Southeast Asia

Brunei Darussalam
Cambodia
Indonesia
Lao People's Democratic Republic
Malaysia
Myanmar
Philippines
Singapore
Thailand
Viet Nam

Brunei Darussalam

GDP is estimated to have contracted in 2008 as a result of a decline in oil and gas production, which dominates this economy. Lower external demand for energy and the fall in global energy prices are likely to suppress growth again this year. Hefty surpluses in the fiscal and external current account provide a deep cushion against external shocks. Efforts to diversify the economy have made some advances, but if the private nonenergy sector is to expand more rapidly, progress is required to streamline business regulation, foster innovation, and develop the financial market.

Economic performance

The economy depends heavily on oil and natural gas: production of hydrocarbons, including liquefied natural gas, accounted for about half real GDP in 2007 (Figure 3.22.1). The nonenergy sector comprises mainly services (42% of GDP), of which government services account for a significant share (19% of GDP). Manufacturing and agriculture are small at less than 2% of GDP each. Private sector activity, other than in oil and gas, grew modestly from 28.3% of GDP in 2003 to 31.0% in 2007. This consists predominantly of wholesale and retail trade, transport and communications, finance, construction, real estate, and other services.

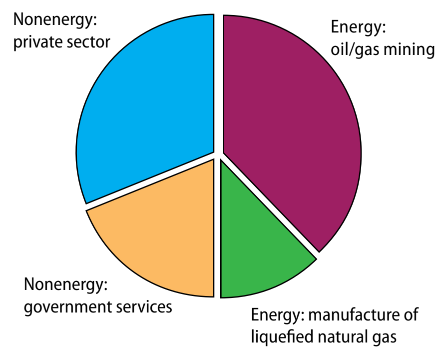
GDP fell by 3.9% in the first half of 2008 (the latest period for which data are available). For the full year, GDP is estimated to have contracted by 2.7% (Figure 3.22.2). Aging oil and gas fields and consequent stoppages in production for maintenance and upgrading of wells and pipelines were the primary reasons for the lower economic output. The Government's desire to extend the life of energy production, in view of limited proven reserves and until a vibrant nonenergy sector develops, also means that the long-term trend of energy output has been broadly stable (Figure 3.22.3).

Government services also likely contributed less to GDP in 2008 than in 2007. A government decision to bring forward bonuses paid to civil servants had the effect of increasing the measured value of government services late in 2007. This effect started to dissipate in the second quarter of 2008.

Large current account surpluses, equivalent to close to 50% of GDP in recent years, are mainly attributable to merchandise trade surpluses. Higher global oil and gas prices lifted export receipts, offsetting the decline in production. Exports of oil and gas were equivalent to more than 96% of total export revenue in the first half of 2008. Major customers in order of importance are Japan, Indonesia, Republic of Korea, and Australia. Clothing shipments, which make up the bulk of other merchandise exports, have declined since the expiry of global quotas at end-2004.

Import values are much lower than those of energy-oriented exports, reflecting the small population (390,000 in 2007) and economy (GDP of

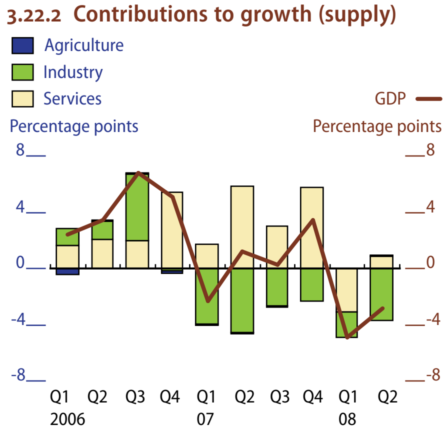
3.22.1 Composition of real GDP, 2007



Sources: Department of Economic Planning and Development, *Brunei Darussalam Statistical Yearbook 2007*; staff estimates.

Click here for figure data

3.22.2 Contributions to growth (supply)



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

Click here for figure data

This chapter was written by Sharad Bhandari and Mohammed Parvez Imdad of the Southeast Asia Department, ADB, Manila.

US$12.3 billion in 2007). Machinery and equipment have the largest share of imports. Brunei also imports most of its food.

Inflation averaged 2.7% last year, well above the 0.6% average of the previous 5 years (Figure 3.22.4). Food (29% of the consumer price basket) was the primary contributor, reflecting higher international prices.

A currency board arrangement, which links the Brunei dollar to the Singapore dollar one to one, has contained inflation expectations and, historically, contributed to low inflation. The inflation rate in Brunei is also suppressed by an extensive system of government subsidies, covering rice, sugar, and fuel, as well as housing, education, and health services. Prices of motor vehicles, infant milk powder, cigarettes, and cooking oil are controlled. The absence of taxes on personal income and on sales of goods and services also helps keep inflation low. The only significant taxes are levied on corporate profits. Import duties are also low, equivalent to 2.4% of total tax receipts in FY2007 (ended 31 March 2008).

Taxes, dividends, and royalties from oil and gas companies account for about 90% of fiscal revenue (Figure 3.22.5). Fiscal expenditure has fallen in the past couple of years, mainly reflecting a decline in development spending. Implementation of projects under the national development plan, Rancangan Kemajuan Negara 2007–2012 (RKN), has lagged significantly behind allocations. Higher revenue and lower expenditure have contributed to a sharp increase in the fiscal surplus in recent years.

In order to speed up RKN project implementation, the Government last year devolved the appointments of project consultants to each ministry responsible for the projects. It also moved toward a design–build method for projects so that one provider (contractor or designer) is accountable for both the design and construction.

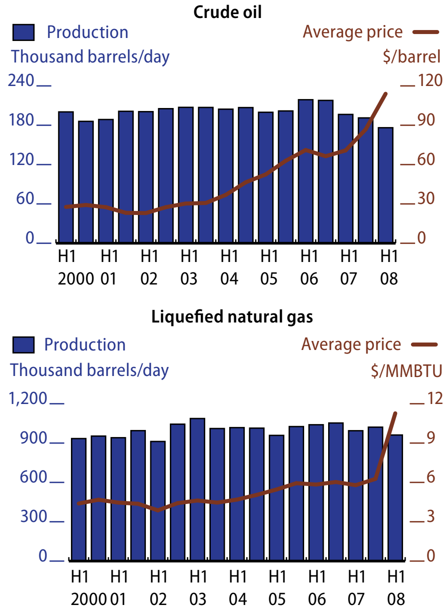
Some advances were made in diversifying the economy in 2008. Construction started on a US$450 million methanol plant and is scheduled to be completed by the end of this year. It is the first major investment at the Sungai Liang Industrial Park, which is being developed as a petrochemical hub. iCenter, the country's first business incubator to develop local small and medium-sized enterprises in information and communications technology, was launched in 2008. About 16 companies have started providing business services in Internet and related applications in the iCenter.

Economic prospects

The global economic downturn is transmitted to Brunei's economy primarily through lower world demand for energy and the fall in international energy prices. The country has ample financial resources of its own and no external debt, so transmission through the financial channel is limited. Income from investment in foreign assets may moderate, but is unlikely to have a significant impact near term given the country's large resources. Foreign direct investment and tourism may slow somewhat, though.

The lack of timely and comprehensive economic data for recent periods makes forecasting difficult. Furthermore, given the unpredictable nature of unplanned stoppages for maintenance that has affected oil and

3.22.3 Hydrocarbon indicators

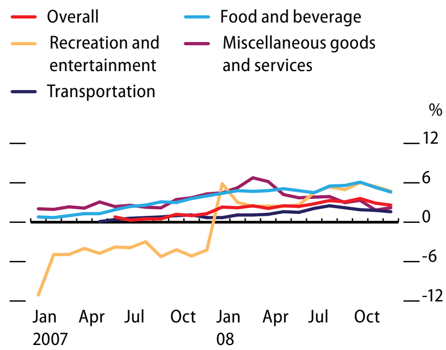


MMBTU = million British thermal units.

Source: Department of Economic Planning and Development, *Brunei Economic Bulletin*, December 2008.

Click here for figure data

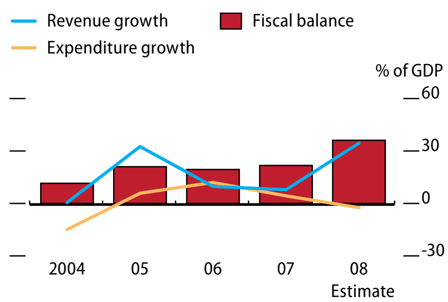
3.22.4 Inflation



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

Click here for figure data

3.22.5 Fiscal indicators



Note: Data are for fiscal years running from April to March.

Sources: Ministry of Finance, Brunei Darussalam; staff estimates.

Click here for figure data

gas output in recent years, growth projections are based on assumptions that energy production will decline by no more than 1% in 2009 and 2010 from levels in 2008, when they fell at a significant rate for a second consecutive year. The nonenergy private sector may contract somewhat this year under the cumulative impact of the global downturn on trade, transport, and tourism.

Public spending will support growth. Government services output is expected to increase with efforts to expedite the RKN projects. The contribution of government services to growth should also rise as the unfavorable base effects (from the advancement of bonuses) have dissipated. Based on these factors, GDP growth may contract by about 0.4% this year (Figure 3.22.6).

In 2010, GDP growth is expected to mirror a modest upturn in global demand and a rise in energy prices, although hydrocarbon output may remain subdued. The start of production from the methanol plant and associated activities, as well as the planned Visit Brunei Year 2010, is likely to provide new sources of growth. Public spending will continue to support expansion.

A surplus, albeit smaller, in the fiscal accounts is likely this year. Financing for plausible increases in spending is available, given the accumulation of large surpluses. In addition to assets of sovereign wealth funds, mainly the Brunei Investment Agency, government deposits in the banking system rose from 18% of GDP in 2002 to 20% in 2007.

Export receipts are set to decline significantly this year owing to lower energy prices. Imports may moderate less as investment in RKN projects and requirements for food prop them up. The trade surplus and hence the current account surplus is likely to shrink significantly. However, at above 30% of GDP the current account surplus will remain the largest among the economies of East and Southeast Asia. In 2010, expected exports of methanol and improved inward tourism should also help support the surplus.

Inflation will likely moderate this year and next toward 1% as a result of quiescent world commodity prices. Looser fiscal and monetary policies may preclude a sharper fall in inflation. Monetary policy eased in line with a shift in October 2008 by the Monetary Authority of Singapore to zero appreciation of the Singapore dollar's nominal effective exchange rate, from a gradual appreciation previously.

The main domestic risk to the growth forecast is the performance of the oil and gas sector and progress in the RKN projects. If energy output is lower than assumed because of unforeseen problems in wells and pipelines, GDP is likely to contract more than projected. Conversely, smoother energy production would contribute to a possible expansion of GDP this year. The effort to speed up implementation of RKN projects, if successful, could also spur growth.

Development challenges

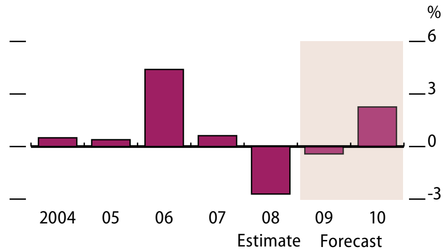
In spite of some success, diversification of the economy away from its dependence on oil and gas remains a major challenge. The country's proved reserves of oil are estimated to be sufficient for close to 20 years and reserves of gas for about 30 years, according to data from the US

3.22.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.4	2.3
Inflation	1.5	1.2
Current account balance (share of GDP)	39.3	35.3

Source: Staff estimates.

3.22.6 GDP growth



Sources: Asian Development Bank, *Key Indicators 2008*; staff estimates.

Click here for figure data

Energy Information Agency. Exploration of new fields and expansion of current fields may prolong the life of energy reserves, but heavy reliance on the sector increases the vulnerability of the economy to external shocks.

Various initiatives underpin efforts to diversify. The Government plans to develop Pulau Muara Besar port in Brunei Bay as a container port, export processing zone, and manufacturing hub. In 2008, an international company was appointed as the port operator and another was engaged to develop a master plan. In addition, the authorities have identified several industries for development. These include downstream petrochemicals (in addition to the methanol plant); tourism, acquaculture, and agriculture; Islamic businesses, including halal products and financial services; and information and communications technology services.

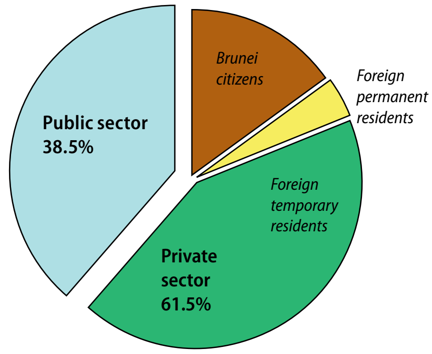
The Government has implemented liberal trade, investment, and labor policies to mitigate the structural constraints that result from a small domestic market and limited human resources. For example, about 75% of private sector employment in 2006 comprised foreign workers (Figure 3.22.7).

Nonetheless, Brunei ranks relatively low for its level of development in the World Economic Forum Global Competitiveness Index (Table 3.22.2) The main constraints, apart from market size, appear to be related to innovation, business sophistication, goods market efficiency, and financial market sophistication. Policies to foster small and medium-sized enterprises by developing incubators, industrial clusters, and training programs attempt to address the first two constraints.

Better alignment of public versus private sector incentives for employees would also be important to attract skilled workers at competitive compensation to the private sector. Recognizing the importance of a robust financial system to foster private sector growth, the Government is developing a plan for a capital market and a modern payment and settlement system.

Detailed indicators of goods market efficiency show a significant competitive disadvantage resulting from the lengthy procedures involved to start a business. The World Economic Forum ranks Brunei 125 on the number of procedures and time required to start a business. The World Bank's *Doing Business 2009* report puts Brunei 88 out of 181 countries in the ease of doing business, compared with 20 for Malaysia and 1 for Singapore. Progress in streamlining procedures for businesses is thus likely to be important in diversifying the economy.

3.22.7 Employment, 2006



Sources: Department of Economic Planning and Development, *Brunei Darussalam Statistical Yearbook 2007*; staff estimates.

Click here for figure data

3.22.2 Rank in Global Competitiveness Index, 2008–09

Details	Rank (in 134 economies)
Overall Index	39
Basic requirements	29
Institutions	41
Infrastructure	39
Macroeconomic stability	2
Health and primary education	47
Efficiency enhancers	77
Higher education and training	69
Goods market efficiency	91
Labor market efficiency	16
Financial market sophistication	75
Technological readiness	54
Market size	116
Innovation and sophistication factors	87
Business sophistication	89
Innovation	91

Source: World Economic Forum. 2008. *The Global Competitiveness Report 2008-2009*, available: http://www.weforum.org.

Cambodia

Headwinds buffeted the economy in 2008, contributing to double-digit inflation and then cutting into economic growth. Continuing weakness in garment exports, tourism, and construction is forecast to reduce GDP growth this year. This deceleration, combined with rising prices, threatens to undermine steady gains made to reduce poverty. Thus the major challenge is to diversify growth and make it more resilient, inclusive, and beneficial to the poor.

Economic performance

The momentum of high growth in 2007 carried over into the first half of 2008 and slightly beyond, as garment exports and tourism stayed robust, agricultural output relatively strong, and construction activity buoyant. Late in 2008, however, the economy felt the combined effects of political instability in neighboring Thailand and the closure of Bangkok's airports; and of the start of the global economic downturn in terms of an associated deceleration in demand from traditional export markets and weakening investor sentiment. Imports by the principal market, the United States (US), of Cambodian garments declined by 2% in value terms in 2008, according to US data. Tourist arrivals slowed and construction activity fell sharply following a drop in land and property prices after several years of rapid growth.

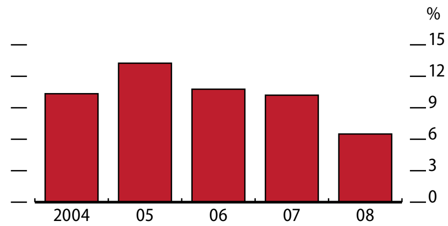
Largely on the basis of these factors, GDP growth in 2008 slowed to an estimated 6.5% (Figure 3.23.1). Agricultural expansion was relatively buoyant at 4.5%, spurred by good weather and higher farmgate prices, but overall growth in total manufacturing production (5.0%) and services (8.5%) was lower than in 2007.

On the expenditure side, rising domestic demand, fueled by an increase in commercial bank lending and wealth effects from previously fast-rising property prices, stimulated increasing amounts of consumption-related imports and contributed to inflation pressures. Net exports continued to subtract from GDP growth.

Inflation accelerated from 6.4% in September 2007 to a peak of 25.7% in May 2008, driven largely by the global surge in oil and food prices (Figure 3.23.2). In addition, because the economy is heavily dollarized (over 90% of total bank deposits are held in US dollars), a depreciation of the riel and the US dollar against trading partner currencies contributed to imported inflation, while rising domestic demand contributed to domestically generated pressures. The domestic price of rice doubled between mid-2007 and mid-2008, a result of domestic supply shortages, in turn partly created by increased exports from provinces bordering Thailand and Viet Nam in response to higher prices in those countries. Prices of pork, chicken, and fish also rose steeply. Later in the year, food and fuel prices declined and, combined with an appreciating riel and

This chapter was written by Eric Sidgwick of the Cambodia Resident Mission, ADB, Phnom Penh.

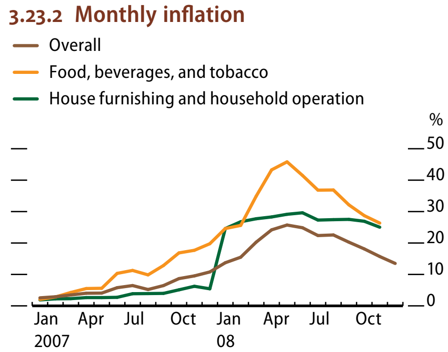
3.23.1 GDP growth



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

3.23.2 Monthly inflation



Note: Data refer to Phnom Penh only.

Sources: Economist Intelligence Unit, *Country Report*, February 2009; CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, all downloaded 3 March 2009; staff estimates.

Click here for figure data

US dollar plus monetary policy measures taken at midyear, helped bring down inflation to 13.5% by December. The year-average figure of 19.7% was three times 2007's rate. The riel's real effective exchange rate appreciated by about 10%, reflecting higher inflation in Cambodia.

In response to the higher oil and food prices, the Government took a series of fiscal-related steps to help offset the negative social effects, including raising wages and allowances of civil servants and teachers, and improving the supply of rice in the hardest-hit rural areas. Despite these moves, higher than projected government revenue and containment of current expenditure to its budgeted level permitted an increase in the current budget surplus to 3.7% of GDP.

The overall budget deficit (including capital spending) narrowed to 2.1% of GDP in 2008 from 2.9% the year before. Total domestic revenue rose by just under a half percentage point of GDP, to 12.5%, with tax receipts edging up to 10.4% of GDP (from 10.2% the year before), mainly on continued improvements in administration and collections. Total budget expenditure declined marginally, to 14.6% of GDP, reflecting lower externally financed investment. Concessional loans and grants continued to finance the overall fiscal deficit.

