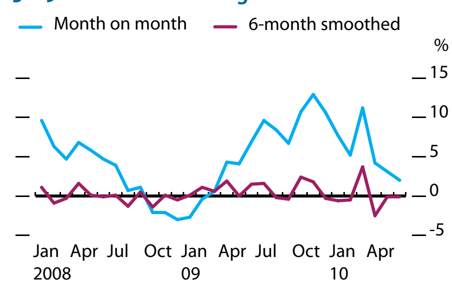
3.6.9 Growth of leading index



Note: The 6-month smoothed growth rate is computed as the ratio of the current month's index to the average index of the preceding 12 months.

Source: Department of Statistics, Malaysia. http://www.statistics.gov.my (accessed 10 September 2010).

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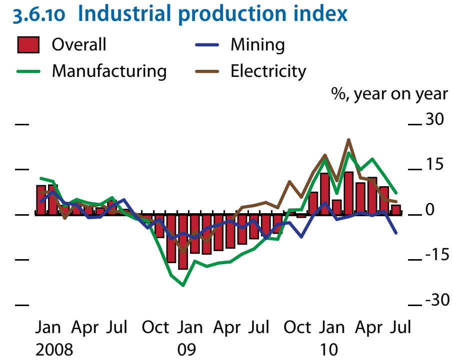
3.6.10 Industrial production index



Sources: CEIC Data Company; Department of Statistics, Malaysia. http://www.statistics.gov.my (both accessed 8 September 2010).

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market and higher incomes coupled with a pickup in business earnings and asset prices. Private investment in fixed capital and inventories will continue to get support from the recovery in export-oriented manufacturing industries, though investment growth still is moderated by excess capacity in some parts of the economy. Efforts to reduce the fiscal deficit are likely to damp public consumption and investment during the rest of 2010.

GDP growth is expected to moderate to a shade over 4% in the second half of this year, mainly owing to a base effect (the economy picked up in the second half of 2009). The government's index of leading indicators has contracted month on month since March 2010, while the 6-month smoothed growth rate of the index decelerated from 11.2% in March to 2.0% in June 2010 (Figure 3.6.9), indicating a slowing pace of economic growth for the rest of this year. Growth in the industrial production index slowed in June and July (Figure 3.6.10).

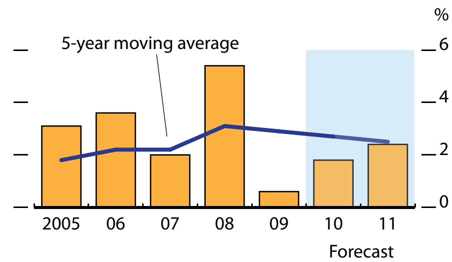
For 2011, GDP growth is forecast at about 5.0%, moderating from this year owing to less favorable base effects, unwinding of policy stimulus, and more subdued growth in several major export markets. Private consumption and fixed investment are projected to remain robust next year, as the labor market strengthens further and the output gap is closed. Public consumption, though, will probably be subdued because of the move to fiscal consolidation.

Upward pressure on prices has been milder than anticipated, so that the 2010 inflation forecast is lowered to 1.8%. The continuing output gap, exchange rate appreciation, and maintenance of price controls on basic goods will keep inflation at low levels. In 2011, higher domestic demand, combined with planned reductions in subsidies, will add to inflation, while the firming exchange rate and subdued global commodity prices will counteract some of that influence. Taking these factors into account, inflation now is forecast at 2.4% in 2011 (Figure 3.6.11).

On the trade front, export growth is projected to moderate over the rest of 2010 and into next year, due to a less supportive external environment, the completion of inventory buildups in industrial economies, and lower prices for some commodities. Import growth is expected to remain robust owing to buoyant domestic demand. A narrowing of the trade surplus is likely to be reinforced by a further deterioration in the income balance because of increased outflows of profits and dividend payments.

This narrowing should be partly offset by an improvement in the services account as inbound tourism picks up. Forecasts for the current account surplus are edged down to the equivalent of 13.2% of GDP this year and about 12.0% in 2011, putting the balances a little below those of recent years (Figure 3.6.12).

3.6.11 Inflation



Source: Asian Development Outlook database.

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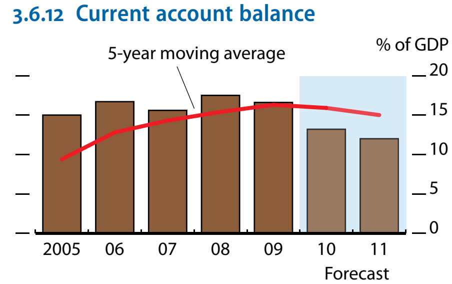
3.6.12 Current account balance



Source: Asian Development Outlook database.

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Pakistan

The economy achieved a modest recovery in FY2010, as foreign reserves strengthened and inflation moderated. However, continued pressure from subsidies as well as weak tax receipts overwhelmed the targeted budget deficit. Assessing the medium-term outlook is problematic due to the devastating floods that began in early August and that clearly hit short-term growth. Coping with the human toll and the massive damage will be daunting. The urgency of fiscal reforms to create space for reconstruction and development funding is now more pressing than ever.

Updated assessment

Continued power shortages and security conditions held growth to a modest 4.1% in FY2010 (ended 30 June 2010), up from 1.2% in FY2009 (Figure 3.7.1). The severe energy shortfall is estimated to have reduced GDP growth by 2.0%–2.5%. Growth for the 3 years from FY2008 averaged 3.0%, substantially below the 6.2% pace recorded in the previous 6 years.

From the demand side, higher private and public consumption expenditure accounted for most of the expansion (Figure 3.7.2). Private consumption grew by 3.9% (accounting for two-thirds of GDP growth), fueled by gains in rural income buoyed, in turn, by better procurement prices and improved availability of consumer credit during the second half of FY2010. The resulting increase in demand for intermediate goods benefited from improved access to credit, bolstering corporate liquidity. Public sector consumption expanded by 13.4% (contributing about one-quarter of the rise in GDP), boosted by higher spending on public safety and internal security.

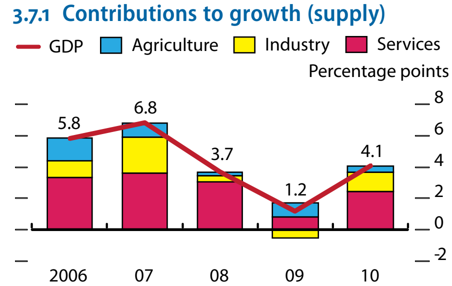
Unsurprisingly, investment remained weak in the context of subdued economic recovery and continued energy shortages. Total fixed capital formation contracted by 2.0% for the year: private investment dropped by 5.1%, more than offsetting a 6.5% increase on the public side. The decline in large-scale investment in manufacturing (15.4%) is a worrisome sign for the urgently needed strengthening and modernization of the structure of production, as are the very large contractions in investment for electricity and gas (11.0%) and transport and communications (14.1%), where additional capacities are needed to support sustained growth.

Net exports contributed moderately to growth, though this was mainly due to a fall in imports as exports expanded only modestly.

From the production side, a 4.6% expansion in services accounted for 59% of the rebound, led by stronger wholesale and retail trade and by an increase in public administration and defense. Gains in the sector were not uniform, however, and the finance and insurance subsectors continued to contract.

This chapter was written by Dawn Elizabeth Rehm and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

3.7.1 Contributions to growth (supply)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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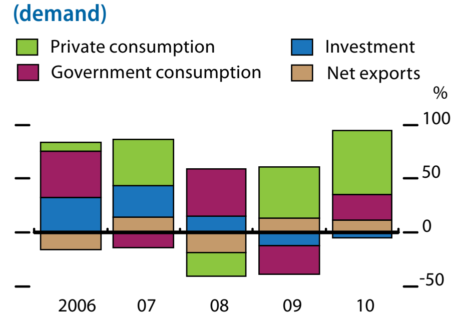
3.7.2 Share contributions to GDP growth (demand)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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Large-scale manufacturing expanded by 4.8%, reversing the FY2009 contraction, with growth concentrated in areas associated with discretionary consumer spending, as well as pharmaceuticals (Figure 3.7.3). Production in the textile industry contracted as higher world prices for cotton yarn led to increased yarn exports, crimping supplies available to domestic value-added industries. Industry contributed 30% of overall growth, and the trend of a steady declining contribution by this sector to growth was reversed. The return of less favorable weather conditions kept agricultural growth to 2.0%, accounting for about 11% of the economic expansion.

Fiscal performance fell short of FY2010 budget targets. Planned policy reforms lost momentum as pressures on foreign reserves eased and calls for higher spending increased. The fiscal deficit at 6.3% of GDP was substantially higher than the 5.3% of GDP outcome in FY2009 and the deficit target of 5.1% of GDP (Figure 3.7.4). Even though the Public Sector Development Program was slashed by a fifth to 3.5% of GDP, this cut was insufficient to offset increased outlays for security, subsidies, and transfers to provincial governments.

Actual development spending rose by 7.8% but was significantly below its planned level. Reductions in development spending, which fell 14.5% short of its planned level, cut heavily into infrastructure outlays. This compression of development spending to rein in the deficit is both undesirable and counterproductive, as substantial infrastructure improvements are needed to support investment in the delivery of basic public services.

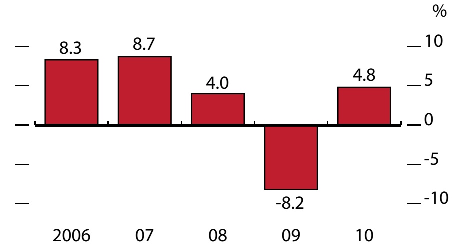
Overruns on current expenditure by the federal government for FY2010 amounted to 0.6% of GDP, with increases in security spending and other transfers, and a surge in energy-related subsidies. Despite a 37% rise in customer tariffs, power-related subsidies ballooned from the budgeted 0.5% of GDP to 1.0%, as tariff increases were insufficient for cost recovery. Total subsidies (including fertilizer and food) climbed to 1.6% of GDP.

