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.

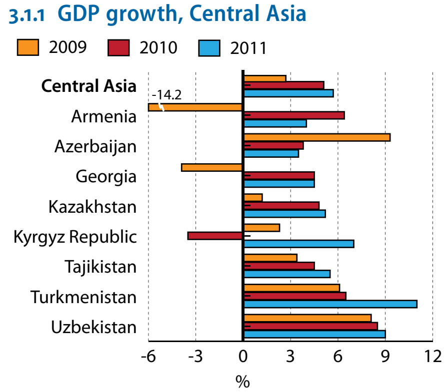
The *Update* maintains the GDP forecasts for Turkmenistan and Uzbekistan, while revising downward projections for Azerbaijan and the Kyrgyz Republic. Growth in Azerbaijan's oil production has slowed, and the Kyrgyz economy suffered from political unrest.

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



Source: Asian Development Outlook database.

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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.

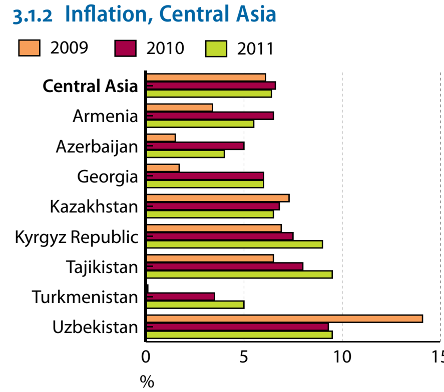
Due to the slow recovery of domestic demand, inflation in most countries will generally remain subdued in 2010–2011, and well below the double-digit levels experienced during earlier years of very rapid growth. In Armenia, inflation increased between the last quarter of 2009 and the first quarter of 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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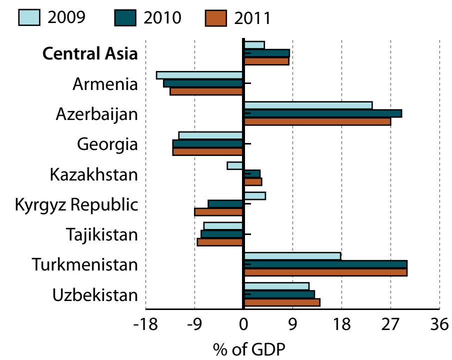
in current account deficits. The narrowing of the current account deficits in Georgia and Tajikistan from *ADO 2010* projections is mainly explained by the strong recovery of remittance inflows.

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.

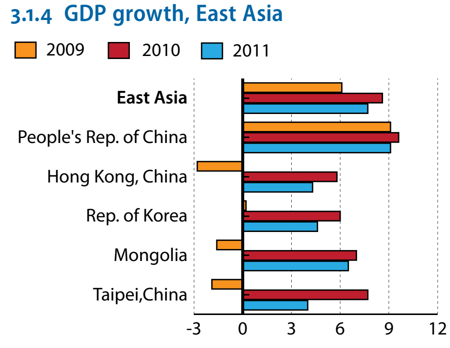
One reason for the sharp GDP gains was double-digit economic growth in the PRC, the major trading partner of the other four East Asian economies. PRC imports surged by 45.8% in the first 8 months of this year.

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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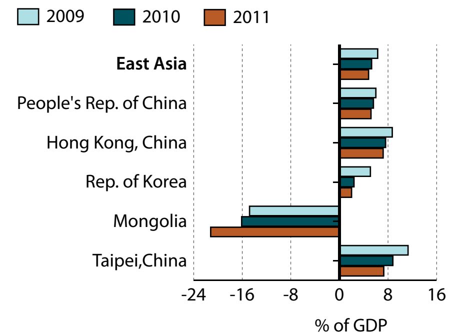
Current account surpluses in relation to GDP are projected to decline from 2009 levels in all economies through the forecast period (except in Mongolia, where imports of capital equipment for mining projects will widen its external deficit). Imports will likely rise in tandem with domestic demand and 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



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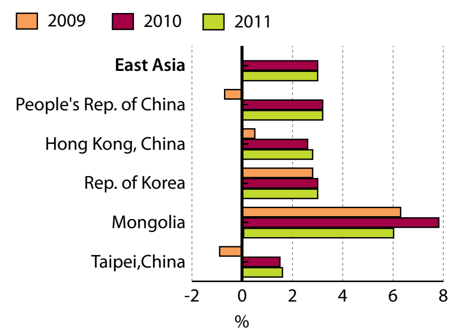
3.1.6 Inflation, East Asia



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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.