Fueled by rising foreign capital inflows and bank deposits in the first half of the year, broad money growth accelerated sharply, peaking at 63% in April 2008 (year on year) (Figure 3.23.3). This contributed to an unsustainable rate of growth in bank credit, which exceeded 100% (year on year), and stoked inflation. The monetary authorities responded by imposing a 15% limit on bank credit to the real estate sector at end-June, by doubling the minimum reserve requirement on foreign currency bank deposits to 16% a month later, and by easing restrictions on capital outflows.

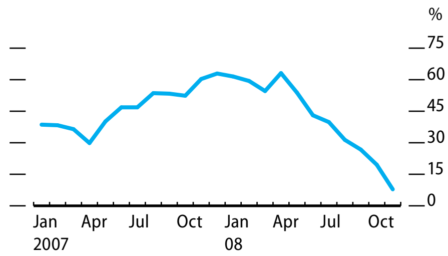
These moves helped ease credit growth and inflation in the second half. After clear signs that inflation pressures were dissipating, on 1 February this year the authorities reduced the minimum-reserve requirement to 12% and removed the cap on lending for real estate.

Export performance is heavily dependent on garment shipments to the US and Europe, but these markets weakened in the second half of 2008. Garment exports were also hurt by higher domestic inflation, which led to a 20% rise in garment workers' minimum wage. In 2008, such exports to the US fell by 2% (Figure 3.23.4), as lower prices more than offset small volume gains.

Rising domestic demand and higher international oil prices lifted imports, and the trade deficit widened to an estimated 18% of GDP in 2008. Growth in tourist arrivals eased to 5.5%, the slowest gain since 2003. Arrivals were up by 10% through midyear, but declined to around 3% following the political turmoil in Thailand and the onset of the global financial crisis. The current account deficit therefore widened to an estimated 14.0% of GDP. International reserves increased to just over $2 billion by December 2008 (equivalent to 3.5 months of import cover), reflecting buoyant inflows of aid and, until the latter part of the year, foreign direct investment (FDI).

Total public debt remains sustainable, but there are risks. At end-September 2008, total nominal external public debt was $2.8 billion, equivalent to 27.0% of GDP (down from 29.7% at end-2007) (Figure 3.23.5),

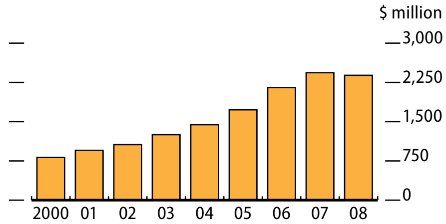
3.23.3 M2 growth



Sources: CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, both downloaded 3 March 2009.

Click here for figure data

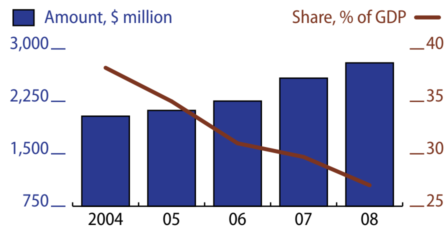
3.23.4 US imports of textiles and clothing from Cambodia



Source: Office of Textiles and Apparel, available: http://otexa.ita.doc.gov, downloaded 3 March 2009.

Click here for figure data

3.23.5 Public external debt



Sources: International Monetary Fund, *Country Report* No. 09/48; staff estimates.

Click here for figure data

while domestic public debt stood at about $100 million, equivalent to 0.75% of GDP, one third in foreign currency. Over half the external public debt stock is owed to multilateral institutions, and includes the negotiated debt stock for the Russian Federation ($457 million) and the agreed amount of total principal owed to the US ($162 million). Most of the external public debt is highly concessional.

The ratio of external public debt service to domestic exports of goods and services is low, at around 0.8%. Cambodia is not servicing its debts with either the Russian Federation or the US and it remains in arrears to both creditors, although negotiations on outstanding debt obligations are continuing. According to an analysis conducted in late 2008, external public debt is sustainable and the risk of debt distress is moderate. However, the country remains vulnerable to external shocks, and a protracted economic downturn could result in debt burden indicators breaching their indicative thresholds for extended periods.

In terms of structural reform, progress was made in implementing a public financial management reform program. Advances were also achieved in preparing for the devolution of functions, human resources, and financial resources from the central to local levels. The aim is to promote transparent and accountable local development and delivery of public services, and to contribute to more effective poverty reduction.

On the logistics front, an automated system for customs clearance and risk management was test-piloted in the port of Sihanoukville (through which 30–40% of total trade is routed), from May 2008. This has reduced processing times and costs for clearing customs, according to private sector users.

As for fostering private sector development, Cambodia moved up a little in the World Bank's *Doing Business 2009* rankings, to 135 in a list of 181 countries, but it fell in Transparency International's *Corruption Perceptions Index 2008*, to 166 out of 180.

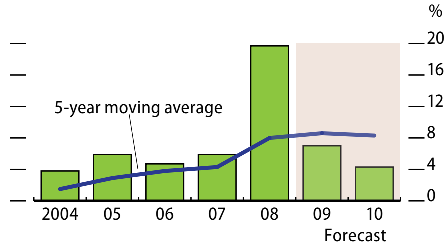
Economic prospects

Inflation, which affects the poor and those on low fixed wages the most, is forecast to decelerate to single-digit levels, but economic growth is set to decline sharply. The following forecasts are predicated on the Government's ability to regain overall macroeconomic stability in the form of a return of inflation to sustained low single-digits (Figure 3.23.6); increased and more efficient infrastructure spending; and a continued safeguarding of the health of the financial system (through sustained improvements in regulation and supervision).

Against this background, growth is forecast to slow to 2.5% in 2009, for three main reasons. First, garment exports are expected to contract because of lower demand in the US and Europe, higher wage costs, cessation of safeguards on the People's Republic of China at end-2008, and increasing competition from Viet Nam. Orders for delivery in the first half of 2009 are sharply lower than at the same time last year, and the outlook is poor for overall retail sales in the US.

Second, the growth in tourist arrivals has already slowed significantly (Figure 3.23.7), reflecting the combination of recession in Europe and a continued decline in the number of tourists from the Republic of Korea

3.23.6 Inflation

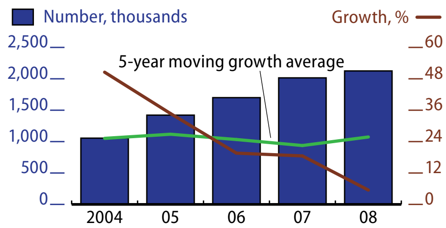


Note: Data refer to Phnom Penh only.

Sources: Asian Development Outloook database; staff estimates.

Click here for figure data

3.23.7 Tourist arrivals



Source: Ministry of Tourism, available: http://www.mot.gov.kh, downloaded 3 March 2009.

Click here for figure data

3.23.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	4.0
Inflation	7.0	4.3
Current account balance (share of GDP)	-16.0	-10.0

Source: Staff estimates.

(the most important source country), partly owing to a much weaker won against the US dollar.

Third, the recent slowdown in construction growth from rapid rates is expected to continue and to turn negative for the year as a whole, reflecting reduced FDI from Korea, which is heavily invested in the sector, and the decline in property prices. Non-tourism services are also projected to grow much more slowly than in recent years, reflecting the overall downturn in economic activity and sentiment.

On a more positive note, agricultural production is expected to be marginally higher this year than last year's estimated growth of 4.5%, reflecting improvements in irrigation, a drop in fertilizer prices from last year's high, and a continuation of policies to increase production. These policies include improving the availability of high-yield seeds, strengthening disease and pest control, providing more irrigation facilities for dry paddy lands, and increasing the popularity of the system of rice intensification to increase the productivity of irrigated rice cultivation, which has contributed to raising overall land productivity.

Offshore oil and gas deposits have been found, but the amounts that are economically recoverable are uncertain, and any revenues that might be generated from exploiting the deposits would not flow within the forecast period.

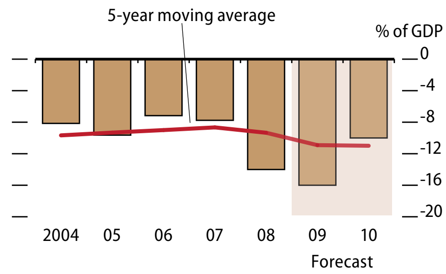
Domestic credit is expected to be somewhat tighter this year, as capital inflows and growth in bank deposits slow. Inflation is forecast to continue moderating, to average 7.0%, reflecting lower domestic demand and global oil prices. The current account deficit is set to widen further, to 16.0% of GDP (Figure 3.23.8), as easing domestic demand fails to compensate for declining export-related receipts from garments and tourism. International reserves are expected to decline, taking import cover to below 3 months.

The Government has requested development partners to accelerate their disbursements on existing projects and their approvals of projects planned for 2009, in order to help offset the likely reduction in private domestic demand and exports. In addition, the prime minister has stated that public spending in 2009 will be redirected toward growth enhancement and social safety nets, although he has not given details. The 2009 budget, which was prepared while the global financial crisis was beginning to unfold, did not contain any specific measures to offset the possible adverse effects of the crisis, but by early March 2009, the authorities had announced their intention to double development spending in 2009 on transport, public infrastructure, and irrigation. They were also considering accommodating a somewhat larger overall budget deficit in 2009 than originally envisaged.

In terms of structural measures, the Government has indicated that it is looking at how to relieve constraints to growth and faster poverty reduction, by, for example, providing some tax relief to the garment and tourism industries, and accelerating trade facilitation reforms.

In 2010, GDP growth is expected to pick up to 4.0%, in line with the anticipated rebound in industrial-country growth in the second half of next year. Inflation is projected to return to its recent historical average of just under 5%, while the current account deficit will narrow slightly to around 10.0% of GDP, as exports recover faster than imports.

3.23.8 Current account



Sources: Asian Development Outloook database; staff estimates.

Click here for figure data

3.23.1 Development challenges

Cambodia recorded strong economic growth averaging over 11% in 2004–2007, which was a key factor in reducing poverty to around 30%. However, this achievement is at risk of being undermined by the sharp run-up in food and fuel prices in 2008, and by the subsequent global financial crisis and economic downturn.

The immediate needs are for the Government to continue bringing down inflation to low single digits, and to help mitigate the adverse effects on the most vulnerable of the decline in growth.

Medium to long term, the Government will need to promote policies and reforms to sustain rapid growth. This requires not only strengthening existing sources of growth, but exploiting new avenues, in particular those that benefit the poor, including—since over 80% of the population lives in rural areas—a renewed emphasis on agricultural and rural development.

Faster rural development could be achieved if the coordination and implementation of various government plans were improved, notably five programs under the Strategy on Agriculture and Water 2006–2010, whose objective is to help diversify economic growth and reduce poverty.

It will also be necessary to integrate these initiatives with related reforms, including the extension of social and physical infrastructure, and the creation of more nonfarm jobs.

Finally, raising the priority for current spending on well-targeted social safety nets for the most vulnerable would also help maintain the gains in poverty reduction.

Indonesia

After expanding by about 6% for several years, growth decelerated in the fourth quarter of 2008 when exports and manufacturing took a hit from the global downturn. GDP growth is forecast to slow this year because of subdued domestic and external demand, before picking up in 2010. Inflation has eased from double-digit rates. Thanks to improved macroeconomic management and a strengthened financial sector, the economy is now in better shape than during the Asian financial crisis. Low levels of public debt, a minimal budget deficit, and its actions to line up external funding support the Government's plans for a fiscal stimulus to bolster the economy.

Economic performance

The economy maintained growth of about 6.3% during the first 3 quarters of 2008, before decelerating to 5.2% year on year in the final quarter as the global slowdown cut into exports and manufacturing. Full-year GDP growth of 6.1% was driven primarily by private consumption and a welcome boost in investment (Figure 3.24.1).

Private consumption, which accounted for 57% of GDP and about half of GDP growth, grew by 5.3% in 2008, a little faster than the 5.0% of 2007, despite rising food and fuel prices. Spending on durable goods was buoyant for much of 2008, supported by an expansion of consumer finance. Sales of motorcycles for example, most of which were bought on credit, rose by 32.6%.

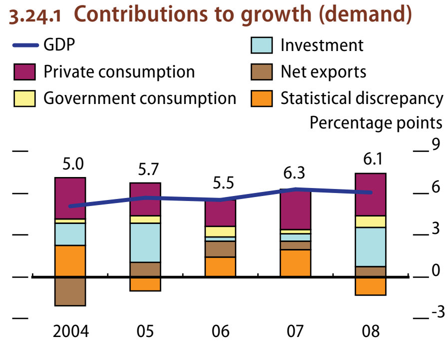
Investment put in one of the best performances for many years. Growth in gross fixed capital formation accelerated to 11.7%, and its ratio to GDP increased to 23.7% after a decade of weakness (Figure 3.24.2). Nearly three quarters of the fixed investment went into buildings, although growth in this category eased to 7.3% relative to 2007. In contrast, investment in machinery and equipment rose by about 25.3%. Realized foreign direct investment (FDI), excluding that in oil, gas, and some other industries, increased by about 44% to $14.9 billion, mainly into transport and communications. Total investment contributed a substantial 2.8 percentage points of total GDP growth. Net exports added 0.7 percentage points.

From the production side, growth of services (44% of GDP) picked up to 8.9%, contributing more than half the total expansion (Figure 3.24.3). The communications subsector continued to accelerate, reflecting demand for mobile telephone services, which have risen from a low base a decade ago to an estimated 138 million subscribers.

Industry grew by 3.7%, its slowest rate in 7 years, and contributed 1.6 percentage points of total growth. The deceleration was caused in part by weaker growth in manufacturing. This subsector was hurt late in the year by a softening in external demand and a squeeze on domestic credit,

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

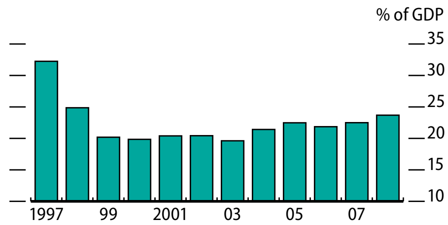
3.24.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 17 February 2009.

Click here for figure data

3.24.2 Real gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 17 February 2009.

Click here for figure data

notably credit for working capital. Power shortages in some cities, due to underinvestment in generation, also hindered factory output.

Manufacturing has faced problems for several years: exports of textiles, electronics, footwear, pulp and paper, and wood products have stagnated even as the world market expanded, suggesting that Indonesia is becoming less competitive. The country's exports have, in fact, become more dependent on volatile world markets for mineral and agricultural commodities. The mining and quarrying subsector (which includes oil and gas) last year grew a torpid 0.5%, even though global prices for metals and energy were high in the first half. Underinvestment, especially in oil extraction, has limited the supply response to higher prices. Oil production has fallen during the past decade, although it started to pick up last year. In other industry subsectors, utilities and construction maintained fairly solid growth in 2008.

Agriculture's share of the economy is relatively small at 14%, but it employs 41% of the work force. Farm production climbed by 4.8% in 2008, well above its average growth rate in recent years. This outturn was helped by unusual rains in the dry season and an expansion of output from rubber and palm oil plantations attributable to high global commodity prices. Rice production rose by 5.5% to 38.6 million metric tons of milled rice, thus meeting a government self-sufficiency target of 37 million metric tons. Government subsidies for hybrid seeds and fertilizer, as well as the good weather, spurred rice production.

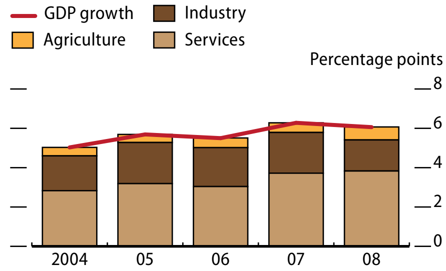
Merchandise exports in nominal terms rose by 18.0% to $139.3 billion for the whole year 2008 on account of higher global prices for commodities, including coal, oil and gas, palm oil, and rubber. However as the global downturn deepened, total exports dropped by 8.5% in the fourth quarter from the prior-year level (Figure 3.24.4).

Merchandise imports surged at double the pace of exports in 2008, to $116.0 billion, reflecting higher prices for commodity imports (including oil), and buoyant domestic demand for much of the year. Import growth braked sharply in the fourth quarter, though. On these developments, the full-year trade surplus fell by 28.8% to $23.3 billion. After deficits for trade in services ($13.0 billion) and in the income account ($15.3 billion) are included, the current account surplus fell to $606 million (0.1% of GDP).

Portfolio investment outflows in the second half of 2008, prompted by rising risk aversion and heightened demand for liquidity worldwide, contributed to a deficit of $1.7 billion in the capital and financial account. The overall balance of payments was in deficit by $1.9 billion. International reserves fell by $5.3 billion over 2008 to $51.6 billion (4.3 months of imports of goods and services), in part a result of the capital outflows and of central bank sales of foreign exchange to support the rupiah. Total external debt as a share of GDP was about 34%, steady with 2007, but down from 55% in 2004. The debt service ratio over the 4-year period fell to an estimated 18% from 27.1%.

Spurred by rising global prices of oil and food, inflation nearly doubled from 6.6% year on year in late 2007 to a peak of 12.2% in September 2008. Bank Indonesia eventually responded to the inflation surge and raised its policy interest rate between May and October, from 8.0% to 9.5%. Inflation eased a little to 11.1% by year-end (Figure 3.24.5), for a year-average rate of 10.3%. As global commodity prices fell back

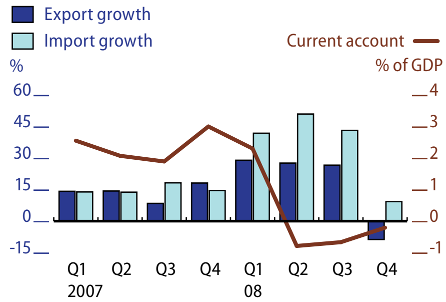
3.24.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 17 February 2009.

Click here for figure data

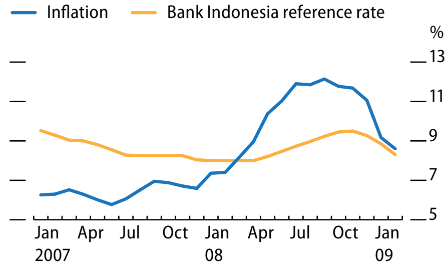
3.24.4 External indicators



Source: CEIC Data Company Ltd, downloaded 10 March 2009.

Click here for figure data

3.24.5 Policy rate and inflation



Note: Break in inflation series starting June 2008.

Sources: Bank Indonesia, available: http://www.bi.go.id; CEIC Data Company Ltd., both downloaded 17 February 2009.

Click here for figure data

and economic growth decelerated in the fourth quarter, the central bank had room to lower its policy rate, by 175 basis points to 7.75% between December 2008 and March 2009.

Broad money (M2) growth averaged 16.1% for the year, in a gradual slowing from 2007 as the central bank reduced excess liquidity in the banking system. Growth in credit to the private sector remained high for most of the year, adding to demand-side price pressures (Figure 3.24.6).