The ratio of federal tax revenue to GDP fell to its lowest level in more than 30 years, as tax collection declined from 9.1% of GDP in FY2009 to 9.0% (Figure 3.7.5), well below the 9.4% target. A major factor was the sustained contraction of the telecommunications and finance sectors, both of which are heavy taxpayers.

The fiscal position is even more precarious than implied by the budget deficit alone. Net tax revenue available to the federal government (9.0% of GDP) was well short of current outlays (12.0% of GDP) in FY2010. Notably, the combined total of subsidy outlays (1.6% of GDP), defense spending (2.6% of GDP), interest costs (4.4% of GDP), and pensions (0.5% of GDP) amounted to 9.1% of GDP. General operating expenses of the federal government (2.9% of GDP) are thus left to be financed by borrowings (Figure 3.7.6). Additional pressure on domestic credit markets came from escalating losses of state-owned enterprises in recent years, which amounted to an estimated PRs245 billion or 1.7% of GDP in FY2010.

After declining to a low of 8.9% year on year in October 2009, inflation climbed back into double digits in the second half of FY2010, and was 12.7% in June 2010 (Figure 3.7.7). Second-half pressures came

3.7.3 Production growth of large-scale manufacturing



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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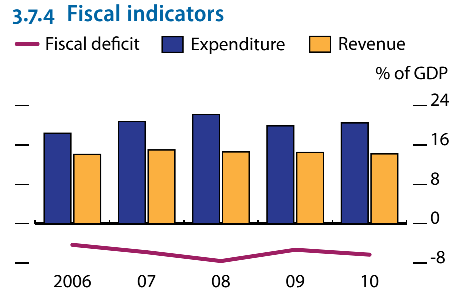
3.7.4 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk (accessed 8 September 2010).

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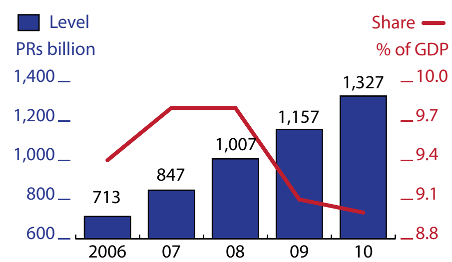
3.7.5 Federal Board of Revenue tax collection



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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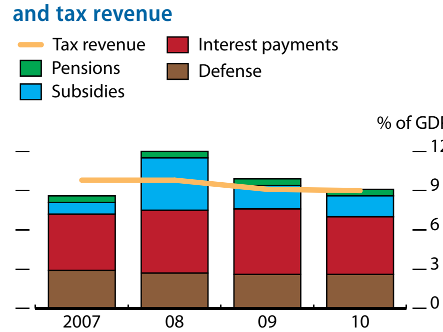
3.7.6 Federal nonoperating expenditure and tax revenue



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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from higher global prices for food and energy and upward adjustments in electricity tariffs and administered domestic fuel prices. Inflation in FY2010 averaged 11.7%, well below the 20.8% of FY2009.

In a context of moderating inflation, the State Bank of Pakistan (SBP), the central bank, cut the discount rate by 150 basis points during the first 5 months of FY2010 to 12.5% in an effort to bolster economic activity. Broad money aggregates accelerated during the second half of the fiscal year as government recourse to bank financing surpassed FY2009's borrowing.

Overall, broad money expanded by 12.5% in FY2010, up from 9.6% in FY2009. For the year as a whole, federal government borrowing from the banking sector rose to PRs309.5 billion (2.1% of GDP), damping private sector credit availability. Banks exhibited a preference for buying government securities during the year, regarding lending to the private sector as involving too-difficult credit-risk assessment. As a result, private sector credit, despite showing improvement from the previous year, remained significantly lower than FY2008's level (Figure 3.7.8).

Concerned with the resurgence of inflation pressures in the second half of FY2010 and the expansionary effects of fiscal overruns, the SBP took a cautious stance in setting policies for FY2011, increasing its policy rate by 50 basis points in early August 2010.

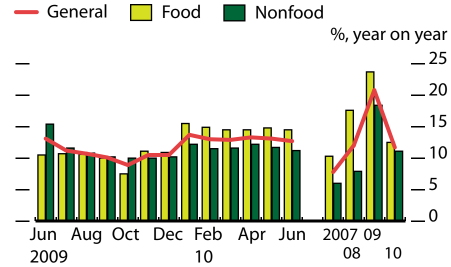
The current account deficit narrowed to $3.5 billion (2.0% of GDP) from $9.3 billion for FY2009, reflecting a contraction in the trade deficit and improvement in the invisibles accounts (Figure 3.7.9). On the trade front, imports declined by about 2.3% as financial weakness in two key industries (steel and oil refining) as well as a fall in investment crimped import demand. Moreover, exports recovered from a slump the previous year to expand by about 2.7%, with higher sales of rice, textiles, and pharmaceuticals.

About three-quarters of the improvement in the current account, however, came from a combination of a lower services account deficit (mainly owing to receipts of logistical support supporting the war against terror), lower interest payments, and continued strong growth (14%) in workers' remittances (Figure 3.7.10).

Although the current account deficit improved, financing became more difficult. The capital and financial account surplus fell by 14.8% to $5.2 billion in FY2010, though this was less steep than the 26.2% fall of FY2009. Foreign direct investment inflows fell by two-fifths to $2.2 billion, but a strengthening in other financing flows offset most of that. Unfortunately, much of the drop in such investment came in the communications, power, and transport sectors, where expansion in operating capacity is essential for faster economic growth.

Gross foreign exchange reserves, including commercial bank holdings, increased strongly in FY2010 to $16.8 billion (Figure 3.7.11). The gain came from the overall balance-of-payments surplus and net additions from International Monetary Fund funding under a standby arrangement. The exchange rate was relatively stable against the dollar, depreciating by 4.8% during FY2010. However, high inflation relative to trading partners' led the real effective exchange rate to appreciate by 8.3%, hurting export competitiveness (Figure 3.7.12).

3.7.7 Inflation



Source: State Bank of Pakistan. *Annual Report 2009–10*. http://www.sbp.org.pk

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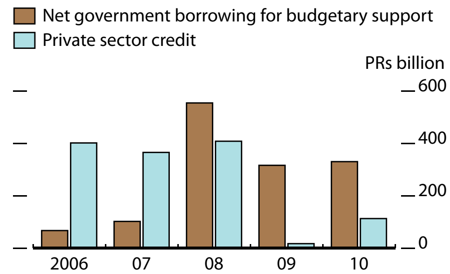
3.7.8 Bank financing of the deficit



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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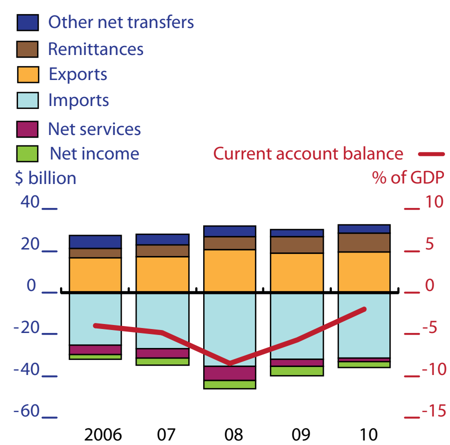
3.7.9 Components of the current account balance



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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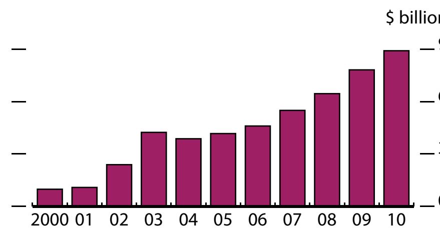
3.7.10 Workers' remittances



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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Prospects

The impact on economic prospects of the massive flooding that began in early August 2010 is difficult to quantify. A comprehensive damage and needs assessment will be completed only after publication of this *Asian Development Outlook* (*ADO*) *Update*. The picture should also be a little clearer when an international donors' conference is held in late November.

It seems evident, however, that the economic impact will be heavily negative in the short run, due to extensive damage and reallocation of resources to cater for urgent needs. As losses in crops and livestock, damage to infrastructure, and limited economic activity in a large part of the country will damp growth prospects in virtually every sector, such that tepid GDP growth of 2.5% is expected in FY2011. Nevertheless, reconstruction and rehabilitation activities will subsequently have a positive impact on GDP.

As the major transportation arteries of the country have been severely damaged, shortages of goods and services—even with rapidly ramped-up imports—are expected to put substantial upward pressure on prices. Moreover, the likelihood of delayed sowing of crops in the upcoming season and, potentially, in the following season will create shortages of food and other commodities while undermining farmers' incomes.

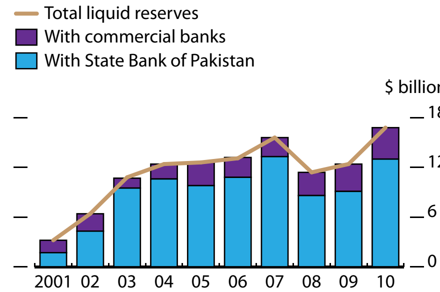
Inflation, for the most part induced by supply-side constraints, is expected to be higher than the 8.0% forecast in April's *ADO 2010*. This *Update* projects average inflation in FY2011 at 13.0%. The SBP in its Monetary Policy Statement for FY2011 projected inflation at 11%–12% (higher than the federal government target of 9.5%). The price hike emanating largely from the supply constraints will pose challenges for effective monetary management of the SBP. Also, while the central bank will find it difficult to fully implement its earlier monetary stance in the present circumstances, it will need to make substantial efforts to keep demand for credit from exacerbating inflation pressures.

Pressures on the current account will also intensify in FY2011. These will stem both from a steeper than earlier forecast rise in imports (reflecting the launch of reconstruction activity) and from domestic supply shortages pushing food, raw cotton, and other essential imports upward. Limits on existing infrastructure capacity and flood damage are expected to hold down export growth—already, flood-related damage has curtailed cotton and rice exports.

Still, workers' remittances, which increased by 13.2% in July–August 2010 over the same period the previous year, are expected to remain strong. If substantial grant aid is provided for relief, the deterioration in the current account deficit may be limited to 4.3% of GDP.