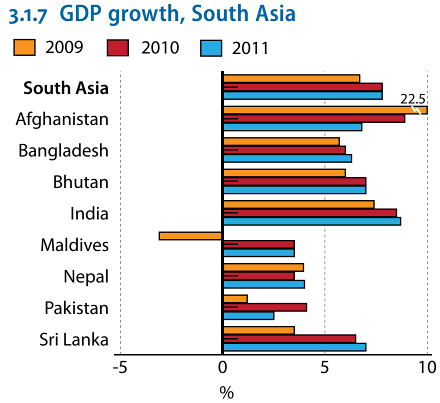
While expansionary fiscal policies were the key factor in mitigating the effects of the global economic crisis, South Asian authorities are now exploring the timing of withdrawal of fiscal stimulus measures to avoid an unsustainable buildup of public debt. India's government is targeting a gradual decrease 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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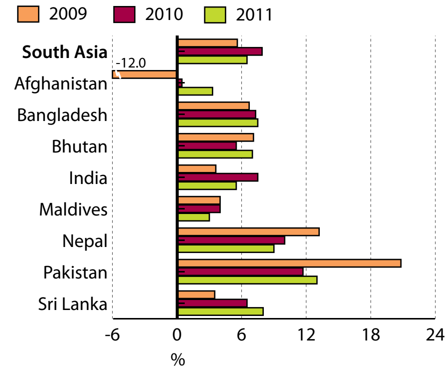
7.9% in FY2010, 1.9 percentage points higher than previously forecast (Figure 3.1.8). This change essentially reflects the revised upward forecast for India, since changes for other countries from *ADO 2010*'s forecasts were marginal. Inflation pressures are, however, expected to ease to 6.5% in FY2011, 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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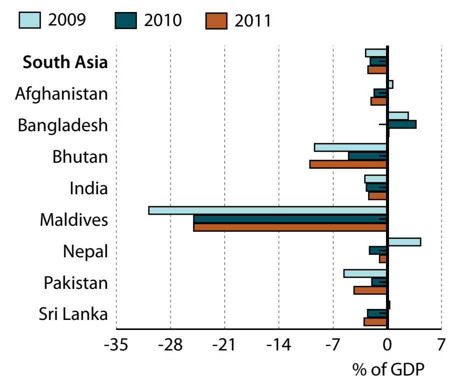
3.1.9 Current account balance, South Asia



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.

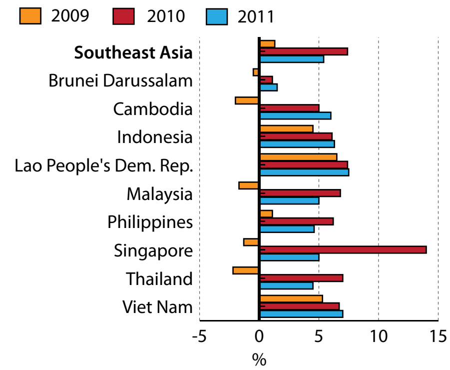
Growth forecasts for 2010 are revised up from April for all subregional countries, except Brunei Darussalam and Myanmar, with those most open to international trade—particularly Malaysia, Singapore, and Thailand—recovering the fastest. Singapore had the fastest year-on-year growth (17.9%) in the first 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.
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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.