The rupiah was firm against the United States (US) dollar until the last quarter, when capital outflows contributed to a sharp depreciation and prompted Bank Indonesia to intervene in the foreign exchange market to support the currency. The year-average exchange rate against the dollar depreciated by about 6% relative to 2007, and the real effective exchange rate depreciated by 4.6%.

Yields on government bonds shot up during the global exodus from emerging markets in September and October. They came off those peaks later, but at end-2008 were still well above year-earlier levels (Figure 3.24.7).

Soaring oil prices in the first half of 2008 boosted the cost of government subsidies of fuels and electricity by about $3 billion against the planned budget target. To contain the rising cost of subsidies, the Government raised the administered prices of fuels in May by nearly 29%. It provided cash compensation to 70 million of the country's poor and near-poor to cushion the impact of the higher costs of fuel and food. The sharp slide in global oil prices late in 2008 enabled the Government to lower the price of gasoline in December and again in January 2009. Fuel prices remain administered, but the Government has introduced a monthly price review to avoid large one-time changes and to better control the impact of subsidies on the budget. Outlays on subsidies claimed 27.9% of total government expenditure last year.

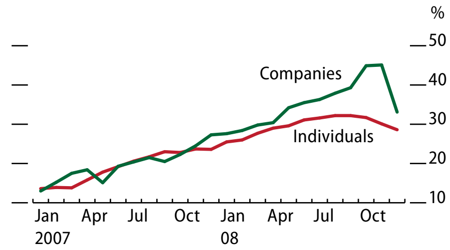
Revenue collection has increased substantially in recent years to reach the equivalent of about 20% of GDP, achieved through widening the tax net, improving tax administration, and targeting the booming commodity sectors. Last year, total government revenue rose by 38.6% and total expenditure by 30.1% (Figure 3.24.8). The fiscal deficit narrowed to 0.1% of GDP, the smallest gap in 12 years.

Economic prospects

Given the gloomy international outlook and easing inflation pressures, the forecasts assume that the Government will increase its emphasis on stimulating economic growth this year and next, while keeping the fiscal deficit to prudent levels. It can do this in part because better macroeconomic management and a stronger financial sector have put the economy in better shape than it was in the 1997–98 financial crisis. Low levels of public debt and the tight rein on the fiscal deficit in recent years provide scope for fiscal stimulation and the domestic banking sector is on a stronger footing.

The forecasts also assume that the central bank will have room to further reduce interest rates and that it will maintain banking system stability. Normal weather and absence of economically damaging natural disasters are also assumed.

3.24.6 Growth of private sector credit

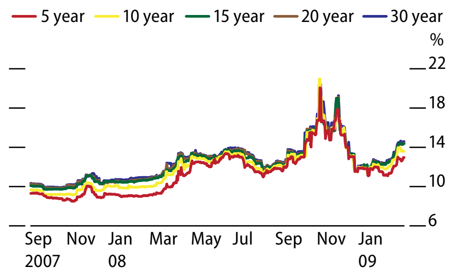


Note: Data refer to commercial bank credit.

Source: CEIC Data Company Ltd., downloaded 11 March 2009.

Click here for figure data

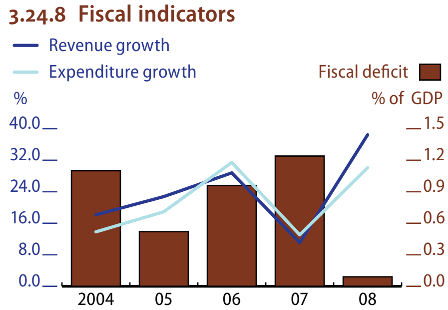
3.24.7 Government bond yields



Source: Bloomberg, downloaded 4 March 2009.

Click here for figure data

3.24.8 Fiscal indicators



Sources: Ministry of Finance; *Asian Development Outlook* database; staff estimates.

Click here for figure data

Both domestic and external demand will slow sharply this year. The external sector is expected to be a drag on growth. On the domestic side, which provided nearly all the GDP growth in 2008, private consumption growth will slacken as the labor market weakens, remittances from Indonesian workers abroad subside, and rural incomes decline. Agriculture is unlikely to grow as strongly as in 2008, when unusual rains and rising commodity prices boosted production. Forecast lower inflation in 2009 will to some degree offset these consumption-damping influences. Also, government consumption expenditure is expected to increase, a result of a fiscal stimulus package approved in February 2009 (Box 3.24.1), coupled with additional spending ahead of parliamentary elections in April this year and presidential elections in July.

Private investment will diminish in the face of subdued domestic and external demand and lower profits. Further, banks have been generally more cautious in lending since the economy started to slow. Some investment projects are likely to be postponed. The Government is taking steps to provide credit guarantees for certain infrastructure projects, but its allocations so far are low relative to overall infrastructure needs.

On the balance of these factors, GDP growth is forecast to slow to 3.6% in 2009, but pick up to 5.0% in 2010 (Figure 3.24.9), if the global economy recovers in the second half of 2010 as assumed.

Weaker domestic demand and lower prices for fuel and commodities trimmed inflation to 8.6% in February 2009, and producer-price inflation has also eased. These trends are expected to continue, bringing year-average inflation down to 6.3% this year and possibly leaving scope for a further reduction in interest rates.

With major trading partners the European Union, Japan, Korea, Singapore, and the United States in recession or headed in that direction, merchandise exports are expected to fall by at least 25% in 2009. January bodes ill for the year: they plunged 36.1% (Figure 3.24.10). For the year, average prices of most export commodities will be below last year's levels.

Import growth will slow too, along with weaker domestic demand and lower commodity prices. The trade surplus is forecast to decline to around $15 billion and the income and services accounts will remain in deficit. Remittances are projected to decline as labor markets weaken in host countries. The current account is likely to be in deficit in 2009, before returning to surplus in 2010.

A government drive to arrange external financing has bolstered the overall balance of payments. It has reached agreement with development partners to access more than $5 billion of standby loans, if conditions in international capital become too restrictive. The Government expects that the standby loans will underpin market confidence and enable it to meet financing requirements from market sources.

The authorities also moved quickly to raise funds through domestic and international bonds. They sold $3 billion in 5- and 10-year notes in February 2009 (but paying more than 8 percentage points above the comparable US Treasury yield) and sold Rp5.56 trillion ($467 million) of Islamic financial certificates, or *sukuk* bonds. Furthermore, Indonesia has access to $13.7 billion under currency swap arrangements that provide additional assurance for international reserves.

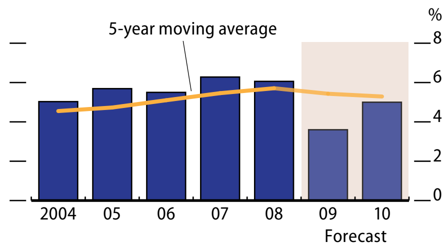
Reflecting the strengthening of the banking system since the Asian

3.24.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.6	5.0
Inflation	6.3	6.9
Current account balance (share of GDP)	-0.6	0.8

Source: Staff estimates.

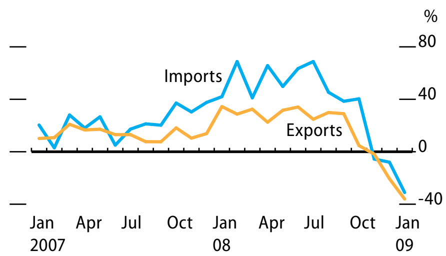
3.24.9 GDP growth



Sources: Ministry of Finance; *Asian Development Outlook* database; staff estimates.

Click here for figure data

3.24.10 Merchandise trade growth



Note: Based on customs data.

Source: CEIC Data Company Ltd., downloaded 6 March 2009.

Click here for figure data

financial crisis, capital-adequacy ratios are now generally high and the ratio of nonperforming loans was 3.8% in December 2008. Still, given strong, nearly 32% growth in lending last year, the economic slowdown will likely result in somewhat higher levels of nonperforming loans in the forecast period. The Government has expanded deposit insurance on rupiah and US dollars deposits of up to Rp2 billion ($165,000) per account since October 2008 to strengthen confidence in the banks.

Possible delays in implementing the fiscal stimulus are a risk to the above forecasts. Budgeted outlays are often not spent until the second half of the year. Delays in disbursements would be particularly harmful now, when timely action is required. The tax waivers in the package can be implemented quickly, though. Another risk is a sharper depreciation of the rupiah. This would push up prices of imports and could further erode domestic demand. Finally, consumption will be more deeply affected if job layoffs are more widespread than expected.

Development challenges

Protecting the poor will be a high priority during the economic slowdown. More than 55% of the working population lives on less than $2 a day, so these people are vulnerable to even a small loss in income. Poverty incidence, which fell from 16.6% in March 2007 to 15.4% in March 2008, is expected to slow its decline this year.

The unemployment rate is forecast to rise above 9% as layoffs spread domestically and more overseas workers lose their jobs and return home. Underemployment will likely exceed 30%. Still more people will be pushed into the informal sector—it already accounts for about two thirds of the labor force—where wages are low and job security weak.

To protect the most vulnerable groups, the Government is extending the community empowerment program that has been useful in improving basic services. It also could build on cash transfer programs, which worked well in 2008 to compensate the poor for higher fuel and food prices.

Over the longer term, the private sector would be in a position to play a greater role in creating jobs if the Government accelerated reforms to improve the business climate. Constraints to private sector expansion include poor infrastructure, uncertain laws and their implementation, and governance issues, including corruption.

Decentralization of policy making from the center to local administrations since 2001 has complicated conditions for businesses because local policies are not always coordinated with those in Jakarta. Furthermore, delays in implementation of development policies are often traced to regional governments, which now manage about 30% of the total government expenditures but do not always have the capacity to carry out major programs.

3.24.1 Fiscal stimulus

The fiscal stimulus package totals Rp73.3 trillion (1.4% of GDP), or $6.5 billion. Supplementing the original budget, it is to be carried out this year. Nearly 35% of the package is to support private consumption through waivers of income and value-added taxes and through subsidies for cooking oil and generic medicines.

Assistance for industry (about 50% of the package) includes tax breaks, waived import duties, a subsidy on diesel, discounts for electricity, and support for trade finance. Infrastructure projects (about 13% of the package) focus on labor-intensive works involving water supply projects, low-cost housing, roads, and ports. Funds will be allocated to extend the community empowerment program (about 1% of the package), which encourages village-level participation in planning and carrying out rural infrastructure, education, and health projects.

According to official estimates, the extra spending will widen the fiscal deficit to 2.5% of GDP this year.

Such a deficit appears manageable, particularly as part of it will be financed by unused budget outlays from last year. Total central government debt at end-2008 was $149.5 billion, or a relatively low 33% of GDP, and most of it is long term.

Lao People's Democratic Republic

Expansion of mining, hydropower, and services maintained robust economic growth in 2008, in a context where inflation accelerated initially, but slowed later in the year. The global economic slowdown is expected to reduce growth in 2009 through its impact on trade, tourism, and foreign investment. An immediate need is to ensure macroeconomic stability and safeguard progress achieved in recent years, including reductions in poverty. The gradual improvements in trade and investment conditions, prompted by the preparations to join the World Trade Organization, should help in that regard.

Economic performance

Solid economic growth of 7.2% in 2008—similar to the average of the previous 5 years—was based on continuing expansion of industry (especially mining and hydropower), and services. Industrial production grew by 10.2%, with increases in copper and gold mining output, power generation, and construction. Production of copper rose by 42% to about 89,000 metric tons and of gold by 4.1% to about 4.3 metric tons (Figure 3.25.1). Output of both was boosted in April 2008 when the Phu Kham copper and gold mine started production. Hydropower output rose by 5.7%, mainly a result of higher rainfall in water-collecting areas.

Services expanded by 9.7% and contributed more than half of total GDP growth (Figure 3.25.2). Subsectors to grow included finance, with the opening of four new commercial banks and expansion of two others, wholesale and retail trade, government services, and transportation and communications. However, tourist arrivals rose by just 1%, damped by the global economic slowdown and political instability in neighboring Thailand.

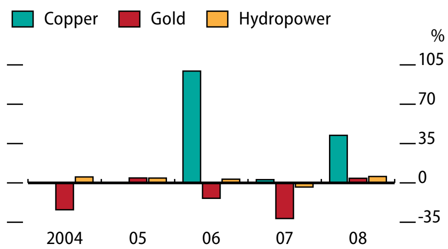
Agriculture, which employs over 70% of the labor force, was hit by severe floods in late August that damaged 10% of the arable area and curtailed production of rice and vegetables. Production increased, though, of tree crops (including coffee), livestock, and fish farming, lifting total agricultural output by 2.0%.

Early in the year, higher global prices for food, oil, and fertilizer spurred inflation, which peaked at 10.3% year on year in May 2008 (Figure 3.25.3). The Government took steps to cushion the impact of higher imported inflation. It froze the price at which it levies duties and other taxes on petroleum products at April 2008 levels; imposed a ban on exports of glutinous rice, the staple rice (partly relaxed in November); and regulated prices of some other consumption goods.

The Bank of the Lao PDR let the kip gradually appreciate against the US dollar (by 10.3% in 2008) and the Thai baht (by 15.2%; about 70% of the country's imports are from Thailand). Inflation decelerated later in 2008 when global oil and food prices eased, leaving the year-average rate at 7.6%, well up from 2007 but below the average for 2003–2007.

This chapter was written by Christopher Hnanguie and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

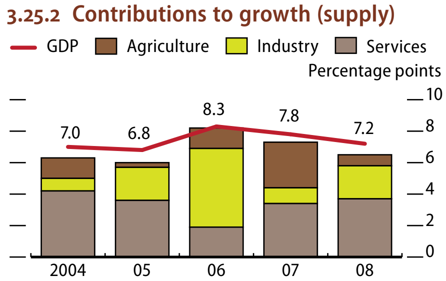
3.25.1 Energy and mineral production growth



Sources: Ministry of Energy and Mines, Lao PDR; US Geological Survey, available: http://http://minerals.usgs.gov; CEIC Data Company Ltd., both downloaded 13 March 2009; Oxiana Ltd., various annual and quarterly reports, available:http://www.ozminerals.com; Pan Australian Resources Ltd., various annual and quarterly reports, available: http://www.panaust.com.au.

Click here for figure data

3.25.2 Contributions to growth (supply)



Sources: Asian Development Outlook database; Department of Statistics of the Lao PDR.

Click here for figure data

The fiscal deficit (excluding grants) widened to an estimated 5.8% of GDP in FY2008 (ended 30 September 2008) (Figure 3.25.4). Expenditures rose to the equivalent of 20.5% of GDP. Revenue rose to 14.7% of GDP, from 14.0% in FY2007, exceeding the target for a second consecutive year. A recentralization of tax collection to the central Government from the provinces has helped revenue efforts over the past couple of years, as has improved tax enforcement and an increase in tax and royalty collections from mining (about one third of all government revenue).

A debt-sustainability analysis conducted by development institutions in June 2008 noted that external public debt declined to about $2.4 billion at end-2007, for a still-high 59.5% of GDP, from 77% of GDP 2 years earlier. Most of the debt is to multilateral development banks and the Russian Federation, and is on concessional terms.

Merchandise exports are dominated by copper and gold, followed by clothing, power, and coffee. Increased exports of these two metals drove an estimated 21.2% rise in total merchandise exports in 2008, despite weakness in the fourth quarter as a result of the slump in global copper prices (Figure 3.25.5). Clothing exports rose by 15% in 2008. Merchandise imports climbed by an estimated 11.9%, the higher cost of imported fuel being a major factor. The current account deficit widened to 18.9% of GDP. After inflows of foreign direct investment and grants, the overall balance of payments was in surplus for the first 3 quarters (the latest available data). Gross international reserves rose by almost 19% to $622 million, sufficient to cover 5 months of non-resource-related imports.

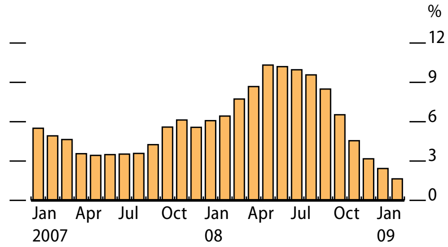
Banking, while still underdeveloped, has expanded since the Government approved a commercial banking law in 2006. In addition to three state-owned commercial banks, there are now two public–private banks, two domestic private commercial banks, and nine foreign bank branches. The state-owned commercial banks account for 59% of total banking assets, although their share is declining. Lending to the private sector more than doubled in 2008 to the equivalent of 15% of GDP. The central bank lowered its policy interest rate in three steps, from 12% to 7%, to stimulate borrowing.

Although the ratio of nonperforming loans to total loans has come down from high levels over recent years, loan quality is expected to deteriorate as the economy slows. Further progress is needed to recapitalize the state-owned commercial banks (their capital-asset ratio was 0.42% last year, compared with 15.6% for private banks) and to strengthen bank risk assessment and supervision.

Preparations to join the World Trade Organization (WTO) in 2010 were stepped up last year, with the formation of a new body to coordinate the effort and to oversee associated trade-related reforms. Laws and regulations are being changed to meet WTO requirements. The Government added an offer on market access to services to its offer on market access to goods that it submitted in 2007.

The private sector continued to develop gradually. Laws to promote business and investment that were passed some time ago are being implemented. A special economic zone is being trialed in Savannakhet province, aimed at promoting foreign and domestic investment, attracting technology and skills, and generating jobs. Faster private sector growth is retarded by poor infrastructure, cumbersome regulations, limited

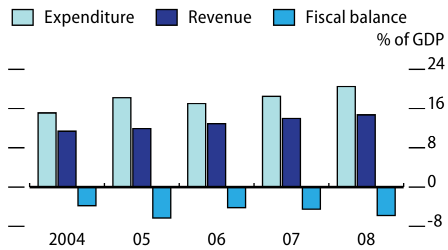
3.25.3 Monthly inflation



Source: Bank of the Lao PDR, available: www/bol.gov.la, downloaded 13 March 2009.

Click here for figure data

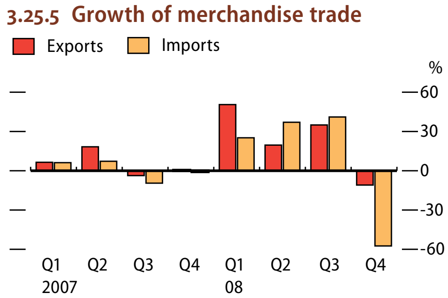
3.25.4 Fiscal indicators



Sources: *Asian Development Outlook* database; Ministry of Finance, Lao PDR.

Click here for figure data

3.25.5 Growth of merchandise trade



Sources: CEIC Data Company Ltd., downloaded 13 March 2009; staff estimates.

Click here for figure data

availability of skilled labor and finance, and inadequate land security. Boosting private activity will need a switch from the system of business licensing to one of business registration. Similarly, there is a need to enhance transparency, simplify, and define tax procedures. Another hindrance to firms is business customers' high power tariffs. In finance, the banks could assist development of small and microenterprise startups that have solid business proposals by simplifying lending procedures and clarifying which assets can be used as collateral.

Economic prospects

Growth will slow in 2009 and 2010 as the global economic downturn hits exports of clothing and copper, as well as tourism. Orders for clothing exports in early 2009 were down by 15–20%. Foreign direct investment is expected to diminish in the face of weaker prices for metals (particularly copper) and tighter international funding. Several planned projects have been delayed, including expansion of a copper and gold mine and work on three new hydropower stations. Slower export growth will curtail incomes and consumption spending, and weigh on business confidence and investment.