Flood-related expenditure will also alter the fiscal outcome, relative to the budget posted for FY2011, widening the fiscal deficit from the targeted 4.0% (Box 3.7.1). In this context, it will be even more important to address trends that were troublesome for the FY2010 outturn. Revenue measures are more urgent in view of the massive reconstruction requirements, as are improvements in revenue administration and collection.

3.7.11 Foreign exchange reserves



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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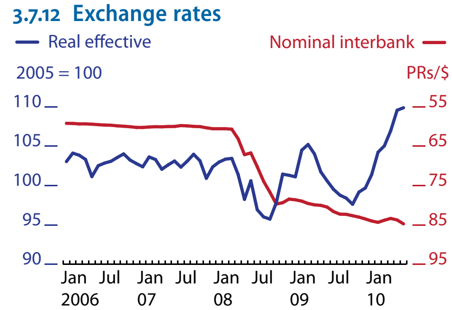
3.7.12 Exchange rates



Source: International Monetary Fund. International Financial Statistics online database (accessed 9 September 2010).

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3.7.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth[a]	-	4.1	-	2.5
Inflation	12.0	11.7	8.0	13.0
Current acct. bal. (share of GDP)	-3.6	-2.0	-4.2	-4.3

[a] In light of the government's revisions to the GDP series in June 2010, April's *ADO* GDP growth forecasts are not comparable with current forecasts and have been omitted.

Note: The projections for FY2011 are preliminary and subject to revision.

Source: ADB estimates.

3.7.1 Fiscal alignment

The massive flood-related devastation underscores the need for reprioritization on the fiscal front so as to expand fiscal space for reconstruction. The federal government in the budget for FY2011 has already emphasized its commitment to fiscal consolidation and to policies needed to support a robust expansion of the economy.

A 50% hike in government salaries reflected the recommendations of the Pay and Pension Commission, in an effort to offset the erosion of their real incomes in the past 3 years. To offset the expansionary impact of these provisions, the federal budget included a freeze on all nonsalary recurrent outlays at FY2010 levels and a rationalization of the Public Sector Development Program as well as a reduction in the salaries of ministers.

The budget for FY2011 also called for an aggressive 45% reduction in total subsidies, including a 67% reduction in allocations to cover electricity tariff differentials. These lower subsidies would require efficiency measures that produce saving equivalent to the 30%–40% increase in tariffs that would otherwise be required to meet cost recovery. Flood-related damage and social safety net requirements will necessarily impact the expected deficit for FY2011.

Policies for FY2011 recognize the inconsistency between current losses by state-owned enterprises (SOEs) and fiscal sustainability. Bank credit outstanding to SOEs reached 2.6% of GDP, and financing of commodity operations stood at 2.8% of GDP. Since it has not drawn up immediate plans to privatize key SOEs, the federal government has established a committee to develop an overall approach to improve their management and operation.

Total outstanding guarantees for SOEs at end-April 2010 amounted to 4.2% of GDP, underscoring the budget's vulnerability to SOEs, both in terms of their performance and their contingent liabilities. Privatization for some large SOEs is on hold for the moment, but measures to improve management and reduce their increasingly burdensome losses are urgent.

Specific tax measures in the FY2011 budget, which could lift tax revenue by 20%, include: a 1% increase in the goods and services tax to 17%; reforms to that tax from 1 October 2010 to improve revenue and limit cascading; a capital gains tax on stocks and shares; higher excise duties on cigarettes and household appliances; higher withholding taxes on commercial importers and air tickets; and improvements to revenue administration. Additional revenue measures are being formulated to generate revenue for relief and reconstruction.

The FY2011 budget targets a rise in federal government public sector development spending of about one-third relative to the FY2010 outturn, taking outlays up from 3.5% of GDP to 4.4% in FY2011. Moreover, investment spending was reprioritized to secure more timely completion of key ongoing projects in the areas of transportation, hydropower, and water.

Expectations regarding pledges made by the Friends of Democratic Pakistan in Tokyo in April 2009 have been revised downward in face of the slower than expected pace of disbursements in FY2010. External support in response to flood-related damage will contribute to higher increases in development spending with the magnitude of the increase for FY2011, among other factors, to be determined also by the absorptive capacity of the economy.

An alignment between expenditure and the policy priorities that provide the fiscal space to support critical investments in infrastructure is needed both to broaden the economic base and to achieve sustainable improvements to the current account. Lower imports, lower development spending, and an explosion of unproductive recurrent spending for subsidies simply increase the apparent risk to investment, reducing the inflows needed to put the economy on a sustainable path.

The drain of subsidy requirements for the energy sector also needs attention: while the federal government has increased consumer tariffs, a substantial gap remains, requiring a combination of efficiency gains and further tariff increases. The energy sector as a whole will need to be placed on a financially viable footing if the necessary investment in productive capacity is to be realized.

Both the magnitude and the composition of federal spending in recent years have undermined macroeconomic stability and sustainability, and these trends must change. The compression of development spending to accommodate runaway recurrent costs is not consistent with fiscal sustainability, and neither is an improvement in the external account built on restrained imports needed for investment and capital development.

Philippines

Higher than expected economic growth in the first half of 2010 was driven by strong domestic investment and industrial output, helped by external demand. Consumption (both private and government) continued to expand. Economic growth will likely ease in the second half, but given the strong January–June outcome, the forecast for the full year is raised from April's *Asian Development Outlook 2010 (ADO 2010)*. Growth next year will still decelerate from this year's pace, as anticipated in *ADO 2010*. Inflation has been moderate and is expected to remain so. The current account is forecast to record solid surpluses.

Updated assessment

Recovery in the first half of 2010 was stronger than expected, with GDP increasing by 7.9%, compared with growth of just 0.9% in the first half of 2009. The pace of growth quickened marginally from the first quarter to the second (Figure 3.8.1). Consumption, investment, and net exports all contributed to growth in the January–June period.

Private consumption grew by 5.1%, largely on account of increases in spending on food and drinks, utilities, and transportation. Remittances from overseas workers remained a key support of consumption, growing by nearly 7% to $9.1 billion (the increase in peso terms was 2.2%). About half the total GDP growth in the first 6 months came from the lift in private consumption.

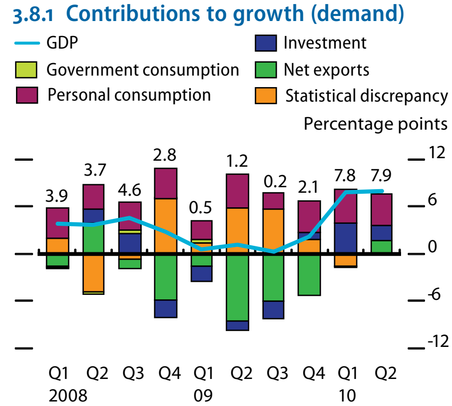
Investment made a significant contribution to GDP growth for the first time since 2007. Outlays on fixed capital investment surged by just over 21% year on year, with equipment investment rising by 30% from low prior-year levels. Strong growth was recorded in spending on commercial vehicles, industrial machinery, and telecommunications equipment. Fixed investment as a ratio to GDP rose to 17.2%, the highest level in 7 years (Figure 3.8.2).

Government expenditure also climbed in the first half, in part a consequence of presidential and legislative elections in May 2010. The government raised spending on social protection programs that include conditional cash transfers to poor families who commit to keep children in school, and on infrastructure, notably reconstruction of typhoon-damaged facilities. Net exports of goods and services made just a small contribution to GDP growth, reflecting a strong rise in imports that accompanied the recovery in exports.

From the production side, GDP growth was driven by a rebound in industry, notably manufacturing (representing 66% of the sector), where output rose by 16.2% from depressed prior-year levels. Export-oriented electronics manufacturers did particularly well as export demand rallied. In other industry categories, construction (17% of the sector) expanded by 15.7% and mine production (8%) rose by a rapid 23%, supported by

This chapter was written by Teresa Mendoza and Norio Usui of the Philippines Country Office, ADB, Manila.

3.8.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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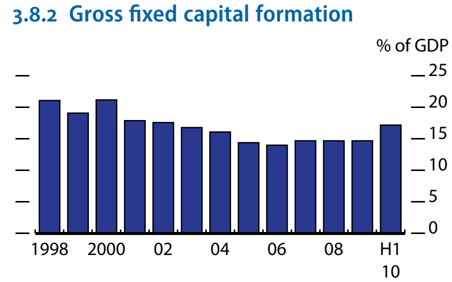
3.8.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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the recovery in global demand and higher metals prices. Industry as a whole contributed 5.0 percentage points of the total 7.9% GDP growth (Figure 3.8.3).

Services, the biggest sector of the economy, grew by 6.7% in January–June 2010. However, agriculture contracted by 2.9%, mainly owing to dry weather caused by an El Niño weather pattern. The dry spell was so severe that it cut agricultural employment by 802,000, offsetting much of the employment generated by industry and services. Consequently, the unemployment rate rose to 8.0% in April 2010 from 7.5% in April 2009. Underemployment accounted for another 17.8% of the workforce. As a mark of the broad-based scarcity of jobs, about 20% of the unemployed have college degrees.

Inflation edged higher (Figure 3.8.4) to average 4.2% in the first 8 months of 2010, although price pressures were generally milder than anticipated in April at the launch of *ADO 2010*. A 2.8% appreciation of the peso against the US dollar over this period helped to shield the economy from imported inflation. Bangko Sentral ng Pilipinas, the central bank, withdrew several liquidity-enhancing measures it had implemented during the global financial crisis. It did, though, maintain the low policy interest rates it had brought in during the crisis—4.0% for the overnight borrowing rate and 6.0% for the overnight lending rate.

Merchandise exports on a US dollar basis rose steeply each month, from low prior-year levels, to be 38.5% higher in the first half (Figure 3.8.5). Exports were propelled by a near 50% jump in shipments of electronic products. Imports increased by 29.7% in the first half, reflecting the stronger demand for capital equipment and consumer goods, and the need to supply imported inputs for export-oriented manufacturing industries.