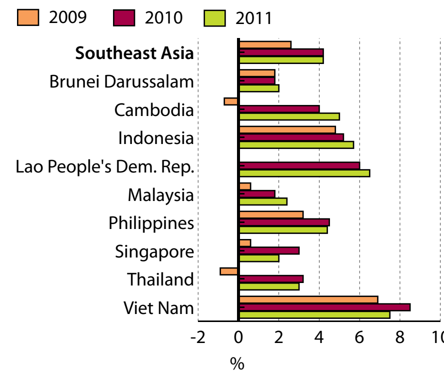
The world economy is experiencing considerable uncertainty, though, and there are signs that economic activity across Southeast Asia is starting to decelerate. Investment due to restocking is slowing in Indonesia, Malaysia, the Philippines, and Thailand, suggesting that the restocking cycles in both 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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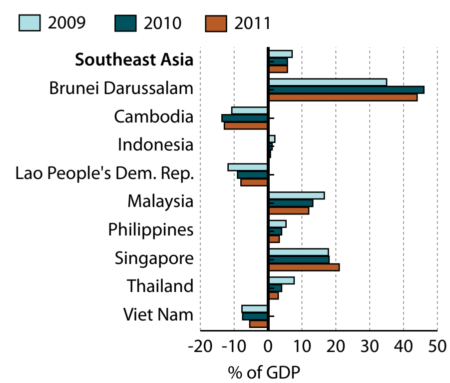
3.1.12 Current account balance, Southeast Asia



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.

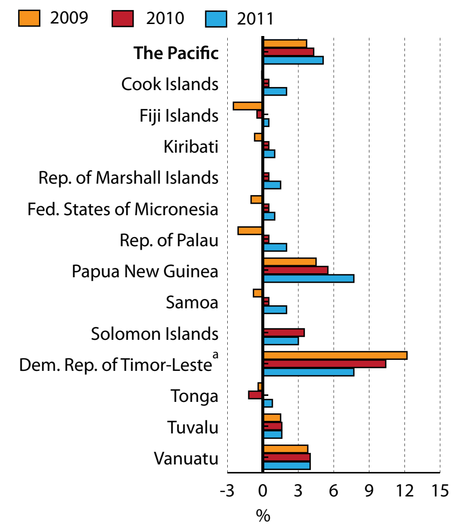
Growth in tourist arrivals in most destinations in the Pacific has slowed this year as the Fiji Islands regains some of the market share that it lost last year (partly on account of floods). But heavy discounting of tourism services in the Fiji Islands is expected to translate into minimal increases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

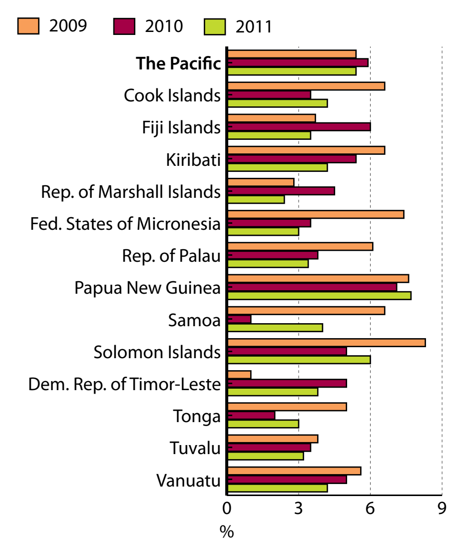


[a] non-oil GDP.

Source: Asian Development Outlook database.

Click here for figure data

3.1.14 Inflation, The Pacific

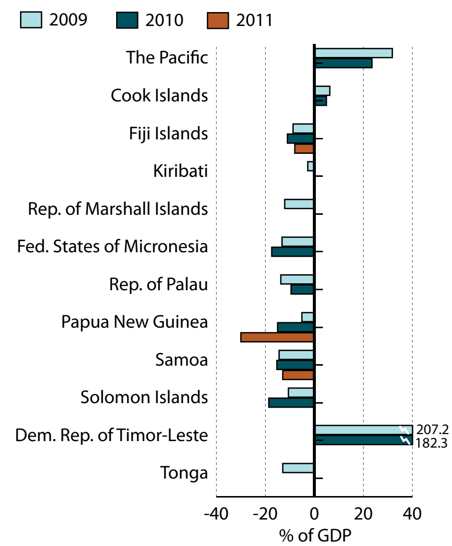


Source: Asian Development Outlook database.

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.