On the positive side, government spending on facilities for some special events will contribute to growth. The Southeast Asian Games are scheduled to be held in Vientiane late this year and the 450th anniversary celebrations for Vientiane as the capital will be held in January next year. Assuming reasonable weather, agricultural production is forecast to expand faster this year than last, when floods damaged crops. Irrigation systems are gradually improving and additional bank credit is being made available to bolster farm output. The 1,082 megawatt Nam Theun 2 hydropower project, the country's biggest, comes into full commercial operation late in 2009.

Furthermore, the Government is preparing measures to cushion the economy from the impact of the global slowdown. These include provision of credit and other support for small and medium-sized enterprises and temporary reductions in power tariffs for mining companies that face cash-flow difficulties. It is also considering suspending a 10% value-added tax that came into effect on 1 January this year. On the monetary side, the central bank is prepared to support credit for farmers and small firms.

On these factors, GDP growth is expected to decelerate to 5.5% in 2009 and stay close to that rate in 2010 (Figure 3.25.6). Year-average inflation is projected to ease to 5.0–6.0% in the forecast period (Figure 3.25.7). Lower average global oil and food prices this year will put downward pressure on inflation, though this impact is expected to be partly offset by other influences, notably the value-added tax (unless it is suspended). The current account deficit is forecast to be around 16% of GDP (Figure 3.25.8). International reserves will likely decline further as foreign direct investment and remittance inflows wane.

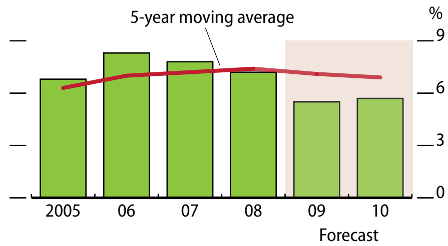
The Government plans to lift spending in FY2009 by about 10%. However, its revenue will slip by at least that rate as a result of the slump in global copper prices as well as the likely suppression of tax revenue caused by slower economic activity. The fiscal deficit is expected

3.24.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	5.7
Inflation	5.0	6.0
Current account balance (share of GDP)	-15.9	-16.0

Source: Staff estimates.

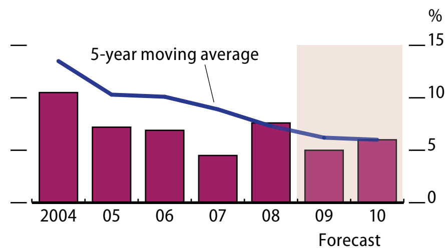
3.25.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

3.25.7 Inflation



Sources: National Statistics Center, Lao PDR; Bank of the Lao PDR, available: http://www.bol.gov.la, downloaded 18 March 2008; staff estimates.

Click here for figure data

to widen to about 5% in 2009. The authorities are therefore looking at ways to reprioritize spending so as to put more emphasis on supporting growth. In this situation, it may divert planned spending on social development, such as health and education. Fiscal strains are likely to intensify in FY2010, given the weakness in revenue and the likely need to support growth.

Risks to the above forecasts include cutbacks in mining production and the related possibility of more serious erosion than expected in government receipts. Expansion of credit by state-owned commercial banks last year, coupled with the slowing economy in 2009, raises the risk of higher nonperforming loans, which in turn could lead banks to be more cautious in their lending.

Development challenges

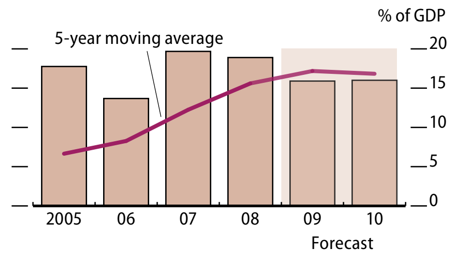
The immediate priority is to ensure macroeconomic and financial stability, and to prevent the global economic fallout from unraveling past achievements. Poverty incidence, for example, has declined, from 33% in 2002 to around 28% in 2008. At a time when the economy is slowing and vulnerable groups need to be protected, changes in budget priorities put at risk funding for social development and poverty reduction.

Other achievements that need to be upheld include the increased momentum in economic growth (averaging 7.5% over 5 years), suppression of formerly double-digit inflation, and the strengthened fiscal position. Monitoring the impact of the slowdown on the economy to enable sound policy making will require improvements in the timeliness and reliability of economic and financial data.

Closer commercial links with neighboring countries in recent years provide greater opportunities for the country to access outside markets, technology, and capital. Indeed, investment and trade have surged, mainly involving natural resources (mining, hydropower, and agriculture). It is now important to ensure that development of natural resources is environmentally sustainable.

A more diversified economy would generate more employment than is possible through mining and power generation, and would reduce vulnerability to volatile global commodity prices. In this regard, improving the environment for private sector development is key. That requires addressing constraints referred to above. Shortages of skilled labor indicate that education and training should be high on the list of priorities for investing the public revenue from minerals and hydropower. Related to skill shortages is weakness in public services because, although the Government has rolled out reforming policies, it has very limited capacity to carry them through, in particular at the local level.

3.25.8 Current account deficit



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Malaysia

Growth in this trade-sensitive economy came to a virtual halt in the second half of 2008 as the global environment deteriorated. Inflation began to moderate in tandem with slowing growth. With external demand looking bleak, GDP is likely to contract this year, before resuming growth in 2010. The authorities have pushed through fiscal and monetary measures to support domestic demand. In view of the large current account surplus, substantial foreign reserves, and disinflation, the Government has scope to stimulate the economy without endangering macroeconomic stability.

Economic performance

Intensification of the global economic downturn in the second half of 2008 was a major factor in slowing GDP growth sharply, as exports and industrial output declined, and the momentum in services growth eased. GDP rose by just 0.1% year on year in the fourth quarter of 2008, the lowest rate since the third quarter of 2001 and down from 7.4% in the first quarter of 2008 (Figure 3.26.1). Strong growth in the first half resulted in an expansion of 4.6% for the year as a whole, below the average 6.0% rate in the previous 5 years.

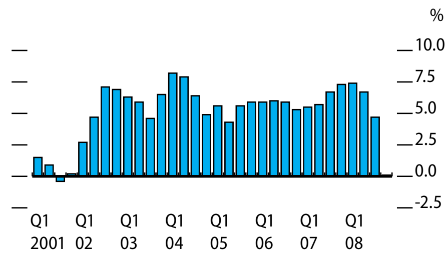
Growth in services, which account for 54% of GDP, slowed from a hectic pace as overall economic activity moderated, but still expanded by 7.3% in 2008. This rate was higher than the average performance in recent years, and was supported by wholesale and retail trade, finance and insurance, and government services, which together account for about 31% of GDP. Services contributed about 4 percentage points of total GDP growth.

Industry, making up 39% of GDP, posted weak growth of 0.9%. Manufacturing, the main subsector, slowed significantly with the downturn in external demand. Although production for the domestic market held up fairly well, output of export-oriented manufacturing, such as electronics, contracted in the second half. Mining production was also weak, as the increase in oil output was largely counterbalanced by the decline in natural gas production as a result of repair and maintenance of some plants and pipelines.

Solid growth of 3.8% in agriculture (about 7% of GDP) reflected a healthy rise in output of livestock, fisheries, fruits, vegetables, paddy, and, in the first half of the year, palm oil.

Consumption provided the impetus to growth in aggregate demand (Figure 3.26.2). Private consumption (just over half GDP) grew by a buoyant 8.4% in 2008. It benefited from an increase in rural incomes that stemmed from high commodity prices in the first half of 2008; low real interest rates; more intense competition among retailers, especially hypermarkets; and a substantial increase in civil servants' salaries in July 2007. A stable labor market supported private consumption: the

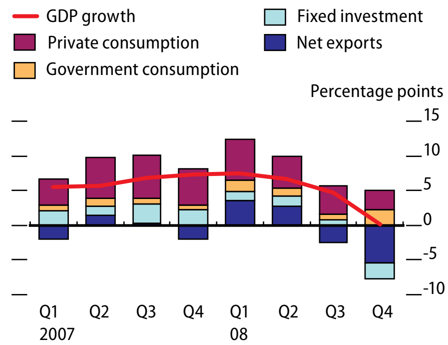
3.26.1 GDP growth



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 27 February 2009.

Click here for figure data

3.26.2 Contributions to growth (demand)



Sources: CEIC Data Company Ltd.; Bank Negara Malaysia, available: http://www.bnm.gov.my, both downloaded 27 February 2009.

Click here for figure data

This chapter was written by Sharad Bhandari of the Southeast Asia Department, ADB, Manila.

unemployment rate was 3.1% in the third quarter, unchanged from a year earlier. (However, employment as a share of the working-age population declined from 61.4% to 60.9% over the period with a fall in the labor-force participation rate, indicating an increasing number of people dropping out of the workforce.)

Government consumption rose by 11.6%, reflecting primarily the higher salaries for civil servants. The contribution of net exports to GDP growth fell as the global downturn worsened, but domestic demand and hence imports were more resilient. For the year as a whole, net exports subtracted 0.5 percentage points from overall GDP growth.

After 2 years of strong growth, fixed investment slowed sharply last year. A steady deterioration in the global economic environment, particularly weakness in demand for electronic products, and domestic political uncertainty crimped investment growth. (The ruling coalition lost its two-thirds majority in the National Assembly in the March 2008 elections.) Fixed investment declined to 19.7% of GDP in 2008 from an average 21.3% of GDP in the previous 5 years (Figure 3.26.3).

Much of the moderation in fixed investment in 2008 appeared to reflect subdued private investment, while public investment was supported by projects under the Ninth Malaysia Plan 2006–2010. Federal government capital spending rose by 21% during the first 3 quarters of 2008.

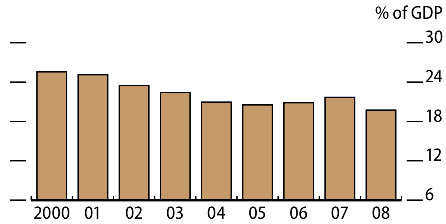
Merchandise exports in nominal ringgit terms fell from year-earlier levels in the last quarter (Figure 3.26.4) as global demand weakened and prices of most commodity commodities dropped. For the full year though, exports were up 9.6%, boosted by an increase of almost 40% in major commodity exports, especially palm oil, petroleum, and natural gas. Resource-based manufactured exports, such as food, petroleum products, and rubber, as well as chemical products, also rose strongly. The rise in these exports more than offset continued weakness in electrical and electronic exports (42% of total exports).

Imports posted modest 3.3% growth in 2008, reflecting the import-intensity of electrical and electronic exports (imports of electrical and electronic components account for more than a third of total imports), softer prices of manufactured imports and, in the latter half of the year, the slowdown in domestic demand.

The consequent rise in the trade surplus helped raise the current account surplus to an estimated 17.9% of GDP. The services account retained a reasonable, albeit lower, surplus in the first three quarters of 2008 (the latest data available). A services surplus had been realized for the first time in 2007, partly owing to a strong increase in tourism receipts as a result of promotional activities, including Visit Malaysia Year. These receipts remained buoyant in 2008, though growth decelerated. The income and transfers accounts are likely to have recorded deficits of 2–3% of GDP, as in 2007.

The overall balance of payments posted a deficit for the year as a whole. Net portfolio investment outflows accelerated in the second half, reflecting more intense risk aversion and deleveraging by international investors. Inward foreign direct investment flows moderated and direct investment abroad by Malaysian companies continued to increase, leading to a net outflow (Figure 3.26.5). International reserves fell by about $12 billion during the year to $89.8 billion, sufficient to cover

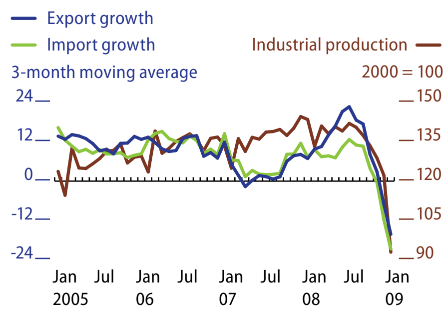
3.26.3 Fixed investment ratio



Source: Asian Development Outlook database.

Click here for figure data

3.26.4 Trade and industrial production

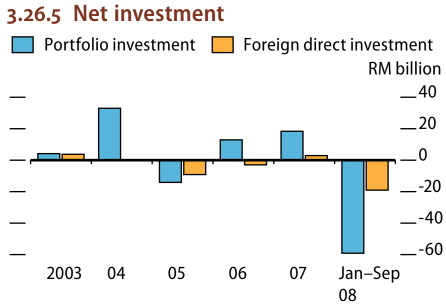


Note: Exports and imports based on customs data.

Source: CEIC Data Company Ltd., downloaded 13 March 2009.

Click here for figure data

3.26.5 Net investment



Source: CEIC Data Company Ltd., downloaded 27 February 2009.

Click here for figure data

6 months of imports and more than three times the level of short-term external debt.

The reduction in net foreign assets thus subtracted from liquidity growth toward the end of the year, in contrast to earlier months (Figure 3.26.6). However, M3 growth slowed only slightly, with a rise in the financial system's net claims on government (reflecting an expansionary fiscal stance) taking up some of the slack.

Inflation spiked in June 2008 to 7.7%, largely a result of a reduction in fuel subsidies. It peaked in July, when electricity tariffs were raised (Figure 3.26.7.) Subsequently, the fall in global commodity prices, along with slowing domestic demand, eased inflation pressures. Still, average inflation for the year was 5.4%, more than double the average of the previous 5 years.

The central bank, Bank Negara Malaysia, took several steps to ensure financial stability and support growth. It provided, in October 2008, full guarantees on local and foreign currency deposits of financial institutions through end-2010 in order to thwart potential instability in the financial system as the global credit crisis intensified. As the growth outlook deteriorated, leading to expectations of a steady deceleration in inflation, the central bank also eased its monetary policy stance. From November 2008 to February 2009, it lowered the overnight policy rate by a total of 150 basis points to 2.0%. It accompanied these cuts by lowering the statutory reserve requirement for banks by 300 basis points to 1% of their eligible liabilities.

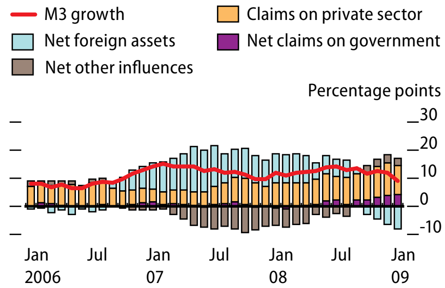
The Government leaned toward a more expansionary fiscal policy. The overall federal fiscal deficit widened to an estimated 4.7% of GDP (Figure 3.26.8). Revenue was boosted by strong first-half economic growth and higher average energy prices (receipts from oil and gas account for over 30% of total government revenue). Expenditure increased more rapidly than expected as a result of higher subsidies and civil service salaries, and, to a lesser extent, greater development spending.

In addition to these more expansionary monetary and fiscal policies, the Government launched measures to attract investment. To ensure smooth implementation of approved projects (in 2003–2008, a significant 77% of approved projects were implemented) and to sustain the interest of investors, the authorities exempted raw materials and intermediate goods for manufacturing from all duties; moved to automatic issuance of manufacturing licenses from December 2008; and established one-stop centers for investors at the local level.

Economic prospects

Malaysia is closely integrated with the global economy: exports of goods and services are equivalent to over 100% of GDP, as are imports. The severity of the global economic downturn and shrinking world trade are expected to tip it into contraction in 2009. GDP is forecast to shrink by 0.2%, the first annual fall in output since 1998. The expected drop in commodity prices from 2008 levels will hurt export earnings and fiscal revenue, but should also damp inflation pressures, bolster the purchasing power of consumers, and enable the diversion of fiscal spending from subsidies to more productive development expenditure. The projections

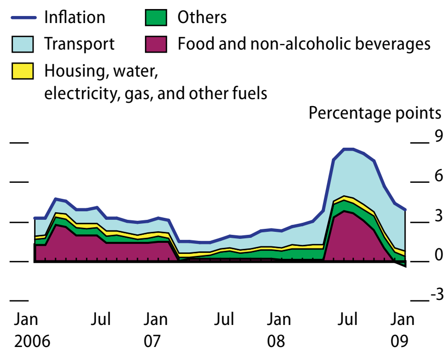
3.26.6 Contributions to M3 growth



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 4 March 2009.

Click here for figure data

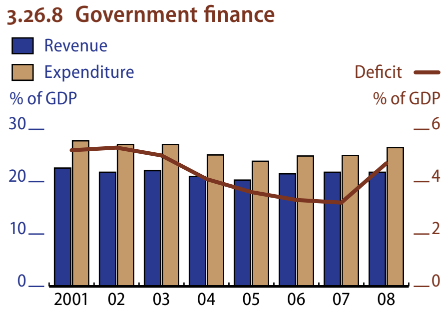
3.26.7 Contributions to inflation



Source: CEIC Data Company Ltd., downloaded 4 March 2009.

Click here for figure data

3.26.8 Government finance



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 27 February 2009.

Click here for figure data

for the economy this year assume that the authorities can implement expansionary fiscal policies in a timely manner, and that the political environment remains stable.

Private consumption and government spending are likely to support demand. Private consumption will be assisted by slowing inflation, continued low real interest rates, and a government decision last year to reduce employees' mandatory pension fund contributions for this year and next. These factors will offset some of the adverse impact of the economic slowdown on employment and earnings. Public consumption and investment will no doubt remain strong, given the Government's determination to provide a stimulus. During the midterm review of the Ninth Malaysia Plan last year, the Government significantly increased the allocation for development spending for 2008–2010.

Exports in real terms are likely to contract this year for the first time since 2001, when the global technology bubble burst. This time, the slump in external demand is more severe given the synchronized nature of the global downturn. Imports are likely to decline at a somewhat slower rate than exports, held up somewhat by consumption and public investment. Net exports are therefore likely to subtract from overall demand growth.

The services and agriculture sectors will slow from their robust pace in recent years. Among the major services subsectors, relatively resilient private consumption and continued efforts to promote tourism should offset some of the fallout from the decline in external trade to hold up wholesale and retail trade. Manufacturing, though, is expected to contract, mainly because of the drop in exports. Assuming normal weather conditions, agriculture may expand at close to 4%, supported by government programs to increase food production, including aquaculture.

The current account surplus will narrow in the forecast period (Figure 3.26.9), but at about 14.0% of GDP it will still be large. Merchandise exports are likely to contract more than imports, reflecting the expected fall in global commodity prices as well as lower volumes. The services account is expected to retain a small surplus.

Monetary policy is likely to remain loose as inflation pressures recede, reflecting slower economic growth and excess capacity, falling commodity prices, and lower imported inflation. A reversal in producer prices, from a rise of 14.4% in July 2008 to a decline of 4.5% in January 2009, presages a further moderation of consumer prices. Since the consumer price index is coming off a high base, the year-on-year rate is likely to turn down quite sharply in the second half of this year. The year-average inflation rate is forecast at 1.5%. Expansionary monetary and fiscal policies are expected to keep the economy away from deflation.