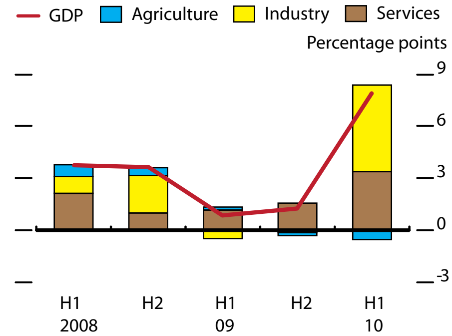
The deficit in merchandise trade narrowed slightly in the first half of 2010 to $4.8 billion, owing to the steeper rebound in exports than imports. However, the surplus in services trade fell to $1.0 billion as higher net outflows on services such as transportation more than offset rising income from business process outsourcing. After taking into account remittances, the current account surplus rose to $4.4 billion, equivalent to 5.0% of GDP.

Portfolio investment recorded net outflows of $1.2 billion, in large part reflecting investors' global risk aversion as a result of the European sovereign debt crisis. Net foreign direct investment fell to just $445 million. Still, the capital and financial account posted lower net outflows of $192 million in January–June 2010 (net outflows were $2.6 billion a year earlier), owing to improvements in trade credits and other flows. The overall balance of payments recorded a larger surplus ($3.3 billion).

External surpluses buoyed the peso and lifted gross international reserves to $49.6 billion in August, representing 9.2 months of import cover and 9.5 times short-term external debt based on original maturity. The buildup in reserves also reflected government borrowing abroad to fund its spending.

Government expenditure rose by 13.3% in the first 7 months of 2010 (excluding interest paid on the national debt), outpacing a 10.3% increase in tax revenue. The fiscal deficit for the first half widened to the equivalent of 4.9% of GDP (Figure 3.8.6).

3.8.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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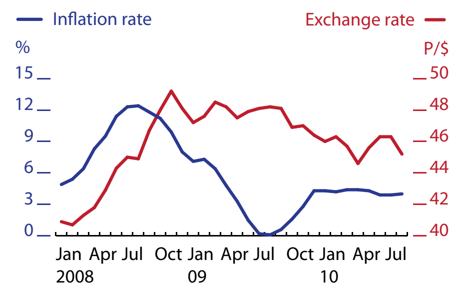
3.8.4 Inflation and exchange rate



Sources: National Statistics Office. http://www.census.gov.ph; Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph (both accessed 3 September 2010).

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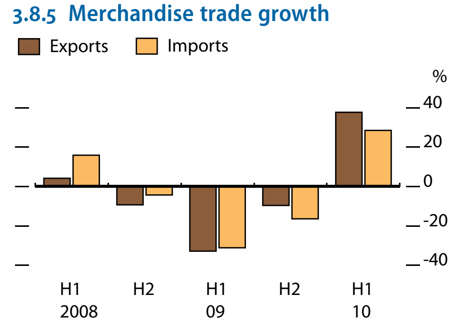
3.8.5 Merchandise trade growth



Note: Based on balance-of-payments data.

Source: CEIC Data Company (accessed 27 August 2010).

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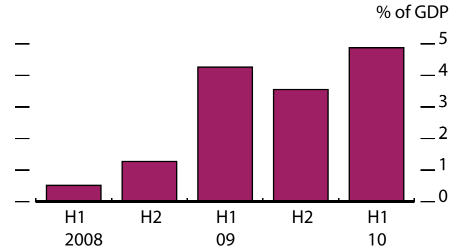
The new government, taking office on 30 June, said it aims to limit the full-year fiscal gap to 3.9% of GDP, the same level as 2009, by tightening expenditure in some areas and more determined tax administration. Certainly, the stronger than expected GDP growth will support the revenue-raising effort, and there are signs of expenditure restraint (noninterest outlays fell by 1.3% year on year in July).

The 2010 gross borrowing program has been expanded to about 9% of GDP, from 7.5% in 2009. Approximately one-third ($5.5 billion) is to be sourced from abroad, with about $4 billion on commercial terms and the rest in official assistance. Notwithstanding the expected higher borrowing, yields on government securities in the first 8 months edged lower than in the prior-year period. Also, the yield spread between the US and Philippines Treasuries narrowed from the peaks of 2008 and 2009. Ample liquidity in the domestic market and a robust external position helped counter concerns over fiscal weakness.

Bank lending to both consumers and businesses has expanded during 2010, with growth in credit for production activities picking up to 12% year on year in July (the highest rate of growth since June 2009). Bank capital-adequacy ratios are well above 10%, while nonperforming loan ratios remain in the low single digits.

3.8.6 Fiscal deficit



Source: CEIC Data Company (accessed 9 September 2010).
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Prospects

The incoming government has signaled the following broad economic policies. First, it targets reining in the fiscal deficit from 3.9% of GDP in 2010 to 2.0% by 2013 and then to keep it at that rate through 2016. Stronger efforts at tax collection, prudent expenditure and liability management, and sales of public assets are intended to help achieve this goal. The government will also push for a fiscal responsibility law that would require legislators who support new appropriations or revenue-eroding bills to identify sources of funding or offsetting cuts in expenditure.

Next, it aims to trim government debt from about 57% of GDP in 2010 to 52% in 2016. The debt-management strategy also includes strengthening oversight of government-controlled firms with large liabilities, lengthening the loan maturity profile, and increasing reliance on domestic capital sources and peso debt. (In September 2010, the government raised $1 billion from its first sale of peso-denominated global bonds. The issue, whose bonds mature in 2021, was heavily oversubscribed and priced to yield 5.0%).

The new administration intends to promote public–private partnerships to build infrastructure and to revamp the institutional and governance framework to encourage these arrangements; to enhance social safety nets and basic social services, and to streamline business-registration procedures.

More immediately, it proposes to pull back the fiscal deficit to 3.2% of GDP in 2011. While slowing the growth of public spending overall next year, the new government plans to put greater emphasis on social services, raising outlays on social services by about 14% to just over one-third of its total spending. The budget for education will increase by 18% (the largest rise in over a decade). The conditional cash transfer program will be

3.8.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	3.8	6.2	4.6	4.6
Inflation	4.7	4.5	4.5	4.4
Current acct. bal. (share of GDP)	3.3	4.0	3.2	3.3

Source: ADB estimates.

expanded to include more poor households, and government-paid health insurance coverage will be broadened to cover more poor families and workers in the informal sector.

National government spending on infrastructure will be reduced by about 10% in 2011 in expectation of increased private sector participation. The government is planning to implement a number of projects in transport and utilities under public–private partnerships next year.

On the basis of inflation remaining within the central bank's target range (3%–5% for 2011), the outlook assumes that monetary policy will remain accommodative for some time, as policy interest rates only gradually edge up to more normal levels.

Signs are positive for continued growth in private consumption and investment. Surveys on consumer and business expectations conducted in the third quarter of 2010 showed gains in indexes of confidence (Figure 3.8.7). Business confidence was bolstered by the stronger domestic and external demand, the smooth political transition after the May elections, and optimism over the new administration. An increasing number of firms indicated that they would expand production and employment.

Consumption will continue to draw support from remittances; indeed, the central bank now expects remittances to increase by 8% to $18.7 billion this year (Figure 3.8.8), raising its forecast from 6% previously. Investment is underpinned by strong business and consumer confidence, rising capacity utilization, and low interest rates. This is reflected in the rising stock market (the share price index rose by 31.2% from end-2009 to mid-September, when it reached a record high), and growth in bank lending. Investment approvals by the Philippine Economic Zone Authority and the Board of Investments, which cover most investment pledges, nearly trebled to about $5 billion in the first half of 2010 from the weak prior-year period.

From the production perspective, manufacturing is expected to maintain solid growth, although it will likely slow from double-digit rates recorded in the first half of 2010 (Figure 3.8.9), when the low-base effect boosted growth. Private construction will continue to benefit from remittance inflows. The rebound in external trade, robust consumption spending, and pickup in investment will be reflected in growth in services. Agriculture could perform better than the first 6 months of this year, although a forecast La Niña weather pattern could produce excessive rainfall and so damage crops later this year.

Economic recovery will decelerate in the second half of 2010, mainly because the low-base effect will fade and inventory rebuilding will level off. The overall global economic environment is expected to weaken as evidenced by the slowdown in the growth of US and Japan in the second quarter of 2010. Seeming to corroborate this, the growth in the value of merchandise imports pulled back sharply to just 1.4% in June from over 31% in May, while the growth in factory output has broadly decelerated.

Taking these factors into account, GDP is projected to expand by 6.2% in 2010, revised up from *ADO 2010* because of the stronger than expected rebound in trade and investment. In 2011, growth is forecast to ease to 4.6% (Figure 3.8.10) as a consequence of base effects and reduced policy stimulus at home and abroad.

3.8.7 Confidence indexes

Source: Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph (accessed 16 September 2010).

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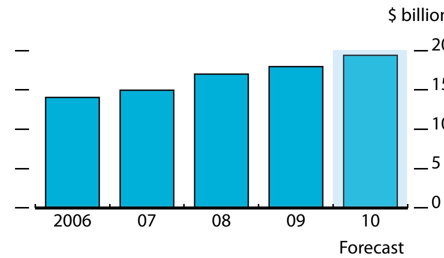
3.8.8 Overseas workers' remittances



Sources: Bangko Sentral ng Pilipinas. *The Philippines: Creating Opportunities through Effective Governance.* http://www.bsp.gov.ph; CEIC Data Company (accessed 10 September 2010).

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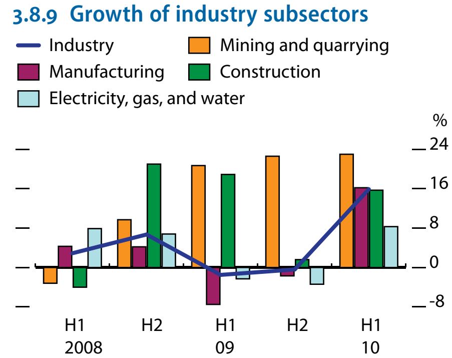
3.8.9 Growth of industry subsectors



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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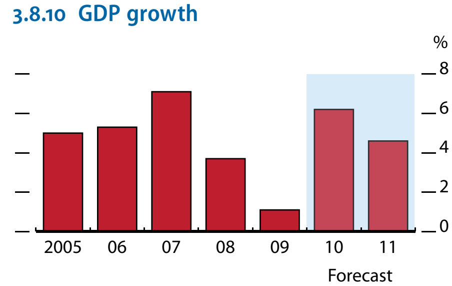
3.8.10 GDP growth



Source: Asian Development Outlook database.

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Inflation will continue to pick up through this year as the economy's output gap closes, and utility and transport prices rise. It is expected to average 4.5% for 2010. This is lower than the forecast made in April mainly due to moderate increases in food prices. Upward pressure on rice prices caused by the dry weather in the first half has been countered by an increase in rice imports (Figure 3.8.11). Contracted rice imports for this year are up by 43% from 2009, and by early August 2.1 million tons, or 94% of the total volume contracted for 2010, had arrived.

The firm peso will also exert downward pressure on prices. In 2011, expected moderate increases in global energy and commodity prices, coupled with slower domestic economic growth and reduced policy stimulus, will likely put inflation at about 4.4% (Figure 3.8.12), slightly lower than forecast in April.

Remittances and earnings from business process outsourcing will contribute to current account surpluses of about 4% of GDP in 2010 (revised up from the April forecast due to stronger than expected merchandise exports), and 3.3% in 2011.

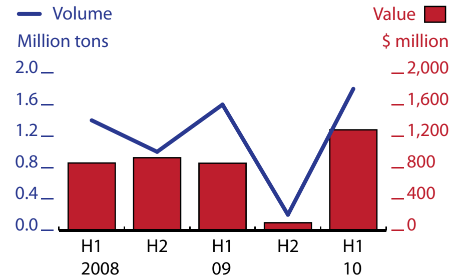
One key challenge for the government is to improve revenue collection so as to support social and development spending, which have lagged for many years. The new administration has said it will avoid increasing taxes or introducing new taxes, so that raising revenue depends heavily on strengthening tax administration.

On the expenditure side, public service wages and benefits (29% of total expenditure in January–July) have risen, mainly due to newly legislated salary increases for the public service, while interest on the public debt accounts for one-fifth of all expenditure, crowding out development spending. National government outstanding debt remains elevated, equivalent to about 57% of GDP (Figure 3.8.13).

A second challenge is to upgrade the investment climate. This enhancement is needed to encourage the creation of new businesses and employment, which is currently inadequate to absorb the growing labor force. The relatively low level of private investment in recent years is attributed to infrastructure deficiencies as well as to weaknesses in governance and in the policy climate.

Risks to the 2010–2011 forecasts come from uncertainty over the strength and pace of the global economic recovery and a stronger than anticipated La Niña weather disturbance that could hurt agriculture. Despite balance-of-payments surpluses and substantial foreign reserves, financial markets could become unsettled if fiscal slippage continues, raising the country's risk premium.

3.8.11 Rice imports



Note: First half 2010 volume figures for January–May 2010 only.

Source: CEIC Data Company (accessed 8 September 2010).

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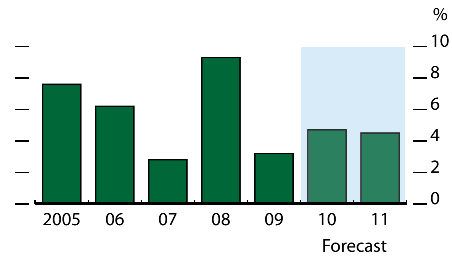
3.8.12 Inflation



Source: Asian Development Outlook database.

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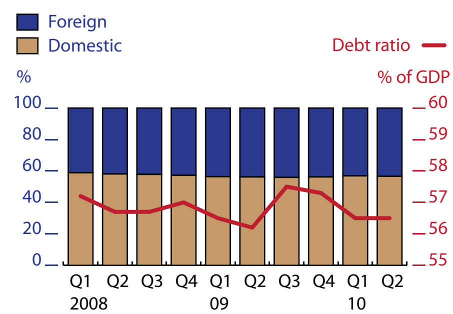
3.8.13 National government outstanding debt



Source: CEIC Data Company (accessed 9 September 2010).

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Thailand

A vigorous economic recovery in the first half of 2010 was driven by a rebound in exports that kick-started industrial production and stimulated investment. Private consumption also recorded solid growth. Second-half growth will show a more subdued pace given base effects, but the full-year 2010 GDP forecast is raised sharply from that projected in April's *Asian Development Outlook 2010* (*ADO 2010*). The more moderate pace of growth in the second half of 2010 is forecast to continue in 2011. An appreciating exchange rate for the baht and rising interest rates will help to curb inflation.

Updated assessment

Recovery from the 2009 economic slump was stronger than expected, especially in the first quarter of 2010 when GDP rose by 12.0% year on year. The momentum continued into the second quarter. It was interrupted when political tensions that had been simmering over recent years boiled over into violent demonstrations over 7 weeks in central Bangkok during April and May. But as the violence was confined mainly to a section of the capital, the economic impact was limited: GDP grew by 9.1% in the second quarter (Figure 3.9.1), and by 10.6% in the January–June half.

A rebound in exports kick-started the recovery, but domestic demand contributed virtually all the gain in first-half GDP (Figure 3.9.2). Private consumption increased by 5.3%, after contracting by 2.3% in the prior-year period. Supporting factors included the much-improved economic and labor-market outlook, higher farm incomes due to rising prices of crops, and fiscal stimulus measures put in place during the recession. Sales of durable goods, such as electrical appliances and passengers cars, surged in the first half (the latter by nearly 60%).

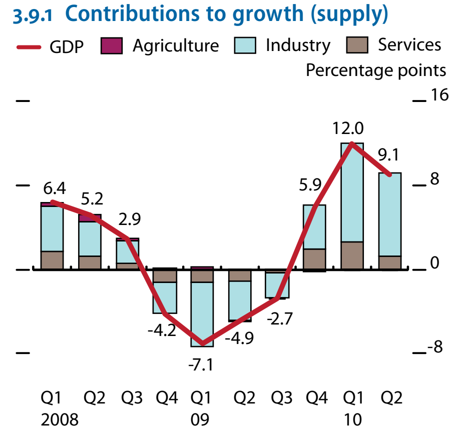
Government consumption expenditure rose by 6.8%, partly owing to disbursements of fiscal stimulus programs initiated in 2009. The government also paid compensation (in the form of grants, soft loans, and tax breaks) to businesses damaged during the violence.

Fixed capital investment increased steeply by 12.5% in the first half, mainly a result of stronger private investment, which rebounded by 17%. Substantial increases were recorded in machinery and equipment investment as businesses expanded production capacity in response to the stronger export and domestic demand for manufactured products. Private construction rose by 9%. That reflected a pickup in both residential and commercial building, stimulated by temporary tax incentives. Fixed capital investment contributed 2.6 percentage points to GDP growth.

Public investment fell slightly in that half relative to a year earlier, owing to slow disbursement of investment by state enterprises, including those in the Map Ta Phut industrial estate. Seventy-six projects were suspended there when a Thai court ruled in September 2009 that

This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

3.9.1 Contributions to growth (supply)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 2 September 2010).

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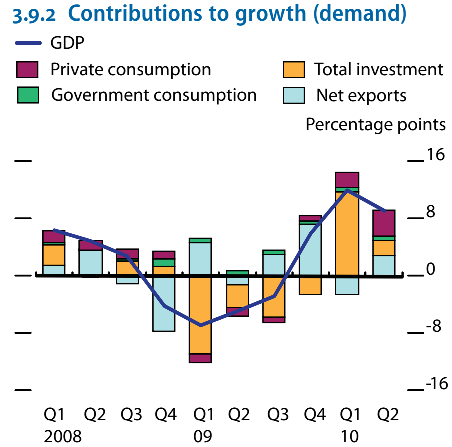
3.9.2 Contributions to growth (demand)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 2 September 2010).

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operating licenses had been issued without completion of the necessary environmental impact assessments. Since then, the government has clarified which industries must undertake these assessments and, in September 2010, the court decided that all but two of the projects could proceed. (The two that remained suspended can resubmit applications for licenses after completing their assessments.)

Disbursement of funds under the Thai Khem Kaeng (Strong Thailand) infrastructure program that started in October 2009 was also behind schedule (69% of the allocated amount was disbursed in the 10 months through July 2010).

On the supply side, industry rebounded by 18.7% in the first half of 2010, after it contracted in the prior-year period, and it contributed nearly all the GDP growth. Spurred by the bounce in export demand, manufacturing production soared by about 23% in January–March (Figure 3.9.3), and by 18% in April–June. Shipments abroad of passenger cars nearly doubled in value in the first 6 months, and those of electrical appliances jumped by two-fifths.

Services started the year on a strong note, but its growth slowed when the political strife and violence eroded consumer confidence and reduced inbound tourism for a time. Still, tourism arrivals rose by 12.1% in the first half (Figure 3.9.4). (Some visitors bypassed the capital and went to other Thai cities.) Agricultural production fell slightly in the first half because of drought and pest infestations in rice and cassava crops.

Growth in manufacturing and services absorbed most of those who lost jobs in 2009, so that by midyear there were signs of labor shortages in some industries.

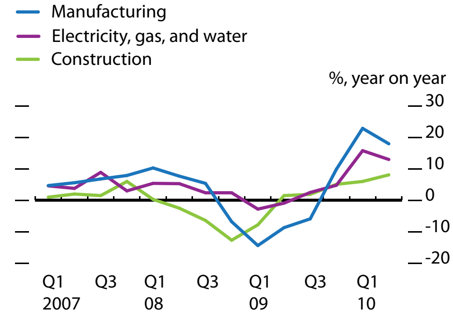
Consumer prices had declined for much of 2009, turning up late last year as domestic demand lifted and global oil prices rallied. The consumer price index continued to edge higher in the first 8 months of 2010, easing a little in April, when the demonstrations in Bangkok dented consumer sentiment (Figure 3.9.5). Inflation averaged 3.4% year on year in January–August. An appreciation of the baht against the US dollar (by 5.3% over the same 8 months) helped to mitigate the impact of higher import prices.