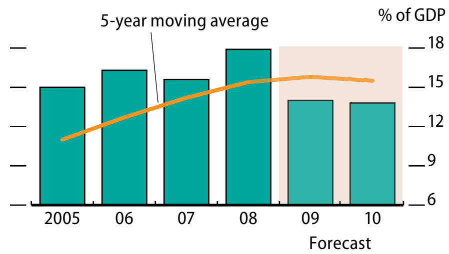
Slower inflation, the large current account surplus, and a comfortable level of international reserves afford the authorities scope to stimulate the economy without jeopardizing macroeconomic stability. The financial system is liquid, with healthy growth in both deposits (9.2% year on year in January 2009) and loans (11.7%). The loan-to-deposit ratio and the financing-to-deposit ratio of 73.4% and 80.9%, respectively, suggest that a higher fiscal deficit can be financed without crowding out the private sector. The banking system's fundamentals are also strong, providing a substantial cushion against the likely adverse impact on banks' balance sheets of the economic slowdown. For example, nonperforming loans

3.26.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.2	4.4
Inflation	1.5	2.4
Current account balance (share of GDP)	14.0	13.8

Source: Staff estimates.

3.26.9 Current account balance



Source: Asian Development Outlook database.

Click here for figure data

have continued to decline to 2.2% of banks' total loans and the risk-weighted capital-adequacy ratio is comfortable at 12.6%.

Bank Negara Malaysia has established an RM2 billion (about US$550 million) facility, which enhances small and medium-sized enterprises' access to financing from February through December this year. The central bank is providing guarantees on financing provided by banks to these firms for up to RM500,000 each and for tenors of up to 5 years. This follows the establishment last year of an RM200 million Micro Enterprise Fund as well as of two other funds to help small companies meet rising costs and to assist in the upgrading of equipment, especially for energy saving. The latter two funds have been fully used.

As the fall in international fuel prices in the latter part of the year obviated the need to provide subsidies, some of these savings were deployed toward an RM7 billion (about 1% of projected GDP) economic stimulus package. It was announced in early November and is to be implemented this year. By March 2009, RM6.5 billion had been channeled to various line agencies to implement the package. The Government expects RM5.2 billion of projects to be under way by June this year.

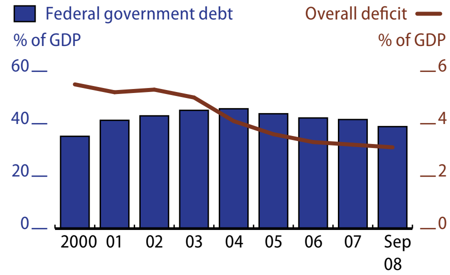
Another RM60 billion (close to 8% of projected GDP) of stimulus measures was announced in March 2009, to be implemented this year and next. These measures include RM25 billion in guarantee funds to provide easier access to capital for companies; an increase in direct budget spending of RM15 billion (of which RM10 billion is allocated for 2009); RM10 billion for equity investments by Khazanah Nasional Berhad (the Government's investment holding company) in subsectors including telecommunications, tourism, and agriculture; RM7 billion in projects under public–private partnerships and other off-budget projects such as the low-cost carrier terminal at the Kuala Lumpur International Airport and expansion of Pulau Pinang airport; and RM3 billion in tax incentives.

Outlays on the stimulus measures and likely sluggishness in government receipts indicate that the fiscal deficit this year may exceed 7% of GDP. Deficits were at least 5% in 2000–2003. Public debt rose from 35% of GDP in 2000 to a peak of 46% in 2004, before trending down to 39% in the third quarter of 2008 (Figure 3.26.10), reflecting the Government's efforts at fiscal consolidation.

Public debt will likely increase over the next few years, but the cost of debt should be manageable as interest rates are somewhat lower than earlier this decade (Figure 3.26.11), reflecting ample liquidity in the financial system and looser monetary policy. Furthermore, 93% of the federal Government's debt comprises domestic debt, mostly held by domestic institutions. (Moody's Investors Service in February 2009 affirmed its A3 rating with a stable outlook on sovereign debt). The likely increase in public debt suggests, though, that fiscal consolidation will need to resume quickly once the economy is on the path to recovery, as it was in 2003–2007.

If the global economy recovers in 2010 and world trade expands in line with global assumptions, the Malaysian economy is expected to resume growth at about 4.4% next year (Figure 3.26.12). The lagged effects of this year's monetary and fiscal stimulus should provide impetus to growth. With firmer external and domestic demand, and the moderate increase in global inflation, consumer prices will likely rise next year by

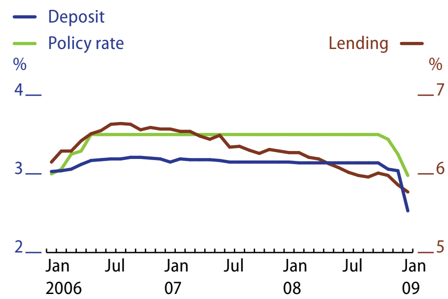
3.26.10 Fiscal indicators



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 4 March 2009.

Click here for figure data

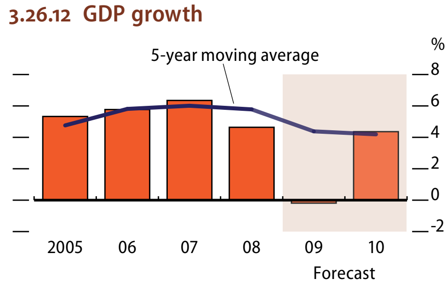
3.26.11 Nominal interest rates



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC data Company Ltd., both downloaded 4 March 2009.

Click here for figure data

3.26.12 GDP growth



Source: Asian Development Outlook database.

Click here for figure data

close to their 10-year average of 2.4%. The current account surplus looks likely to remain at around 14.0% of GDP.

Domestic risks to the outlook are centered on the measures to stimulate the economy—their effectiveness may be compromised if they are not implemented in a timely fashion.

Development challenges

As an upper-middle-income country, Malaysia can no longer rely on low wages and the accumulation of physical capital to sustain the robust levels of growth achieved in the past. Nor can it continue to follow that model to reach its goal of becoming a fully developed economy by 2020. Growth in the future will increasingly depend both on a move into activities that are intensive in knowledge, skills, and technology, and on an increase in total factor productivity.

The midterm review of the Ninth Malaysia Plan published in July 2008 showed that progress was largely on track to meet the targets. (The Plan is further discussed in Box 3.26.1.) In 2006–2007, economic growth averaged 6.1% (the target is 6%), employment rose by 2.2% (the target is 1.9%), and productivity improved as indicated in Malaysia's higher rankings in international comparisons of competitiveness. Incidence of absolute (i.e., food) and overall poverty fell from 2.9% and 5.7%, respectively, in 2004 to 0.7% and 3.6% in 2007. However, the global economic downturn makes it harder to reach the plan targets by 2010.

Eradicating poverty and reducing regional income disparities is another challenge. While the overall poverty rate declined from 22.8% in 1990 to 3.6% in 2007, the rate varies significantly by state, ranging from negligible in Pulau Pinang to a high of 16% in Sabah. The rates are also higher in rural areas (7.1%) than in towns (2.0%). Robust economic growth would help maintain progress in overall poverty reduction, but would probably be insufficient to eradicate remaining pockets of poverty.

To bridge the gap between regions, the Government has planned five development corridors, with the private sector expected to take the lead in developing industries in these areas. Programs to increase access of households in the poorer areas to markets and social services, as well as incentives for firms to invest in those areas, will be important components of the effort to promote equity among regions.

3.26.1 Ninth Malaysia Plan

The Ninth Malaysia Plan 2006–2010 promotes a private sector–led growth strategy to shift the economy up the value chain and boost productivity. Although the share of private investment in GDP rose from 11.3% in 2005 to 11.9% in 2007, it remained relatively modest.

The Government recognizes the benefits of greater private sector participation in the economy in terms of more efficient utilization of resources, innovation in production and distribution, and better service for customers. This underscores the need for continued progress in improving the investment climate so as to encourage private firms to invest and innovate.

In this regard, improvements in the education and training systems are particularly important.

Public–private partnerships envisaged in the Ninth Plan aim to improve the delivery of infrastructure and public services. To the extent that such partnerships entail greater financing by the private sector, their effective implementation would also help reduce the burden on government finances, as well as achieve gains in economic efficiency.

Myanmar

High prices for natural gas exports continued to support modest rates of growth in FY2007. Inflation remained at around 30%, largely the result of money creation to finance fiscal deficits. Recovery and reconstruction after Cyclone Nargis, which inflicted severe human loss and economic damage in May 2008, will take at least 3 years. Economic growth will be diminished this year by weaker performance of Myanmar's major trading partners.

Economic performance

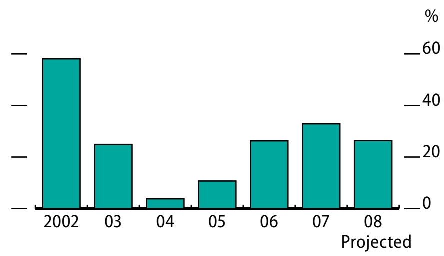
Modest growth and high inflation again characterized the economy in FY2007 (ended 31 March 2008). Official statistics indicate growth in excess of 10% since 2000, but this is not consistent with other variables closely correlated with GDP, such as energy use. Nonofficial estimates put GDP growth at less than half the official estimates. Agriculture remains the dominant sector, contributing about 44% of GDP. Industry, including the natural-gas export segment, accounts for about 20% of GDP, and services the rest. An estimated two thirds of Myanmar's population live in rural areas, often working on small farms or as laborers.

Early on 3 May 2008, Cyclone Nargis hit land at one of the lowest points in Myanmar, setting off a storm surge almost 12 feet high that reached 25 miles inland. The storm laid waste hundreds of villages across large parts of the Ayeyarwaddy River delta, a leading agriculture-producing region, and damaged Yangon, the main city. The cyclone resulted in large-scale casualties, with more than 77,000 people killed, 20,000 injured, and 55,000 still missing. About 2 million people lost their homes and had their livelihoods disrupted. Economic losses were estimated at the equivalent of 2.7% of the officially projected national GDP in 2008.

The Government continued its modest steps to liberalize agriculture. It has ended most production controls and mandatory procurement and, apparently, has eliminated a previous requirement for farmers to grow rice as a dry-season crop in irrigated areas. State enterprises are sourcing more of their agricultural inputs at market prices. Some state enterprises involved in processing and supplying inputs to agriculture have been privatized.

Marketing controls in agriculture have been made less onerous, and farm production has increased in recent years. Although the country used to be a major rice exporter, the Government banned exports of rice and some other farm products in 2004 in an attempt to hold down domestic prices. The rice export ban was relaxed a little in 2006 and eased further in FY2007, when official exports rose to almost 360,000 metric tons (there were also unrecorded exports to neighboring countries). The Government expects another substantial increase in exports in FY2008, despite a 5-month suspension of rice exports following the cyclone.

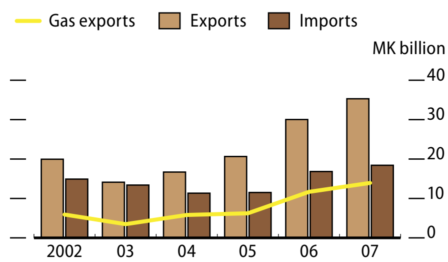
3.27.1 Inflation



Sources: Myanmar Central Statistical Organization, available: www.csostat.gov.mm, downloaded 27 February 2009; staff estimates.

Click here for figure data

3.27.2 Merchandise trade indicators



Source: Myanmar Central Statistical Organization, available: www.csostat.gov.mm, downloaded 27 February 2009.

Click here for figure data

This chapter was written by Pradeep Srivastava of the Southeast Asia Department, ADB, Manila.

The fiscal deficit narrowed to about 3.5% of GDP in FY2007. Rapid growth in tax revenue is a result of improvements to tax administration since 2004, and state enterprises have been increasingly allowed to raise prices closer to market rates. Even with salary increases for civil servants in FY2007, current expenditure was contained. Spending on health and education remains low. However, greater capital outlays, especially on the remote new capital city of Naypyidaw and on the Yangon–Mandalay highway, continue to put pressure on the fragile fiscal position.

Fiscal deficits are financed by central bank money creation, which pushed up broad money supply by nearly 30% in FY2006 and by about 20% in FY2007, in turn propelling inflation to around 30% in both years (Figure 3.27.1 above). Shortages after the cyclone caused short-lived spikes in the price of rice and construction materials.

Rising export income from gas (Figure 3.27.2 above) continues to support the external accounts. The current account surplus was almost 10% of GDP in FY2007. Gross international reserves rose to an estimated $3.4 billion, equivalent to more than 1 year of imports.

Myanmar has a multiple exchange-rate system in which the official rate applies only to transactions undertaken by the Government and state enterprises; it is thus used primarily for accounting purposes. For external transactions, the Government issues foreign exchange certificates, exchangeable at market-determined rates. A large parallel market also flourishes, which exchanges United States dollars for kyats at a small premium over the rate for foreign exchange certificates. This parallel rate was fairly steady at around MK1,200–1,300/$1 in 2008.

Economic prospects

Recovering from the devastation of Cyclone Nargis is the priority. A plan has been prepared under the auspices of the Tripartite Core Group, comprising the Government of Myanmar, the Association of Southeast Asian Nations, and the United Nations. To be funded by donors, the plan proposes a $690 million recovery program during 2009–2011. By end-2008, commitments to the plan totaled $466 million. The Government is making its own reconstruction arrangements as well, but has not given details.

This spending on reconstruction will contribute to growth. Against that, weaker economic performance in People's Republic of China, India, and Thailand—Myanmar's major trading partners—is likely to put downward pressure on export prices of gas and agricultural products. It is also likely to reduce remittances from Myanmar workers there. On balance, GDP growth is forecast to slow in FY2008 and FY2009. The current account is expected to remain in surplus, supported by the planned inflows of foreign aid.

Myanmar has faced international economic and diplomatic sanctions for much of the past two decades. Immediately after the cyclone, the Government did not allow personnel and aid supplies from international agencies into the country, but later in the year it offered cooperation with the agencies. This engagement opens the possibility that cooperation on aid might be broadened to include areas not directly affected by the cyclone, but where poverty reduction is urgently needed. The Tripartite Core Group may well continue to play a role in managing such assistance.

3.27.1 Development challenges

The agenda of required reforms is extensive. Further liberalization of agriculture, domestic trade, and state enterprises would promote growth and help strengthen the fiscal position, paving the way for an increase in spending on poverty reduction, health, and education.

Development of banking and a domestic bond market would help mitigate the need to monetize deficits—a process that feeds into high inflation—while a unified exchange rate would reduce pricing distortions and strengthen incentives in the economy.

Improvements in the environment for private-sector development would lift investment, including nonenergy sectors, and so stimulate growth and employment. Higher standards of governance and transparency are among the requirements for a better business climate.

Limited by weaknesses in human and financial capacity and institutions, official data generally lack timeliness, reliability, and comparability. Strengthening such resources would allow the authorities greater economic assessment capabilities to serve as a base for enhanced policy making.

Philippines

GDP growth slowed sharply in 2008, largely reflecting the effects of decade-high inflation on consumption and of weakening global demand for exports. The Government has eased fiscal and monetary stances and plans a stimulus package. These moves should mitigate the slowdown caused by a forecast decline in exports and sluggish domestic demand, and help protect the poor. But they will not prevent a slide in growth this year.

Economic performance

Hampered by a surge in inflation and weaker external demand, GDP growth slowed to 4.6% in 2008 from 7.2% in 2007. Gross national product, which includes remittances from nearly 9 million Filipinos working abroad, decelerated to 6.1% from 8.0% last year. These remittances rose by 13.7% to $16.4 billion last year, or by about 9% in peso terms, helping support consumer spending. However, rising prices for food and fuel squeezed such spending, which accounts for about 77% of aggregate demand, slowing its growth to 4.5%. Still, private consumption contributed most to GDP growth from the demand side (Figure 3.28.1). Growth in government consumption spending also ebbed, partly owing to a high base effect from election spending in 2007.

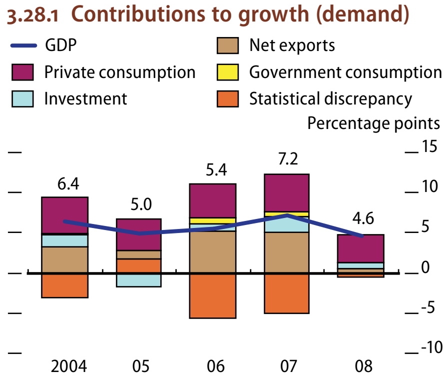
Fixed capital investment decelerated sharply to 3.7% growth last year, from 11.8% in 2007, mainly because of a slowdown in public construction from the high level seen in the 2007 election year. Investment outlays on durable equipment rose by just 1.7% for the year, and contracted in the fourth quarter. The investment ratio—gross fixed capital formation as a share of GDP—at 14.8% was unchanged from 2007, but down by about 6 percentage points from 21% in the early years of this decade (Figure 3.28.2). Total investment contributed less than 1 percentage point to GDP growth. Net exports made a small contribution only, reflecting weaker global demand.

Services, by far the biggest supply-side contributor to GDP growth (Figure 3.28.3), saw growth pull back to 4.9%, as higher prices for fuel and food damped consumer spending. Communications and domestic trade recorded the slowest growth in over a decade, at the same time as expansion of the finance subsector abated.

As for industry, its growth eased to 5.0% last year. Manufacturing (about 70% of the sector) grew by 4.3%, slightly faster than in 2007, although its expansion faltered in the fourth quarter when external demand shriveled. Food processing stood out in manufacturing with solid growth, but production of export-oriented electrical machinery (including semiconductors) and textiles fell. Private construction maintained double-digit expansion, assisted by housing investments from overseas workers, but public construction activity contracted after rapid growth in

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

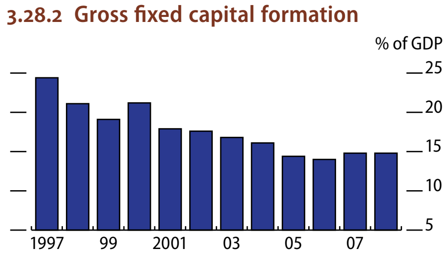
3.28.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

Click here for figure data

3.28.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

Click here for figure data

2007. Mining output was virtually flat, and declining metal prices as the year progressed prompted the deferral of some new mining operations. Agriculture (including fisheries and forestry) grew at a 3-year low of 3.2%, as a result of much higher fertilizer and fuel costs.

Surges in the price of rice and other food (food makes up about half the consumer price index), along with oil, pushed inflation to a peak of 12.4% in August 2008 (Figure 3.28.4). Looking to ensure rice supplies, the Government increased its purchases on the international market in the first half of 2008, when prices were particularly high. Rice has a weight of 9.4% in the consumer price index, so its higher price accounted for 3.7 percentage points of the inflation rate in August. As global commodity prices eased later in 2008, inflation stepped down to 8.0% by December. The year-average rate was still the highest in a decade though, at 9.3%.

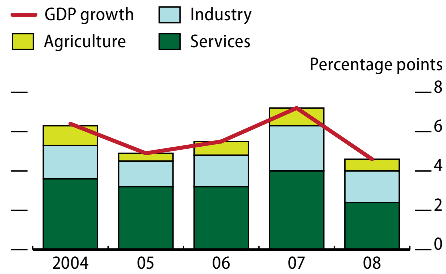
Reflecting the slowdown in external demand, merchandise exports in nominal US dollars fell by 2.6% in 2008 for the first contraction since 2001. In December, as the global downturn deepened, exports plunged by 40.3% year on year (Figure 3.28.5). They declined across all major product categories, with electronic products (about 60% of total merchandise exports) down by 8.3% in 2008 and clothing down by 15.5%. Merchandise imports nudged up by about 5.0%, driven by high world commodity prices for much of the year. The cost of crude oil imports (12.3% of total merchandise imports) shot up by 30.8%, while the cost of rice imports (about 3%) trebled from 2007's level. However, imports of capital goods declined by 4.2%, a sign of the weakness in investment.

These developments propelled the trade deficit to $12.6 billion, from $8.4 billion a year earlier. Inflows of remittances helped keep the current account in surplus, although that surplus fell to $4.2 billion (2.5% of GDP). The surplus in the capital account likewise was sapped by portfolio investment outflows, and inflows of foreign direct investment fell to $1.5 billion. The overall balance-of-payments surplus was $89 million, down from a record $8.6 billion in 2007. This put downward pressure on the peso, which lost 13.0% against the US dollar over the course of 2008.

Gross international reserves rose to $37.6 billion at end-2008, largely on account of government borrowing abroad and a revaluation of gold assets in line with higher world bullion prices. Reserves climbed further by February 2009 to $38.9 billion (6.2 months of import cover and 4.6 times short-term external debt based on original maturity), reflecting proceeds from a government bond issue, loans from multilateral development banks, and privatization of the National Power Transmission Corporation.

After reining in the fiscal deficit over several years, the Government changed tack in 2008 given need to provide more help to vulnerable groups hit by much higher food and fuel prices. Among other assistance, it provided cash transfers to poor families to send their children to school and to pay for electricity, and exempted minimum wage earners from income tax. In addition, the rice subsidies targeted at the poor were much more costly to the budget in 2008, when the price of rice soared. Total government expenditure rose by 10.6% (or 13.3% excluding interest payments). Tax revenue increased by 12.5%, though still below the official target. The Government postponed its goal of achieving a balanced budget

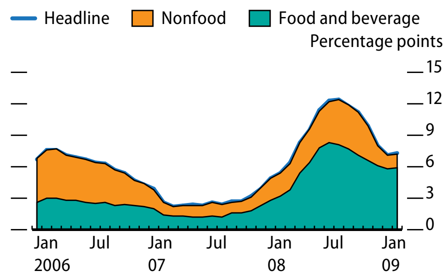
3.28.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

Click here for figure data

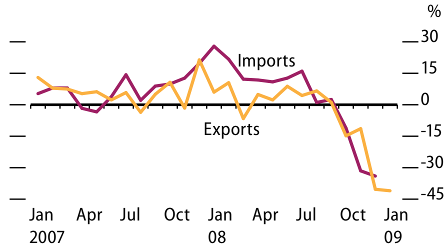
3.28.4 Contributions to inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., both downloaded 10 March 2009.

Click here for figure data

3.28.5 Merchandise trade growth



Note: Based on customs data.

Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., both downloaded 10 March 2009.

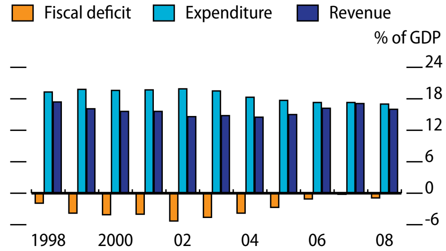
Click here for figure data

in 2008, instead recording a fiscal deficit of 0.9% of GDP (including about $700 million of privatization receipts as revenue) (Figure 3.28.6).

Leaning against inflation pressures, Bangko Sentral ng Pilipinas hiked its policy interest rates by 100 basis points between June and August 2008. Later, as inflation slowed and global weakness heightened risks to economic growth, it cut the policy rates by 125 basis points from December 2008 to March 2009, bringing its overnight lending rate down to 6.75%. It also lowered commercial bank reserve requirements by 2 percentage points in November and took steps to guard against tight liquidity in the banking system, including liberalizing banks' access to the rediscounting facility. Broad money (M3) growth picked up to 15.6% in December from 10.6% a year earlier.

Job creation remained lackluster—average employment growth slowed to 1.6% in 2008 from 2.8% in 2007. The unemployment rate rose to 7.7% in January this year from 7.4% a year earlier. Underemployment remained at around 18% of the workforce.

3.28.6 Fiscal indicators



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

Click here for figure data

Economic prospects

The outlook is for a further deceleration in economic growth in 2009 as global demand weakens for both exports and workers from the Philippines, damping consumption and investment. Projections assume that fiscal and monetary policies remain accommodative, and that there is limited adverse impact on investor sentiment arising from the national and subnational elections scheduled for May 2010.

Consumer spending, though benefiting from the downtrend in inflation, is projected to grow by just 3.0%. That is because remittance inflows will likely flatten in US dollar terms as labor markets weaken worldwide. The number of workers going abroad last year rose until November on a year-on-year basis, but then fell by 5.8% in December (Figure 3.28.7). Furthermore, the domestic labor market is waning as export industries, among others, trim headcounts, alongside the prospect of an influx of unemployed overseas workers. The National Economic and Development Authority, the official development planning body, estimates that about 800,000 workers at home and abroad are vulnerable to losing their jobs.

Against that, higher public spending will support economic growth. The Government in January this year announced plans for a P330 billion ($6.9 billion) economic stimulus package. About 50%, or P160 billion, will come from budget appropriations in 2009 to expand welfare programs, such as cash transfers to poor families as well as labor-intensive infrastructure projects that can be quickly implemented, including road maintenance, reforestation, and classroom building. Another 30%, or P100 billion, is for large infrastructure projects to be funded by government corporations and the social security system.

The stimulus package also includes tax breaks, some of which were in train before the economic slowdown, and which will cost the budget P40 billion. These include an increase in individual taxpayers' personal tax exemptions and a reduction in corporate income tax from 35% to 30%.

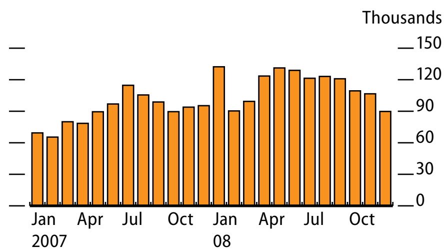
Still, both domestic and foreign private investment is expected to remain sluggish this year because of the weak demand for exports, the

3.28.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	3.5
Inflation	4.5	5.0
Current account balance (share of GDP)	1.0	2.0

Source: Staff estimates.

3.28.7 Deployed overseas workers



Source: CEIC Data Company Ltd., downloaded 18 February 2009.

Click here for figure data

global credit squeeze, and caution ahead of next year's polls. An index of business confidence for the first quarter of this year fell to its lowest level since 2002. With exports of semiconductors, textiles, and other major products slashed in recent months—total exports dropped by 41.0% in January year on year—the value of total exports is projected to fall by about 15% in full-year 2009. Imports of raw materials and intermediate products used in producing exports will fall in tandem. Weaker consumption, investment, and lower average prices of imported oil and commodities will also curtail imports.

In this context, GDP growth is forecast to slow to 2.5% in 2009 (Figure 3.28.8). It is seen picking up in 2010 to 3.5%, if the global economy and trade both rally late next year as assumed. Accommodative monetary and fiscal policies are expected to contribute to the pickup. The current account is seen retaining small surpluses.

From the production side, industry will be hurt this year by depressed demand for manufactured exports, and private construction by weaker growth in incomes and flattening remittance inflows. This will be somewhat counterbalanced by higher public construction resulting from the lift in government spending. Services, particularly those linked to retail trading and real estate, will be hit by the impact of the slackening labor market on consumption and by the expected zero remittance growth. Financial services are unlikely to expand much at a time of global financial turmoil, given the banks' extra caution.

Inflation is set to moderate to 4.5% on average in 2009, a result of the economic slowdown and lower prices for imported oil and food (Figure 3.28.9). In January and February this year, inflation averaged 7.2%, declining toward levels last seen in the first quarter of 2008. That could pave the way for further easing in monetary policy to support growth.

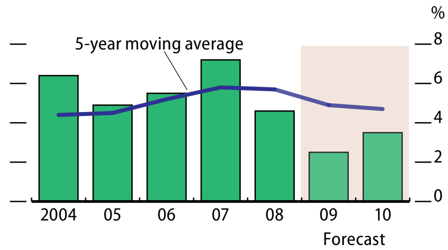
With fiscal spending projected to rise substantially, the budget deficit could widen to about 2.5% of GDP (Figure 3.28.10). Fiscal slippage much beyond this risks unsettling financial markets and rating agencies, raising borrowing costs. In early 2009, Moody's reaffirmed its positive rating outlook, and Fitch and Standard and Poor's their stable outlook, on Philippine sovereign debt.

The agencies underscored the need for the authorities to intensify revenue-raising efforts to support their higher planned spending. This is especially important since revenue will be curtailed this year both by the impact of the economic slowdown on taxes and by the tax breaks provided in the stimulus package.

Amounts raised from the scheduled sale of more state-owned assets will depend partly on the state of financial markets. In January this year, the Government moved quickly to raise $1.5 billion through an issue of 10-year bonds on the international capital market, but it paid a hefty 6 percentage point premium over comparable US Treasuries.

The national government debt has fallen significantly in recent years, from the equivalent of 77.7% of GDP in 2003 to 56.3% in 2008. However, the debt is still high and interest payments absorb a quarter of total expenditure. Moreover, contingent liabilities—mainly guarantees issued by the national Government—add a further $11.2 billion to the debt (Figure 3.28.11). After the Government paid early some external debt in

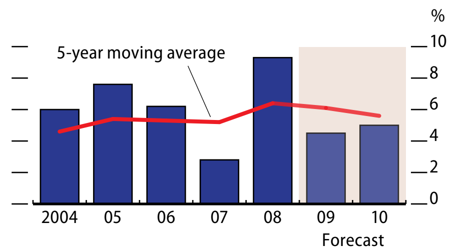
3.28.8 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available:http://www.nscb.gov.ph, downloaded 2 February 2009; staff estimates.

Click here for figure data

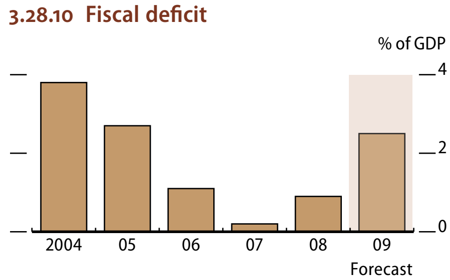
3.28.9 Inflation



Sources: Asian Development Outlook database; National Statistics Office, available: http:www.nso.gov.ph, downloaded 10 March 2009; staff estimates.

Click here for figure data

3.28.10 Fiscal deficit



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009; staff estimates.

Click here for figure data

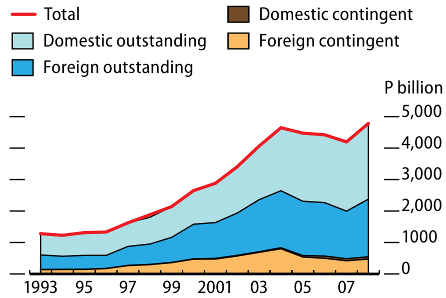
2007, when the peso appreciated, public external debt dropped to about 22.8% of GDP in November 2008 from nearly 50% in 2003.

The Philippine banking sector entered the global financial crisis in a relatively healthy position, with ratios of 15.2% for capital adequacy (end-September 2008) and 3.5% for nonperforming loans (end-December 2008). Its profits will be crimped, though, and loan quality will suffer during the economic slowdown.

Domestic risks to the economic outlook include delayed implementation of the stimulus package due to capacity constraints.

The political risk of disruptions to the 2010 elections cannot be completely ruled out. Also looking to next year, if the global economy does not pick up as assumed, the Government will be hard pressed to fund additional fiscal stimulus measures, given its budget constraints.

3.28.11 National government debt



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

Click here for figure data

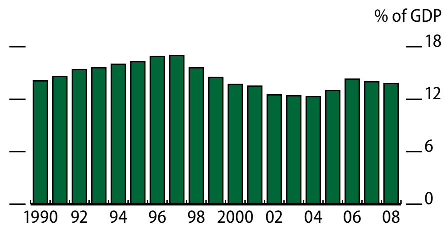
Development challenges

In common with other countries in Southeast Asia, two near-term challenges stand out: safeguarding the achievements of recent years (including stronger growth momentum and progress in fiscal management), and protecting society's most vulnerable groups during the slowdown. Even before the downturn, the incidence of poverty was rising, to 32.9% of the population in 2006 (the latest data available) from 30.0% in 2003, and progress on certain health and education indicators of the Millennium Development Goals was tardy. Social programs to protect the poor sometimes lack funds and often require better targeting.

Still-high debt and the large share of interest payments in the budget expose the economy to swings in financial markets. They also underscore the importance for the Government of containing the debt risk premium through making steady progress on reforms. Further increases in revenue as a share of GDP and reductions in debt would not only reduce vulnerabilities but also build the fiscal resources needed for infrastructure and social programs. Tax revenue as a share of GDP has plateaued at the relatively low level of 14.0% in the past 2 years, after some improvement in 2006 (Figure 3.28.12).

Perennial causes of poverty include a high population growth rate and lack of job opportunities in the country. Deployment of large numbers of workers overseas masks the extent of domestic unemployment. Greater employment generation requires increased investment, but this is unlikely without improvements in the business climate. The 2008–2009 *Global Competitiveness Report* of the World Economic Forum ranks the Philippines 71 out of 134 countries and identifies inefficient government bureaucracy, inadequate infrastructure, policy instability, and corruption as important constraints.

3.28.12 Tax revenue



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

Click here for figure data

Singapore

Moving closely in line with the global business cycle, growth decelerated during 2008 on a year-on-year basis and contracted in the fourth quarter. The economy is forecast to shrink this year, before bouncing back next year. A significant fiscal stimulus package will help cushion the severity of the recession, although in the highly open economy much of the stimulus will leak abroad. Cushioning externally induced macroeconomic volatility is a particularly difficult challenge in a city-state.

Economic performance

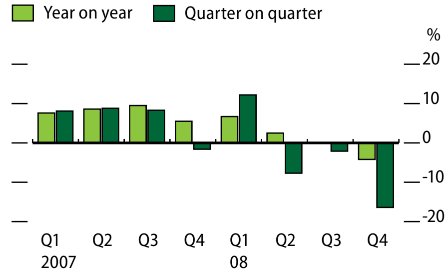
The global downturn hit this exceptionally open economy with full force during 2008. GDP growth was just 1.1%, far short of the 5-year average of 7.3% in 2003–2007 and the slowest since 2001, when GDP contracted during the global information technology slump. Reflecting the high correlation between the global business cycle and Singapore's economic performance, GDP growth slowed from 6.7% in the first quarter, year on year, until the economy contracted by 4.2% in the fourth (Figure 3.29.1). On a quarter-on-quarter basis, output declined from the second to fourth quarters of 2008.

The net export slump caused by the global slowdown acted as a serious drag on GDP growth, which was driven entirely by domestic demand. In particular, construction investment in the public sector played a key role in boosting domestic demand.

The impact of the global downturn was most evident in international trade, which fell by 11.6% in nominal US dollar terms (5.6% in volume terms) in the fourth quarter. Given Singapore's role as a trade hub that supports trade-related services from transportation to trade finance, the slowdown of trade had ramifications far beyond the export-oriented manufacturing sector. This helps explain why Singapore has been among the hardest hit economies. Another factor that has magnified the impact of the global slump is the economy's shift into higher value-added industries, such as biomedical manufacturing. The upgrading helps diversify the industrial base, but also increases dependence on demand from those industrial countries at the center of the global crisis. Total exports fell by 13.9% in the fourth quarter (Figure 3.29.2), although growth in the first 3 quarters, buoyed by high oil prices that raised prices of petroleum exports, allowed for growth of about 13% for the whole year.

Non-oil domestic exports fell by 19.6% in the fourth quarter, and by 1.9% for the year. External demand weakened in 2008 relative to 2007 for integrated circuits, consumer electronics, telecommunications equipment, and personal computers, as well as for pharmaceuticals, petrochemicals, and primary chemicals. Demand for non-oil exports weakened most notably from the United States (US) and Europe. Petroleum exports fell late in the year but rose for the full year by more than 50%. In volume terms, oil exports expanded by 15.5%.

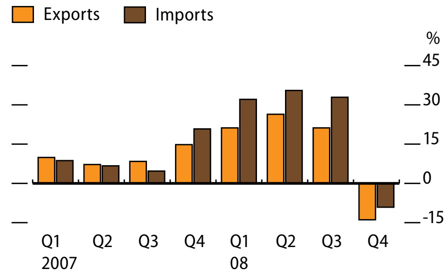
3.29.1 Quarterly GDP growth



Source: Singapore Ministry of Trade and Industry, *Economic Survey of Singapore 2008*.

Click here for figure data

3.29.2 Merchandise trade growth



Source: CEIC Data Company Ltd., downloaded 14 March 2009.

Click here for figure data

This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

In the context of domestic demand, robust investment more than offset faltering consumption. Private consumption growth slowed to 2.4% in 2008, less than half the rate of 2007 (Figure 3.29.3). Consumption contracted in the fourth quarter. Deteriorating labor market conditions have led to concerns over job security and an erosion of consumer confidence. Further denting consumer confidence has been the year-long rout of the stock market. Higher government consumption bolstered overall consumption growth to 3.6%.

Both private and public investment grew at a healthy pace—14% and 13%, respectively. However, private investment contracted by 13% in the fourth quarter as business confidence plummeted in reaction to the fast-deteriorating global outlook. The growth in investment was largely driven by an upturn in construction, which overshadowed generally feeble equipment investment.

From the output perspective, business services, construction, and financial services were the biggest contributors to GDP growth in 2008 (Figure 3.29.4). Construction roared ahead by 20%, while business services and financial services expanded by 7.4% and 5.5%. For the year as a whole, all sectors except manufacturing made positive contributions to GDP growth. However, the financial services industry contracted by 8.1% in the fourth quarter, due to the global financial crisis and the economic slowdown. Trading activities fell substantially in foreign exchange, stock brokerage, and fund management. The fourth quarter also witnessed the contraction of wholesale and retail trade as well as transport and storage, largely as a result of declining world trade volumes.

Manufacturing suffered the biggest contraction, for both the fourth quarter (down 10.7%) and the entire year (down 4.1%). The manufacturing slump was driven by weakening global demand, and was most evident in the electronics and biomedical industries.

Inflation surged to 6.5% in 2008, from 2.1% in the previous year and 1.1% on average in 2003–2007. The surge was sparked by higher global oil and food prices during the first 3 quarters, and inflation eased by late 2008.