During the global crisis, the Bank of Thailand lowered its policy interest rate by 250 basis points to 1.25%. It maintained that low rate through the first half of 2010. After the domestic political situation settled somewhat, and in the context of the revival of the economy and inflation, the central bank started to normalize the policy rate, with increases in July and August of a cumulative 50 basis points (Figure 3.9.6).

As world trade recovered from the 2009 slump, Thailand's merchandise exports rebounded by 36.6% in US dollar terms in the first half of 2010 from the prior-year period. Exports also benefited from tariff reductions effective January 2010 under the ASEAN Free Trade Area (AFTA) agreement. Shipments to Southeast Asian markets jumped by 55.2% in value in the first half. Furthermore, exports to rapidly growing India and the People's Republic of China soared by about 54% and 48%, respectively (against an increase of 27% in exports to major industrial economies—Figure 3.9.7).

Imports soared by 51.7% in January–June 2010, from low levels in the first half of 2009. The sharpest rise was in imports of semifinished goods and raw materials (up by 63%), much of this destined for export-oriented

3.9.3 Growth in industry components



Sources: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 2 September 2010).

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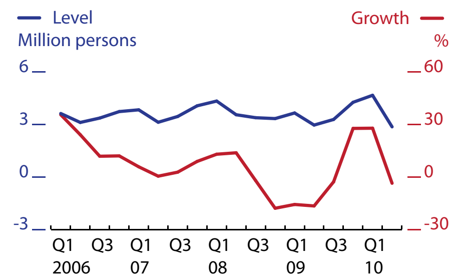
3.9.4 Tourist arrivals



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 2 September 2010).

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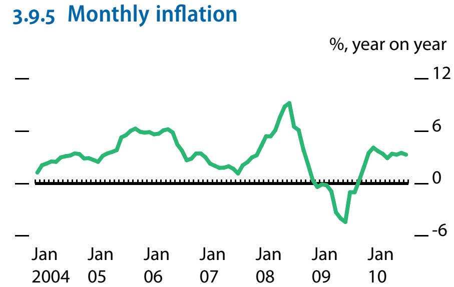
3.9.5 Monthly inflation



Sources: CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 2 September 2010).

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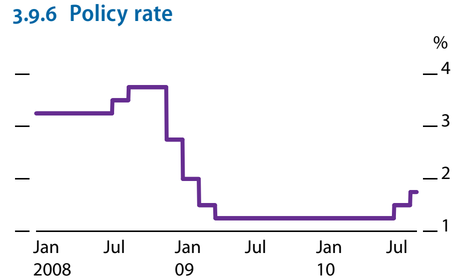
3.9.6 Policy rate



Source: Bloomberg (accessed 5 September 2010).

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manufacturing. Imports of capital equipment rose by 32%, reflecting the boost in fixed investment, and imports of consumer goods climbed by 36%. Higher global oil prices contributed to the rise in the import bill.

The current account registered a surplus of $6.5 billion in the first half of 2010 (4.2% of GDP), mainly a result of a substantial $6.7 billion surplus in merchandise trade. The capital and financial account recorded a net inflow of $5.8 billion in the form of portfolio, direct, and other investment such as loans. However, foreign direct investment inflows have been weakening for several years (Figure 3.9.8).

International reserves rose by 22% to a sizable $151.5 billion in the 12 months to July 2010, equal to 9.6 months of import cover and 4.7 times the short-term external debt.

Domestic financial markets have been buoyant. The SET index of share prices rose by almost 30% in the first 8 months of 2010, recovering from a dip in April–May during the worst of the strife. Demand for government bonds pushed down the yield on 10-year securities by about 1 percentage point to 3.3% over the first 6 months.

The government budgeted to rein in the fiscal deficit to the equivalent of 3.8% of GDP in FY2010 (ended 30 September 2010), from 4.3% of GDP in FY2009. Revenue grew much faster than expected, so the actual FY2010 gap is likely to be just 0.5% of GDP, or less. Most of the financing for the infrastructure program is off-budget.

Public debt as a ratio to GDP declined a touch to 43.2% by June 2010, from 43.9% at end-2009. Nevertheless, the debt is still above the 38.1% level seen in 2008, the result of government borrowing, mainly in domestic markets, to fund fiscal stimulus programs during the economic slump. Strong revenue inflows in the first half of 2010 reduced the need for the government to issue bonds for financing the fiscal deficit in this period.

Prospects

The projections assume that the political situation will be relatively calm during the forecast period, and that national elections scheduled to be held in 2011 will go smoothly.

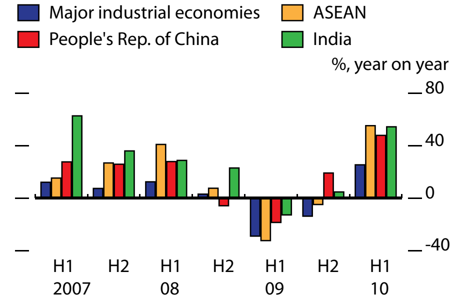
Fiscal policy will likely be aimed at supporting economic growth during the forecast period and ahead of the elections, reinforced by off-budget expenditure under the Thai Khem Kaeng infrastructure program, which runs through 2012. The government is targeting a FY2011 fiscal deficit equivalent to 4.1% of GDP, significantly wider than the expected FY2010 deficit.

As for monetary policy, the Bank of Thailand is expected to edge its policy rate higher in the context of a continuing economic recovery, moderate inflation pressures, and currently negative real interest rates.

The outlook for exports is for further growth, but not at the rapid recovery pace seen in the first half of 2010. For full-year 2010, merchandise exports are projected to increase in value by 25%, stronger than anticipated in April. The forecast for imports is also raised, to 35% for this year. Growth in tourism has resumed after the decline in April–May, and prospects are good for the tourism industry next year.

Private consumption is expected to grow in the second half of 2010, given a recovery in consumer confidence after the April–May

3.9.7 Export growth, selected other destinations



ASEAN = Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam).

Source: Bank of Thailand. http://www.bot.or.th (accessed 2 September 2010).

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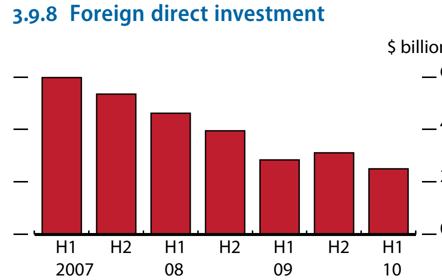
3.9.8 Foreign direct investment



Source: Bank of Thailand. http://www.bot.or.th (accessed 2 September 2010).

Click here for figure data

3.9.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	4.0	7.0	4.5	4.5
Inflation	3.5	3.2	3.0	3.0
Current acct. bal. (share of GDP)	4.0	4.0	2.0	3.0

Source: ADB estimates.

demonstrations (Figure 3.9.9) and higher farm incomes. The private consumption index was growing at relatively high rates at midyear (Figure 3.9.10).

Several government decisions this year will bolster private consumption. Concessions for low-income households—free electricity, water, and public bus and train services—have again been extended, this time through end-2010. The government will provide low-interest loans to low-income households so that they can repay higher-interest debt owed to loan sharks. It will also promote microfinance to improve such households' access to finance. Further, the authorities maintained a freeze on the price of gas used for cooking and for fueling motor vehicles until February 2011.

A 5% wage rise for most government employees from April 2011 will contribute support to consumption spending next year.

Private investment is likely to be underpinned by expectations of further gains in world trade through the forecast period and by growth in bank lending. The government's clarifications of environmental regulations, plus the September 2010 court ruling on the Map Ta Phut projects, should assist the effort to attract investment into industry. The index of business sentiment is higher in 2010 than other recent years, despite a dip during the demonstrations (Figure 3.9.9, above).

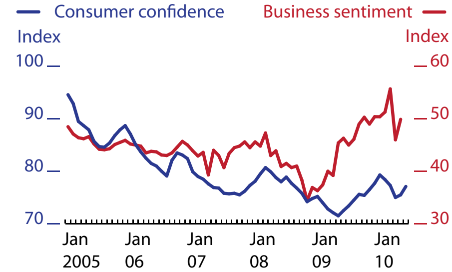
Taking into account the vigorous recovery in the first half of 2010 and the outlook discussed above, the 2010 GDP growth forecast is raised to 7.0% (Figure 3.9.11). Growth in the second half will decelerate markedly, owing to a base effect and expected slower pace of expansion in several external markets such as the PRC. These influences will continue in 2011, when Thailand's GDP growth is seen at 4.5%. The current account is forecast to remain in surplus (equivalent to about 4% of GDP this year and 3% in 2011—Figure 3.9.12).

Inflation for 2010 is forecast to average 3.2%, kept in check by the gradual rise in interest rates and the appreciating baht. Next year, inflation is forecast to be slightly lower, about 3.0%, owing to the deceleration in domestic economic activity coupled with likely modest increases in global oil and commodity prices. Capital inflows and current account surpluses will likely maintain pressure on the baht to appreciate, although the Bank of Thailand might well move to moderate the currency's rise if it sees the pace as excessive.

Risks to the outlook include the frail recoveries in industrial economies and a possible resurfacing of domestic political tensions. Addressing divisions in Thai society illustrated by several years of political turmoil and the violent demonstrations earlier in 2010, the government has drawn up a so-called reconciliation framework that includes a goal of narrowing social and economic gaps. So far, the focus is on broad social protection policies rather than policies to improve economic opportunities in less developed regions of the country.

The government has approved, in principle, the establishment of a national saving fund to provide pensions for people in the informal sector. It has also agreed to the idea of a farmers' welfare fund that would provide pensions and other benefits to farmers and their families, and that would offer financial support for rice production. While there is a need to strengthen the social safety net, it will be important to ensure that the policies are fiscally sustainable in the longer term.

3.9.9 Consumer confidence and business sentiment



Note: A reading of less than 100 for consumer confidence and less than 50 for business sentiment denotes a deterioration.

Sources: Center for Economic and Business Forecasting; Bank of Thailand. http://www.bot.or.th (both accessed 10 September 2010).