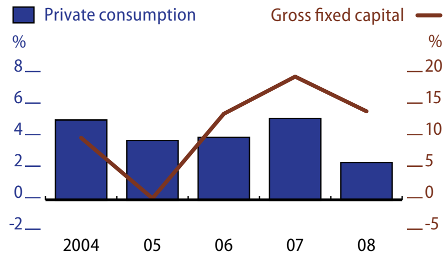
Of greater concern was the deterioration of the labor market in line with the worsening economic outlook. Employment rose by about 27,000 in the fourth quarter, less than half the 56,000 growth in the third, and although for the whole year employment increased by a healthy 227,000, most of the gain came in the first half. The number of layoffs, which climbed to 13,400 in 2008 from 7,700 in 2007, also rose sharply in the final quarter.

In the external accounts, lower surpluses were recorded in both goods and services trade. The current account remained in substantial surplus, equivalent to 14.8% of GDP. Gross international reserves rose to $174.2 billion.

Economic prospects

Structural and strategic dependence on external demand has served Singapore well over the past four decades, transforming it into one of the richest economies. The downside of an exceptionally high degree of globalization is that the economy is hit disproportionately hard when the world trade and growth turn down. Singapore has higher trade

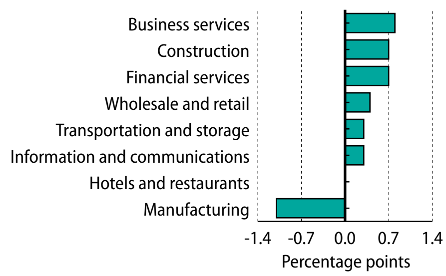
3.29.3 Consumption and investment growth



Sources: Singapore Department of Statistics, available: http://www.singstat.gov.sg/; CEIC Data Company Ltd., both downloaded 10 March 2009.

Click here for figure data

3.29.4 Contributions to growth (supply), 2008



Source: Singapore Ministry of Trade and Industry, *Economic Survey of Singapore 2008*.

Click here for figure data

dependence than other Asian economies and this gap has increased in recent years (Figure 3.29.5). A wide range of its services, too, depend on trade. Further, as a financial center, it will suffer more than most economies from the global financial crisis and cuts in staffing at banks and brokerages. Moreover, it is a subregional headquarters for multinational companies, many of which are trimming operations. Irrespective of the uncertainty surrounding the global outlook for this year, this economy is seen contracting substantially in 2009.

The downward momentum of late 2008 has continued into 2009. Exports fell by 40% in January and imports by 36%, year on year. The slide in exports was across the board in terms both of product groups and export markets. Manufacturing output declined by 29.1% on a year-on-year basis in January.

Private domestic demand is unlikely to provide much relief from the slump in external trade. Uncertainty surrounding the economy is likely to intensify during the first half of 2009, and this will induce households to save rather than spend. Job market conditions are expected to worsen before they get better. As a result, private consumption is set to contract in the first half. The weakening in trade and manufacturing bodes ill for equipment investment, which is likely to contract during the first half. The one area of private domestic demand that remained robust in 2008—construction investment—is likely to weaken in 2009 in response to a stagnant housing market (Figure 3.29.6). Any significant boost to domestic demand will have to come from the Government.

In response to this bleak outlook for 2009, the Government announced an unprecedented expansionary budget in January, with total spending set at S$43.6 billion (US$29.3 billion). The primary operating fiscal balance is set to be in deficit equivalent to 10.2% of GDP for FY2009 starting 1 April 2009, (compared with a surplus estimated at 1.6% of GDP in FY2008).

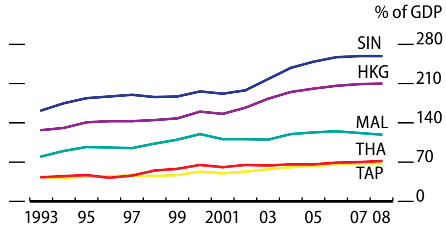
The centerpiece is a stimulus package costing S$20.5 billion. Two notable components are the S$4.5 billion Jobs Credit Scheme (Box 3.29.1) and a Special Risk-Sharing Initiative, which gives individual firms access to working capital of up to S$5 million, with the Government bearing 80% of the default risk associated with those loans. The Government has also cut the corporate income tax rate from 18% to 17%, and provided personal income tax rebates of 20%, capped at S$2,000. The Government plans to use S$4.9 billion from its hefty fiscal reserves, obviating the need to borrow.

Although the large size of the stimulus will inevitably have some positive growth effects, it will at most limit the severity of the recession. The fiscal stimulus will also strengthen social safety nets and protect the most vulnerable groups. For example, workers on the Workfare program, which gives cash grants to low-income working households, will get 50% more in transfer payments to help them cope with the economic downturn.

The Monetary Authority of Singapore in October 2008 in effect loosened monetary policy when it changed its 3-year-old policy of allowing a "modest and gradual" appreciation of the Singapore dollar against a trade-weighted basket of foreign currencies to a target of zero appreciation.

Given the likely trajectory of the global business cycle, the economy is expected to shrink by about 8% in the first half of 2009, year on year, and by about 2% in the second. For the year as a whole, GDP growth is projected to contract by 5.0%, marking the weakest performance since

3.29.5 Exports of goods and services

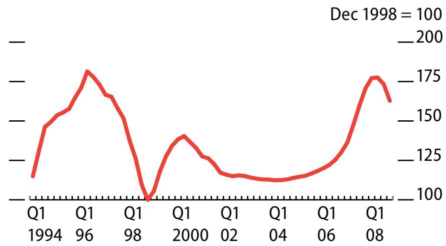


HKG = Hong Kong, China; MAL = Malaysia;
SIN = Singapore; TAP = Taipei,China; THA = Thailand.

Source: CEIC Data Company Ltd., downloaded 12 March 2009.

Click here for figure data

3.29.6 Private residential property price index



Source: CEIC Data Company Ltd., downloaded 12 March 2009.

Click here for figure data

3.29.1 Selected economic indicators (%)

	2009	2010
GDP growth	-5.0	3.5
Inflation	0.5	2.0
Current account balance (share of GDP)	10.0	14.0

Source: Staff estimates.

3.29.1 Jobs Credit Scheme

The Jobs Credit Scheme aims to prevent mass layoffs by offering cash grants to employers to cover part of their wage bill. The cash grant is equivalent to 12% of the first S$2,500 (i.e. up to S$300) of the wages of each employee who contributes to the Central Provident Fund (CPF), the national savings plan. CPF criteria limit Jobs Credit benefits to Singaporean citizens and permanent residents. In effect, it is a temporary wage subsidy to employers that gives them an incentive to retain workers, with the subsidy amounting to a 9% cut in the employer's contribution rate to the CPF.

Anecdotal evidence indicates that the savings and additional cash flow from the Jobs Credit Scheme are quite significant, especially for labor-intensive firms, and is helping to save some jobs (*Singapore Market Weekly* 2009). A more formal empirical analysis using a macroeconomic model found that the program could save up to 30,000 jobs in 2009, and 50,000 each in 2010 and 2011 (Abeysinghe and Gu 2009). Absent the scheme, the GDP contraction and the downward inertia of wages would lead to larger job losses over a longer period. However, it is possible that the scheme may merely transfer resources to those companies that would have kept workers anyway, without having much impact on the employment decisions of struggling enterprises.

The burden of adjustment during recessions in the past has largely fallen on workers, in the form of a cut in the employer's contribution rate to the CPF. Under the Jobs Credit Scheme, that burden is transferred to the Government.

References

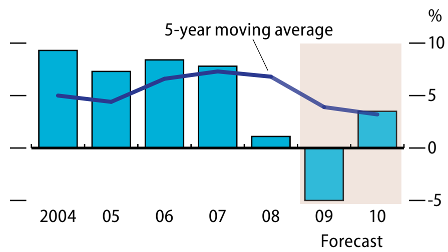
Abeysinghe, T. and J. Gu. 2009. "Jobs Credit Scheme—Measuring its effectiveness." *Straits Times*, 16 February 2009.

Singapore Market Weekly. 2009. "Call It A (Deeper) Recession." 2 March 2009.

independence in 1965. Growth is expected to resume at about 3.5% in 2010 (Figure 3.29.7), on the back of global and regional recovery.

Both upside and downside risks are those associated with the depth and length of the global downturn. The downside risks overshadow those on the upside at the moment, which suggests that a contraction more severe than 5.0% this year is more probable than one less severe. Inflation will fall sharply to average 0.5% this year, due to the recession and weak commodity prices. The current account surplus is projected to decline to about 10.0% of GDP as a result of export compression, before it rises again in 2010.

3.29.7 GDP growth



Sources: Singapore Department of Statistics, available: http://www.singstat.gov.sg; CEIC Data Company Ltd., both downloaded 10 March 2009.

Click here for figure data

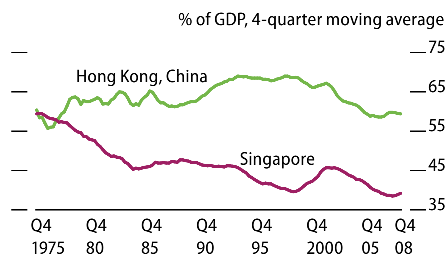
Development challenges

The high import content of goods in this highly open economy and the consequent leakages of fiscal stimulus to other economies constrain the countercyclical impact of fiscal policy. However, strengthening social safety nets and protecting the most vulnerable groups are worthy objectives in themselves. The Government has recently accorded a higher priority to those objectives and it has taken some concrete steps, including the increased transfer payments in the Workfare program.

The deep contraction in this city-state of 4.8 million people brings into sharper focus the lack of a domestic demand base that could cushion the effect of an external shock such as the current one. In this regard, there has been a remarkable reduction in the ratio of private consumption to GDP in recent years. Strong growth of exports can partly account for this drop. However, the share of consumption has been more or less stable, at a far higher level, in Hong Kong, China, a comparable economy (Figure 3.29.8).

A more structural explanation is that high levels of home ownership in Singapore and correspondingly high levels of financial liabilities have suppressed disposable incomes and hence consumption. One possible policy option is to open up more avenues for households, especially older households, to convert their housing wealth into purchasing power.

3.29.8 Private consumption expenditure



Source: CEIC Data Company Ltd., downloaded 12 March 2009.

Click here for figure data

Thailand

Political disruptions undermined the economy in 2008, hurting government expenditure and private investment. Allied to the onset of the global economic slowdown, which punished exports in the fourth quarter, they slowed economic growth to the worst outturn since 2001. Inflation accelerated in the first half, then fell back. The economy is expected to contract in 2009. Expansionary monetary and fiscal policies will help to a degree, but the Government may well need to do more to ensure that growth is sustained after its expected resumption next year.

Economic performance

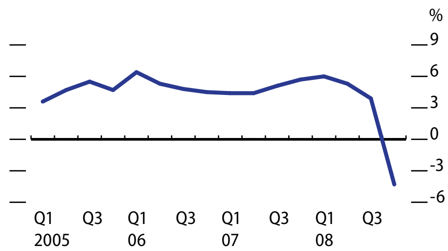
The impact of political disruptions and the global economic slowdown cut economic growth to 2.6% in 2008, about half the 2007 rate and the slowest since 2001. After 6 months of solid growth approaching 6% on a year-on-year basis, the economy braked in the third quarter then contracted by 4.3% in the fourth (Figure 3.30.1) when the global slowdown slashed exports. Over the year, weakness in government expenditure, private investment, and exports sapped growth.

A contraction of public expenditure stemmed from political tensions and associated policy uncertainties. Antigovernment protestors disrupted transportation and sparked clashes that led the Government to declare a state of emergency in Bangkok for 12 days in September. Tensions worsened when the protestors took control of Bangkok's two main airports, which were shut down for 9 days from 24 November. In December, the Constitutional Court disbanded the three main parties in the governing coalition, requiring the formation of a new government. Indeed, Thailand had four prime ministers during 2008. The frequent changes caused delays in budget disbursement and in the implementation of government projects, including mass rapid transit projects proposed since 2007 for Bangkok. Public investment contracted by 4.8% in 2008, compared with 3.4% expansion in 2007, and public consumption grew only by 0.4% (down from 9.1% in 2007).

As the global slowdown deepened, exports of goods and services contracted by 8.7% in the fourth quarter of 2008, after strong growth in the first 3 periods. Services exports grew by just 3.2% in full-year 2008, less than half the rate of the previous year. Tourist arrivals fell by 1.3%, reflecting the domestic political turmoil and closure of the Bangkok airports, as well as a decline in tourists from the major industrial markets, which were sliding into recession.

Goods exports in real terms fell by 9.0% in the fourth quarter, a result of the slump in global demand and the closure of the airports. Exports of machinery and transport equipment were hit hardest, followed by labor-intensive and resource-based products. However, because of solid

3.30.1 Quarterly GDP growth



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 16 March 2009.

Click here for figure data

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

expansion of goods exports in the first half of 2008, notably rice, cassava, and computers, real merchandise exports decelerated only a little to 6.0% in the whole year, from 6.7% in 2007.

Imports of goods and services also declined in the fourth quarter, in response to the weakness in domestic demand. Earlier, industry had increased imports of materials such as metal products and chemicals in anticipation of continued economic growth. Thus real imports for the full year rose by 7.5%, despite the decline in the fourth quarter. A contraction in net exports subtracted 0.2 percentage points from GDP growth (Figure 3.30.2), in contrast to 2007 when net exports were the source of most of that year's expansion.

Private investment growth declined steadily from the second quarter of 2008, contracting by 1.3% year on year in the fourth. The political uncertainty as well as the slowdowns in the domestic and international economies eroded business confidence. However, strong first-half growth in construction of housing and commercial buildings, mainly in the Bangkok area, contributed to full-year growth in private investment of 3.2%, up from 0.6% in 2007. Investment contributed more than half the total GDP growth.

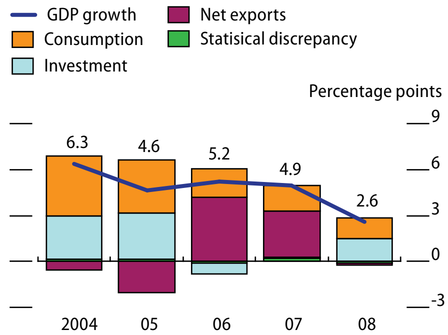
In contrast to other GDP components, private consumption expanded in the fourth quarter, and rose by 2.5% for the whole year, picking up from weak 1.6% growth in 2007, despite the slowing economy and slumping stock market. The stock market index fell by 48% in 2008 (Figure 3.30.3). The increase in consumption was most notable in durable goods such as cars, motorcycles, and electrical appliances. In the second half of the year, slowing inflation and expansionary monetary policy supported consumption spending. Bank credit for personal consumption remained buoyant last year, in contrast to bank credit for industry.

On the supply side, only agriculture posted strong growth in 2008, of 5.1%, up from 1.8% in 2007 (Figure 3.30.4). This improvement was partly due to farmers' response to high prices for agricultural products in the first half. Output of rice, palm oil, rubber, and cassava shot up. Growth of manufacturing, however, slowed to 3.9% from 6.2%, with a significant deceleration in the second half as business confidence and export orders dwindled. Electronics, petrochemicals, and leather goods slowed the most. Services decelerated to only 1.2% growth, from 4.7%, mainly a result of the political turmoil and weakness in tourism. Hotels and restaurants, transport, storage and communications, and wholesale and retail trade came off steeply in the second half.

In the external accounts, the second-half decline of merchandise exports cut the full-year trade surplus to $237 million, a small fraction of the previous year's $11.6 billion. The services, income, and transfers accounts registered a combined deficit of $416 million, in part reflecting the reduction in tourism receipts. The current account turned from a surplus in 2007 to a small deficit (0.1% of GDP) in 2008. After accounting for inflows of foreign direct investment in the first half of the year and in spite of net outflows of portfolio investment (because of the global financial crisis and a slump in domestic stock prices), in the second half, foreign exchange reserves rose by 27.5% to $108.3 billion at end-2008 (Figure 3.30.5), equivalent to almost 9 months of imports.

Domestic financial institutions had little direct exposure to assets

3.30.2 Contributions to growth (demand)



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 28 February 2009.

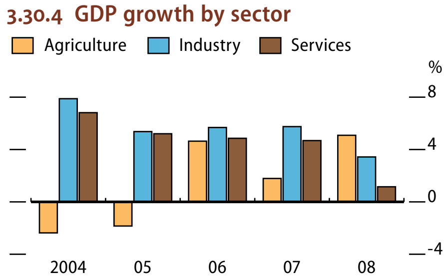
Click here for figure data

3.30.3 SET index

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

Click here for figure data

3.30.4 GDP growth by sector



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 28 February 2009.

Click here for figure data

of troubled financial institutions abroad. Such "toxic" assets constituted under 0.5% of their total assets. In addition, the blanket guarantee on bank deposits in force since 1997 was extended to 2011, thereby helping maintain confidence in banks. Key indicators, such as the bank capital-adequacy ratio (15.3% in September 2008) and gross nonperforming loans to total loans (5.3% in December 2008), imply that the overall health of banks is sound. Still, the domestic economic slowdown is likely to have some impact on credit quality, and banks have become more hesitant on lending.

Inflation quickened to an 11-year peak at 9.2% in July (Figure 3.30.6), driven by rising global oil and food prices. After core inflation (excluding fresh food and energy) exceeded the Bank of Thailand's target in July, the central bank raised its policy interest rate (the 1-day repo rate) by 25 basis points in both July and August, to 3.75%. Inflation slowed sharply to 2.8% by December, mainly owing to the retreat of global oil and food prices and the slowdown in domestic demand. The Bank of Thailand switched its policy stance and aggressively cut its policy rate in three steps between December and February 2009, to 1.5% (Figure 3.30.7). Average inflation in 2008 at 5.5% was more than double 2007's rate.

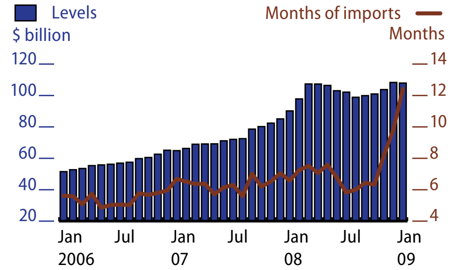
Fiscal policy was generally tight in FY2008 (ended 30 September 2008). Revenue collection increased by 7.3% and exceeded the target. Several fiscal measures were rolled out to stimulate growth, including tax breaks for individuals and small and medium-sized firms as well as funding for community development projects. However, actual disbursement of total budgeted expenditure was lower than in FY2007, mainly due to lack of continuity caused by the frequent changes in administration. The overall fiscal deficit narrowed to 0.3% of GDP, from 1.1% in the previous fiscal year.

Economic prospects

The projections assume that the Government that took office in December 2008 remains in power through the forecast period and that fiscal and monetary policies are expansionary. In January 2009, the cabinet approved a B116.7 billion ($3.4 billion) economic stimulus package aimed at stemming the economic decline. For households, it includes cash transfers for low-income people, training programs for the unemployed, and expanded free schooling and public health services. The Government also extended concessions introduced last year that cover free electricity and water supply for poor households and subsidized public transportation. For businesses, the stimulus package provides low-interest loans for tourism-oriented small firms and funding for small rural enterprises.