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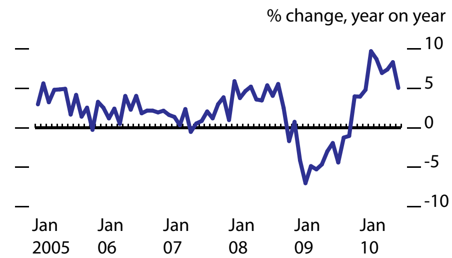
3.9.10 Composite private consumption index



Source: Bank of Thailand. http://www.bot.or.th (accessed 10 September 2010).

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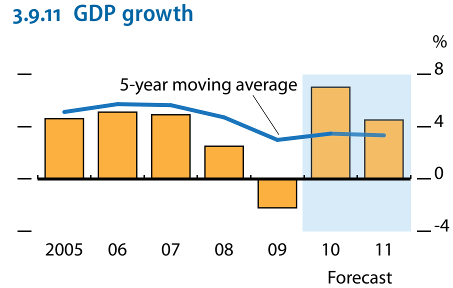
3.9.11 GDP growth



Source: Asian Development Outlook database.

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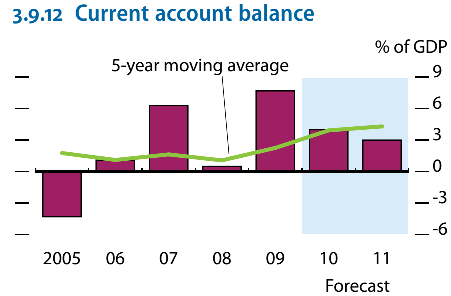
3.9.12 Current account balance



Source: Asian Development Outlook database.

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Viet Nam

Steps taken by the government to stabilize the economy have contributed to an improvement in the external and foreign reserves positions. Economic growth quickened in the second quarter of this year relative to the first and is now forecast to be slightly higher in both 2010 and 2011 than anticipated in April. Projections for inflation are lowered a touch. This outlook assumes that policies during the forecast period focus on macroeconomic stability and that the policy stance is communicated effectively, while also addressing structural reforms.

Updated assessment

Viet Nam started to withdraw policy stimulus late in 2009, and GDP growth slowed from 6.9% year on year in the fourth quarter of 2009 to 5.8% in the first quarter of 2010 (Figure 3.10.1), before picking up in the second quarter. The government tightened policy late last year after credit growth accelerated to nearly 40%, resulting in a sharp deterioration of the balance of payments and a decline in foreign exchange reserves.

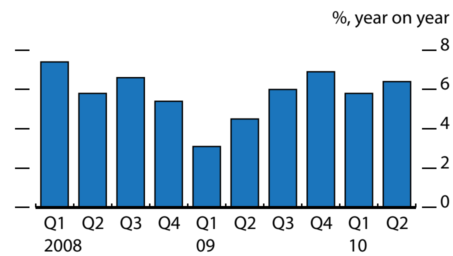
The shift from strong fiscal and monetary stimulus implemented during the global recession to a more balanced policy stance helped to stabilize financial and economic conditions and, together with the global economic recovery, paved the way for solid economic growth this year. GDP increased by 6.2% in the first half of 2010, compared with 3.9% in the same period a year earlier.

Industry expanded by 6.5% in the first half of 2010, with double-digit growth in production of electricity, gas, and water, and a rebound in manufacturing to nearly 8% growth (from just 2% a year earlier) as world trade in manufactured goods recovered. Construction slowed in the first quarter, after credit was squeezed, but it picked up to record 10% growth for the first 6 months. Production of crude oil, however, resumed a declining trend as oil fields matured, falling by 14.6% to 9.8 million metric tons in the first 8 months of 2010 (Figure 3.10.2). Industry as a whole contributed 2.6 percentage points of total GDP growth in the first half.

Reflecting higher levels of private consumption, business activity, and tourism, services grew by 7.1% in the first half, contributing 2.9 percentage points of the GDP growth. Visitor arrivals rose by about 35% to 3.4 million in January–August from a year earlier. The hotels and restaurants subsector recovered from a first-half contraction in 2009 to grow by 8.0% in the first 6 months of 2010. Robust growth was also recorded in transport and communications, as well as financial services.

Output of agriculture improved by 3.3% from 2009 levels. Favorable weather led to a better rice harvest, and fisheries production rose in the first half of 2010. Agriculture made a small contribution to GDP growth.

3.10.1 Quarterly GDP growth



Source: General Statistics Office of Viet Nam.

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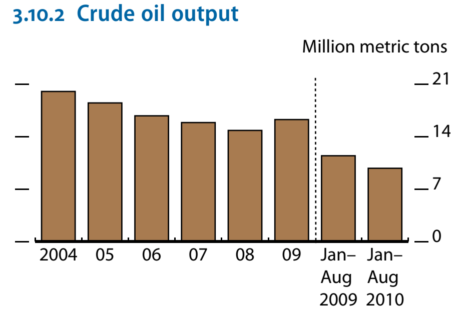
3.10.2 Crude oil output



Source: General Statistics Office of Viet Nam.

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This chapter was written by Lei Lei Song of the Office of Regional Economic Integration, ADB, Manila, Yumiko Tamura, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

Solid domestic demand was reflected in retail sales growth of about 27% in nominal terms in the first 8 months of 2010, with growth accelerating in more recent months. Growth in government-funded investment moderated to about 11% in nominal year-on-year terms in the first 8 months from 48% in the same period of 2009, owing to the withdrawal of policy stimulus in early 2010.

Inflation quickened from 2.0% year on year in August 2009 (as economic and credit growth accelerated) until reaching an apogee of 9.5% in March 2010. Policy tightening and the good rice harvest contributed to pulling back inflation to 8.2% in July and August 2010 (Figure 3.10.3), although it increased to 8.9% in September.

The better global trade environment underpinned a 20.6% rebound in merchandise exports in customs-based US dollar terms in the January–August period. (Exports in 2009 fell by about 10% as global trade contracted.) Demand recovered for Viet Nam's textiles and footwear (about a quarter of all exports), and shipments of electronics and machinery tools jumped by about 40%. Merchandise imports increased by 25.7%, spurred by the recovery in manufactured exports, which rely on imported materials, and higher demand for both consumption and investment goods.

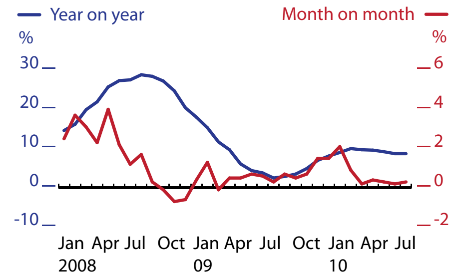
The trade deficit narrowed in the first half of this year from levels in the second half of 2009 (Figure 3.10.4). Preliminary data put the first half merchandise trade deficit at $3.8 billion on a balance-of-payments basis, a considerable improvement on the $8.1 billion gap in July–December 2009 (but wider than a $249 million deficit in January–June that year). Taking into account recoveries in remittances and tourism earnings, the current account deficit narrowed to an estimated $2.7 billion in the first half (5.6% of GDP) from $8.0 billion in July–December 2009. (A surplus of $0.6 billion was recorded in the first half of 2009.)

With an improvement in the capital account, the overall balance of payments likely turned to a small surplus in the second quarter of 2010, after recording deficits since the start of last year. Gross official reserves were estimated at $13.5 billion at end-June 2010 (representing 9.6 weeks of imports of goods and services), a modest rebuilding from $11.8 billion in March 2010, although still down from $14.1 billion at end-2009 (Figure 3.10.5).

Sizable trade deficits and relatively high inflation, coupled with residents switching from local-currency assets into US dollars and gold, continued to put downward pressure on the dong exchange rate. The spread between the black market rate and the reference rate of the central bank (the State Bank of Viet Nam, or SBV) widened to 6.8% in mid-February. That prompted the SBV to devalue the currency by 3.4% in February against the US dollar, followed by a further 2.1% devaluation in August (Figure 3.10.6). The trading band for the dong was maintained at ±3%. Subsequently, the gap between the black market and reference rates narrowed to about 3% in September. From November 2009 to August 2010, the dong was devalued three times, by a total of about 11% against the US dollar.

Monetary tightening steps taken by the SBV included an increase in the base interest rate and removal of interest rate caps and subsidies.

3.10.3 Monthly inflation



Sources: General Statistics Office of Viet Nam; ADB estimates.

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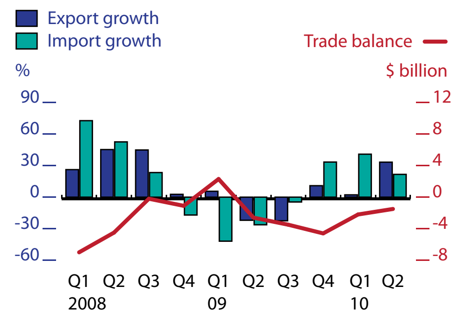
3.10.4 Trade indicators



Sources: State Bank of Viet Nam; ADB estimates.

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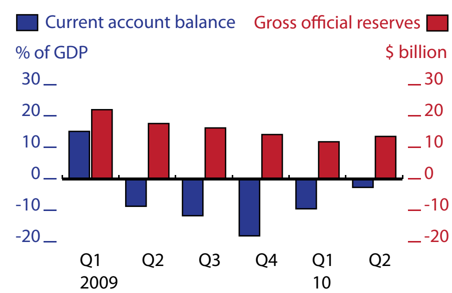
3.10.5 Current account and reserves



Note: Gross official reserves exclude the government's foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Source: State Bank of Viet Nam; ADB estimates.

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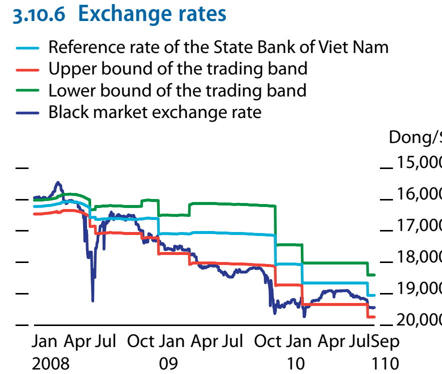
3.10.6 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

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During the global financial crisis, the central bank had cut by half the base rate to 7% (from October 2008 to February 2009), in order to support economic growth. The SBV started to unwind that stimulus in December 2009, when it raised the base rate by 1 percentage point to 8.0% and ended interest rates subsidies on short-term loans. The central bank removed interest rate caps on medium- and long-term loans in February 2010 and on all dong-denominated loans in April.

Consequently, monetary conditions tightened in the first quarter of 2010, although they eased somewhat in the second. Total liquidity (M2) at midyear was up by 12.7% from end-2009 and by 23.7% from June 2009. Commercial banks pushed lending rates above 15% when interest rate caps were removed. However, the authorities responded by urging the banks to moderate the increases, so that lending rates were trimmed to 13%–14% in the third quarter. The VN index of stock prices declined by 8.0% in the first 8 months of 2010.

Credit in the first quarter grew by just 3.6% from end-2009, but by midyear credit growth had picked up to 11.7% from end-2009. That put the year-on-year growth in credit at 28.9%, slowing from the near 40% rate in the second half of 2009 (Figure 3.10.7) toward the official 2010 target of 25% credit growth.

Most of the fiscal stimulus measures implemented during the global financial crisis expired at end-2009. Reflecting a somewhat more restrained fiscal stance, the government is targeting a 2010 budget deficit equivalent to 6.2% of GDP, narrower than the actual deficit in 2009 of 7.0%.

Prospects

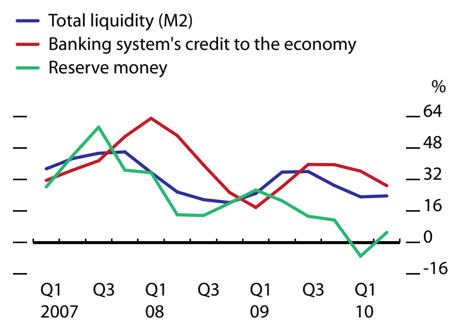
The outlook assumes that the government will maintain macroeconomic stability during the forecast period, so that the balance of payments gradually improves and the fiscal deficit narrows. It is assumed that the authorities target growth in credit at 25% and maintain efforts to safeguard and enhance banking system soundness.

On these assumptions, government investment could be restrained by fiscal consolidation, but recoveries in world trade and financial conditions will underpin growth in private investment. Illustrating improvements in the investment environment, Viet Nam's ranking in the Global Competitiveness Index compiled by the World Economic Forum was upgraded to 59 of 139 countries in 2010 (from 75 in 2009), and its ranking in the Forum's Enabling Trade Index rose to 71 of 125 economies (from 89 in 2009). Progress being achieved in a government drive called Project 30, to simplify bureaucratic procedures, is reducing red tape for businesses.

Private consumption growth is projected to get support during the forecast period from rising incomes and recovering remittance inflows.

Viet Nam is benefiting substantially from the rebound in world trade, which is projected to continue through 2011 at nearly the same pace as this year. Growth in the country's merchandise exports was running at about 30% in July–August, supporting growth in industry and, to a lesser degree, in agriculture. In particular, trade with the People's Republic of China (including Hong Kong, China) has stepped

3.10.7 Growth of money and banking indicators



Note: Banking system data changed since 2007.

Sources: State Bank of Viet Nam. International Financial Statisics online database; ADB estimates.

Click here for figure data

3.10.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	6.5	6.7	6.8	7.0
Inflation	10.0	8.5	8.0	7.5
Current acct. bal. (share of GDP)	-7.6	-7.5	-5.5	-5.4

Source: ADB estimates.

up owing to a rebound in those economies reinforced by a free trade agreement that came into effect in January 2010 between the PRC and the Association of Southeast Asian Nations.

The impact on the trade deficit from the real devaluation of the dong (due to a larger nominal devaluation than inflation differentials) is expected to be limited, largely because exports of manufactured goods usually require substantial imported materials and equipment.

GDP growth for 2010 is, on this basis, seen at 6.7% (Figure 3.10.8). The forecast is raised slightly from April's Asian Development Outlook 2010 (*ADO 2010*) in light of the pace of growth in the first half coupled with expectations of a quickening in the second half, as well as the upward revision in the ADO baseline assumptions for the recovery in world trade in 2010. The economic expansion rate is expected to pick up slightly in 2011, to about 7%, as investor confidence improves in tandem with more subdued inflation and a more robust external position.

The current account deficit, as a ratio to GDP, is forecast to narrow in the forecast period (Figure 3.10.9) due to an improving trade account, inflows of remittances, and the recovery in tourism. Deficit forecasts (7.5% of GDP in 2010 and 5.4% in 2011) are little changed from ADO 2010. The overall balance of payments is expected to continue improving, supported by foreign direct investment attracted by the expanding economy as well as by capital inflows. Foreign reserves are seen increasing modestly to more comfortable levels.

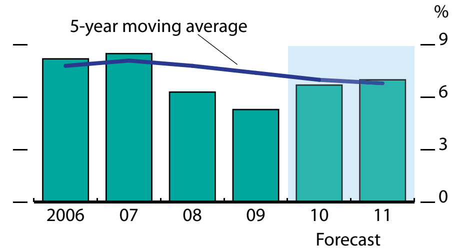
Inflation is projected to average 8.5% in 2010, easing to 7.5% next year (Figure 3.10.10) on the assumption that domestic macroeconomic stability is maintained and that global oil and commodity prices are relatively steady in 2011. These forecasts are lowered slightly from April owing to the improvement in macroeconomic conditions and moderate growth in credit. However, large swings in inflation (from 28% year on year in August 2008 to 2% in August 2009, then up to over 8% this year), together with expectations of dong devaluation, suggest that inflation expectations, too, are not firmly anchored.

The government is putting in place regulations that would enable it to impose price controls on a range of goods sold by private companies. Such controls, if implemented, could limit price increases to some extent in the short term, but would also risk eroding business sentiment.

In a significant step to strengthen the authority of the SBV in implementing monetary policy and safeguarding the financial system, the National Assembly in June 2010 approved a new SBV Law and a new Credit Institutions Law (Box 3.10.1).

Separately, the SBV has taken steps to address the issue of banking system stability with new prudential policies that take effect on 1 October 2010. Under these changes, the capital-adequacy ratio for banks is raised from 8.0% to 9.0% and restrictions are introduced on banks expanding into higher-risk businesses, such as securities and real estate trading. Banks must meet a minimum capital requirement of VND 3 trillion ($158 million) by end-2010. The SBV indicated that it is ready to assist banks to meet the capital requirement, including by facilitating mergers and acquisitions. There have been concerns about

3.10.8 GDP growth



Sources: General Statistics Office of Viet Nam; *Asian Development Outlook* database.

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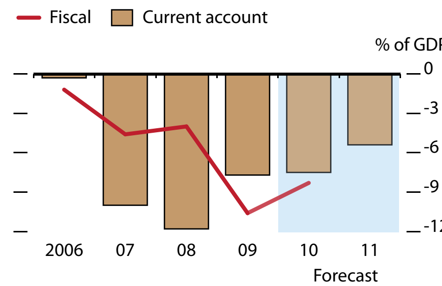
3.10.9 Fiscal and current account deficits



Note: This is overall fiscal balance, including off-budget expenditure and on-lending, not the fiscal balance based on government's definition.

Source: Asian Development Outlook database.

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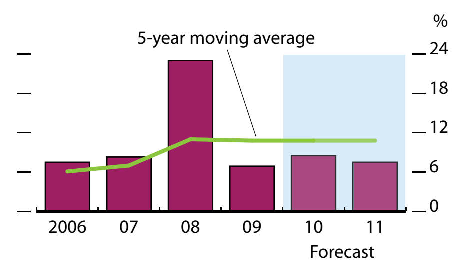
3.10.10 Inflation



Sources: General Statistics Office of Viet Nam; *Asian Development Outlook* database.

Click here for figure data

some banks' capital adequacy, risk-management capacity, and the quality of their loan portfolios.

Domestic risks to the economic outlook in the forecast period center on any premature easing of monetary or fiscal policies (or both), or a perception of looser policy by financial markets and domestic investors. An early easing, or the perception of a relaxation, could derail the macroeconomic stabilization efforts, putting inflation on an upward trajectory and pressure on external accounts.

Such developments would erode consumer and business confidence and deplete already low foreign reserves. The resulting macroeconomic instability would likely require more stringent policy tightening, which would undermine the growth prospects for next year. It will be crucial that the authorities maintain a firm and consistent policy stance, and communicate such a position effectively to the market, until inflation is clearly on a downward track and foreign reserves increase.

The other major challenge is to raise the efficiency of the economy and reduce supply-side constraints through structural reforms. Much has been achieved in lifting Viet Nam to "lower-middle-income" status (a World Bank classification for economies that graduate from the "low income" group when per capita annual gross national income reaches $996). The government is now preparing a new socioeconomic development strategy for the next 10 years, scheduled to start in 2011. This provides an opportunity to address infrastructure bottlenecks, deficiencies in the legal and regulatory framework for the private sector, inefficiencies and corporate governance problems at state-owned enterprises, and shortages of labor skills.

Structural policies that promote productivity growth and support development of higher valued-added activities hold the key to sustaining growth and extending its benefits to more people.

3.10.1 Strengthening the financial framework

Two laws approved by the National Assembly in June 2010—a new State Bank of Viet Nam Law and a Credit Institutions Law—together with various legal documents issued by the central bank and other agencies, mark important progress in strengthening the framework for conducting monetary policy and safeguarding banking system stability. The laws go into effect on 1 January 2011.

The new SBV Law will enhance the central bank's autonomy and accountability in formulating and implementing monetary policy. It explicitly stipulates that the key objectives of monetary policy are to stabilize the value of the currency and to control inflation, putting more emphasis on these objectives than the current law.

Furthermore, the SBV's authority for surveillance and supervision of credit institutions is enhanced by the legislation.

The new Credit Institutions Law will allow credit institutions greater autonomy and flexibility in doing business, for example in setting fees and interest rates and in providing a wider range of financial services.

This law also simplifies administrative procedures for banking and sets out that institutions are to gradually adopt best international practices. It applies both to banks and nonbank financial institutions.