The cabinet also approved B40 billion in tax cuts, targeted mainly at small businesses, the tourism industry, and the property market and a B200 billion short-term credit facility for state enterprises. To bolster farm incomes, the Government will guarantee price support for major crops. As for the program of large infrastructure projects prepared several years ago, the Government intends to focus on extending mass transit rail lines in Bangkok. Work is scheduled to start on one line in the first half of this year and on another in the second half.

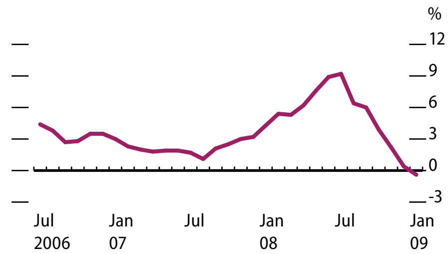
3.30.5 Foreign exchange reserves



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

Click here for figure data

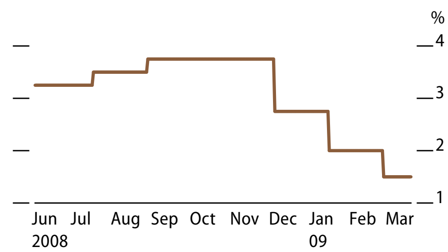
3.30.6 Monthly inflation



Source: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 16 March 2009.

Click here for figure data

3.30.7 Policy rate



Sources: Bloomberg, downloaded 16 March 2009.

Click here for figure data

The sizeable fiscal stimulus including increases in public investment will bolster the economy, albeit it will not ensure growth. The budget deficit, to be funded by both domestic and external financing, is projected to widen to about 5% of GDP in FY2009. In the October–December fiscal quarter, however, disbursements lagged the target, mainly because the new Government continued to face political disruptions, while revenue collections fell short of target. For FY2010, the Government has approved a deficit of about 4% of GDP.

Private consumption is forecast to grow, supported by low inflation and the various measures to assist households through the economic slowdown. However, its growth will slow from 2008, undermined by low consumer confidence (Figure 3.30.8), a rapidly weakening labor market, declines in stock and property prices, and lower farm incomes, despite the price support.

In contrast to private consumption, private investment is projected to contract in the face of weak domestic and external demand and of deteriorating business sentiment. Industrial capacity utilization declined to just 57.1% in January 2009 (Figure 3.30.9), reducing the need to expand production facilities. Moreover, although the central bank has lowered its policy interest rate, banks have become more cautious in lending as a result of the global financial crisis and the erosion of corporate profits induced by the domestic economic slowdown.

Once these strings are drawn together, GDP growth in 2009 is projected to contract by about 2.0%, the first shrinkage since the 10.5% of 1998, which was caused by the Asian financial crisis. As a result, the number of unemployed could rise to almost 2 million in 2009. Growth is seen resuming in 2010, at about 3.0% (Figure 3.30.10), if the global economy revives as assumed. By then, the Government is also expected to have more public investment projects under way.

On the supply side, industrial production is expected to contract, given the poor export outlook and weak domestic demand. Construction will be damped by the low business and consumer confidence and the more circumspect bank lending. Services will suffer from a fall in tourist arrivals and subdued consumer spending. Agricultural production is likely to increase, but less robustly than in 2008, reflecting softer prices for agricultural commodities.

Merchandise exports dropped by 25.3% in January 2009 and by 11.3% in February from the previous year. Merchandise imports plunged by 36.5% in January and by 40.3% in February (Figure 3.30.11). For the year, merchandise exports are forecast to fall by about 18.0%. Merchandise imports will drop by a steep 28.0%, suppressed by weak domestic demand and reduced needs for inputs to the export industries. The trade balance is expected to record a large surplus of $18.0 billion in 2009. The current account is forecast to post a surplus of 8.0% of GDP this year and 4.5% in 2010.

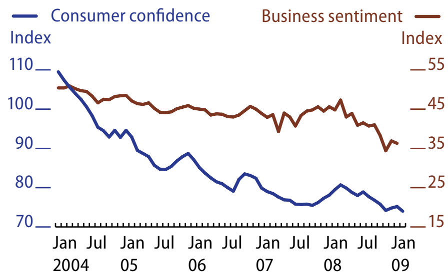
The consumer price index fell by 0.3% in the first 2 months of 2009 from a year earlier, mainly owing to a decline in gasoline prices and charges for electricity and water. (Core inflation rose by 1.7% in that period.) The Bank of Thailand, when it cut the policy rate in February, cited a need to "safeguard price stability," as well as to support the economy. For all 2009, inflation is expected to average just 0.5%

3.30.1 Selected economic indicators (%)

	2009	2010
GDP growth	-2.0	3.0
Inflation	0.5	1.5
Current account balance (share of GDP)	8.0	4.5

Source: Staff estimates.

3.30.8 Consumer and business attitudes

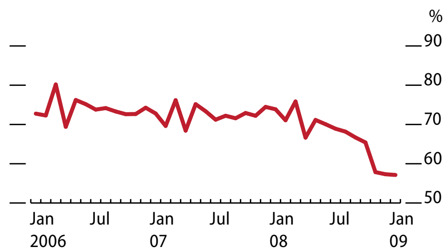


Note: A reading of less than 100 for consumer confidence and less than 50 for business sentiment denotes a deterioration.

Source: Center for Economic and Business Forecasting, Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

Click here for figure data

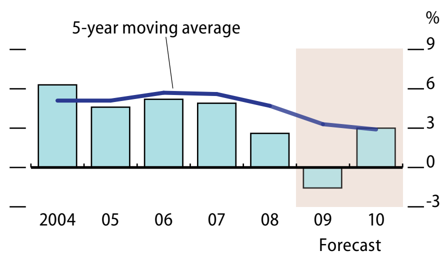
3.30.9 Industrial capacity utilization rate



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 6 March 2009.

Click here for figure data

3.30.10 GDP growth



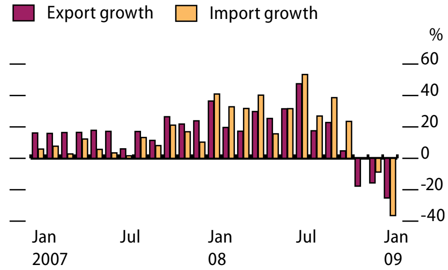
Sources: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 16 March 2009; staff estimates.

Click here for figure data

(Figure 3.30.12). It will be kept down by lower global oil and commodity prices relative to 2008 and by weak domestic demand, which will undermine the ability of producers to raise prices of goods and services. The price index is expected to record year-on-year falls in some months of 2009. In 2010, inflation is seen picking up to 1.5%, in line with the expected economic recovery.

The forecasts are subject to two key downside risks. A more prolonged recession in major trading partners would lower exports of goods and services by more than expected. That would further weaken domestic demand and take GDP below the baseline projection. Political uncertainty is another risk, and that could delay the crucial boost in public spending, and thus seriously affect recovery prospects.

3.30.11 Monthly trade indicators



Note: Data are on a customs basis.

Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

Click here for figure data

Development challenges

The key near-term challenge is to implement the stimulus package effectively to support growth. That requires the Government to improve the disbursement rate of planned expenditure. It also needs to accelerate the rollout of public infrastructure projects, which has fallen behind schedule during the past 3 years of political turbulence.

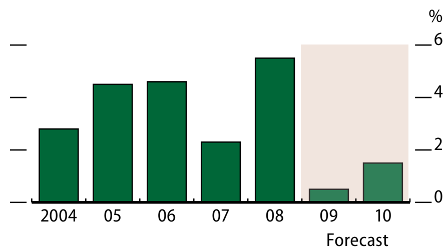
A World Bank investment climate assessment of Thailand in August 2008 found that development of the private sector is hampered by deficient infrastructure, as well as a heavy regulatory burden and shortage of skills. Investment in public infrastructure is needed to maintain the economy's competitiveness in the longer term. Greater private sector participation in infrastructure could be achieved by reforms in the regulatory environment to encourage public-private partnerships. This would reduce the pressure on the budget and free up fiscal resources to address significant shortcomings in education and skills development.

The ratio of public debt to GDP is projected to rise to 43% in 2009. But there still is scope for substantial borrowing for public investment, even in the context of the Government's own self-imposed public debt limit of 50% of GDP. Moreover, foreign exchange reserves are high and external debt has declined steadily to about 24% of GDP.

If the global economic rebound is feeble, the Government might need to consider running significant fiscal deficits for a few years, possibly breaching the self-imposed debt limit in order to support growth. The deficit and debt would then need to be pared back quickly when economic growth is demonstrably sustained.

Thailand could face two other main challenges, depending on the duration of the global slowdown. First, coping with relatively high unemployment for a prolonged period could test policymakers, and social stability. There is a need to consider expanding social safety nets both as a short-term response and over the longer term. Second, while the financial system is sound, a prolonged economic slowdown could lead to a significant rise in nonperforming loans.

3.30.12 Inflation



Sources: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 16 March 2009; staff estimates.

Click here for figure data

Viet Nam

The economy had a turbulent year in 2008. Inflation and the trade deficit surged, and then reversed course. Economic growth slowed and is forecast to moderate further this year, before starting to pick up in 2010. Inflation is projected to be relatively low both years. The current account deficit is expected to widen in 2009 and narrow in 2010. The main near-term challenge is to limit the slowdown in growth while keeping the fiscal and current account deficits in check. In the medium term, the Government needs to ratchet up growth without fueling inflation or widening the current account deficit.

Economic performance

GDP growth decelerated to 6.2% in 2008, down from more than 8% in the preceding 3 years (Figure 3.31.1). Available indirect data suggest that growth of consumption slackened, and that an upturn in foreign-financed investment was offset by a downturn in domestically financed investment. Consumption and domestically financed investment were adversely affected by a volatile and uncertain economic environment, stabilization measures taken by the Government in the first half of the year, and the slowdown of economic activity. Falling stock prices and a cooling real estate market were contributing factors. Year-on-year growth of GDP decelerated from 6.5% in the first 3 quarters of 2008 to less than 6% in the fourth, as the external environment worsened severely.

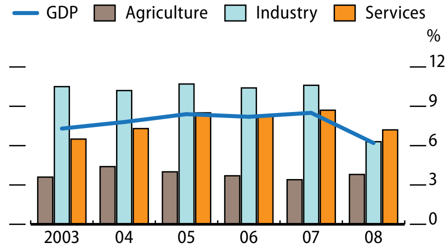
A continued decline in oil production contributed to the slowdown of growth. Total output of crude oil fell to 14.9 million metric tons in 2008 from 15.9 million in 2007. Several new oil fields came on stream in late 2008, but this did not compensate for the decline of output at some old fields.

Month-on-month inflation soared in late 2007 and stayed above 2% in January–May 2008 (Figure 3.31.2). Macroeconomic imbalances, which had built up over several years and manifested themselves in strong inflation pressures and a persistent current account deficit, were exacerbated by domestic supply-side shocks (including poultry and pig epidemics) in late 2007 and early 2008. The rise in world commodity prices contributed to high inflation.

In June–December 2008, month-on-month inflation fell sharply. This reflected the effects of government anti-inflation measures in the first half and the drop in world commodity prices in the second. Month-on-month inflation picked up slightly in January–February 2009 on account of seasonal factors, but was much lower than a year earlier. Year-on-year inflation rose to 28.3% in August 2008, but pulled back to 14.8% in February 2009. Still, the annual average inflation rate, at 23.0% in 2008, was the highest since 1992.

To curb inflation, the State Bank of Viet Nam (SBV), the central bank,

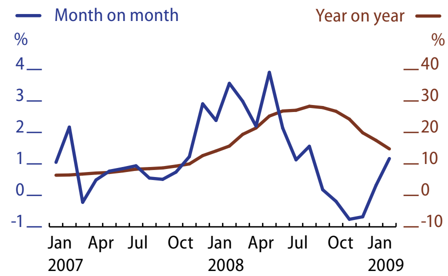
3.31.1 GDP growth by sector



Source: General Statistics Office of Viet Nam.

Click here for figure data

3.31.2 Inflation



Source: General Statistics Office of Viet Nam.

Click here for figure data

This chapter was written by Bahodir Ganiev of the Viet Nam Resident Mission, ADB, Hanoi.

tightened monetary policy significantly in the first half of 2008. Notably, it raised banks' reserve-requirement ratios, issued central bank bills that commercial banks were required to buy, and raised policy interest rates (Figure 3.31.3). SBV lifted the base rate to 14.0% in June 2008 from 8.25% at the start of the year. (There is a ceiling on bank lending rates equal to 1.5 times the base rate.) Consequently, growth of credit and money supply slowed (Figure 3.31.4).

With inflation down sharply and growth decelerating, SBV eased monetary policy quickly in the fourth quarter of 2008 (and in early 2009). In particular, it reduced the reserve-requirement ratios and lowered policy rates (cutting the base rate to 7.0% by February this year). However, these measures did not lead to commensurate increases in credit and money supply because banks had become more cautious in lending and hoarded liquidity. Growth of credit and money supply continued to slow in the second half of 2008.

As part of its efforts to reduce inflation and the trade deficit, in the first 6 months of 2008 the Government tightened fiscal policy and control over investment by state enterprises. Many public investment projects, including those of state enterprises, were suspended, postponed, or canceled. The budget recorded relatively small deficits in the first 3 quarters (Figure 3.31.5).

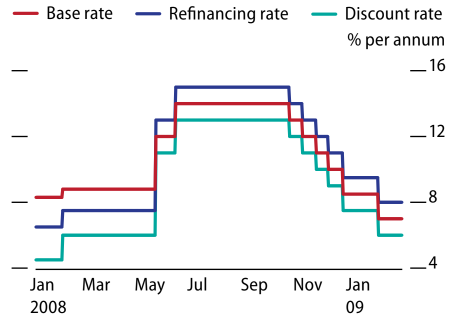
The Government began to loosen fiscal policy toward the end of the year, in order to mitigate the impact on growth of the global financial crisis and economic downturn. The fiscal deficit swelled in the fourth quarter, but over the year it narrowed to an estimated 4.7% of GDP, from 5.5% in 2007.

In early December 2008, the Government announced that it would adopt a fiscal stimulus package of about $1 billion. It later indicated that the size of the package could increase to $6 billion. During January–February this year, the Government approved several fiscal stimulus measures. In particular, it reduced by 30% corporate income tax rates for small and medium-sized enterprises for the fourth quarter of 2008 and for 2009, and cut by half the value-added tax on certain goods and services until end-2009. It also decided to give one-time additional financial assistance to poor households, and to firms a 4 percentage point interest rate subsidy on their short-term (up to 8 months) bank loans contracted and disbursed in February–December this year.

During 2008, Viet Nam maintained a de facto crawling peg exchange rate regime with a trading band in relation to the US dollar, but widened the band from 0.75% to 3.0% around SBV's reference exchange rate (Figure 3.31.6). Several times during the year the formal foreign exchange market did not clear at a rate within the trading band and the black market exchange rate moved outside the band. Most notably, a severe shortage of foreign exchange emerged in the formal market and the black market exchange rate depreciated sharply in June 2008, when expectations of persistent high inflation and a balance-of-payments crisis triggered capital flight and engendered strong downward pressure on the dong.

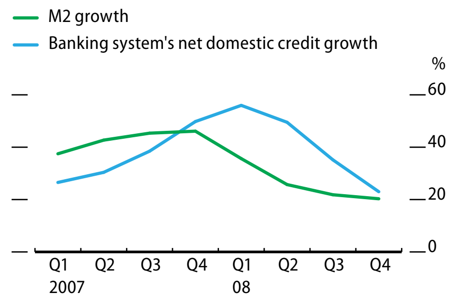
SBV responded by devaluing its reference rate by about 2%, widening the trading band once more, increasing supply of foreign exchange, and issuing data that showed that the preconditions for a balance-of-payments

3.31.3 Policy interest rates



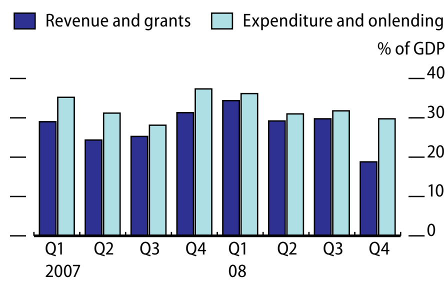
Source: State Bank of Viet Nam.
Click here for figure data

3.31.4 Money and credit indicators



Sources: State Bank of Viet Nam; staff estimates.
Click here for figure data

3.31.5 Government financial indicators



Note: Data include expenditure financed by official development assistance and by issuance of sovereign debt, but exclude lending through the Viet Nam Development Bank.
Sources: Ministry of Finance of Viet Nam; staff estimates.
Click here for figure data

crisis were not in place. The formal market stabilized and the black market rate dropped to levels close to SBV's reference rate.

A shortage of foreign exchange reemerged in the formal market late in the year, as the near-term outlook for the global economy deteriorated rapidly and investors again moved substantial funds from dong- into dollar-denominated assets. To counter this, SBV devalued its reference rate by another 3.0%, bringing the cumulative devaluation for 2008 to 5.4%.

The trade deficit, after widening in 2007 and the first quarter of 2008, narrowed during the rest of the year (Figure 3.31.7). Year-on-year growth of exports accelerated in the first 3 quarters of 2008 owing to a combination of increasing export volumes and (in the first half) rising export prices. Export growth decelerated sharply in the fourth quarter, when external demand weakened significantly and export prices plummeted. Quarterly growth of imports slowed during 2008 (from a very high rate in the fourth quarter of 2007) reflecting the combined impact of the Government's efforts to rein in the trade deficit, the cooling economy, and, in the second half, falling import prices.

For 2008 as a whole, exports rose by 29.1% and imports by 28.1%; the trade deficit widened to $12.8 billion from $10.4 billion in 2007. This widening was outweighed by an increase in remittance inflows (recorded in the balance of payments mostly as inward current transfers). As a result, the current account deficit narrowed to an estimated 9.3% of GDP from 9.9% in 2007.

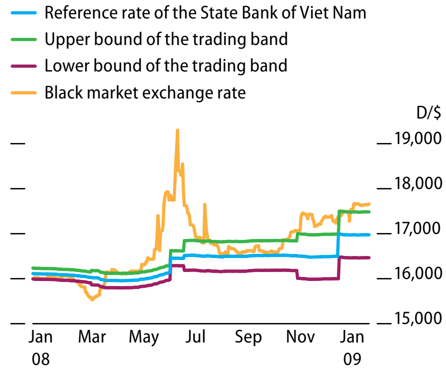
Despite tight global financial conditions, net foreign direct investment (FDI) inflows increased in 2008, in part reflecting government efforts to facilitate FDI projects. However, inflows of foreign portfolio investment plunged. The overall balance of payments recorded a small surplus, and gross official reserves rose to about $23 billion at end-2008 from $21 billion a year earlier (Figure 3.31.8).

The global financial crisis did not directly affect Viet Nam's banks, which are not yet deeply integrated into the international financial system. It did, though, contribute to declines in foreign portfolio investment inflows and stock prices. The VN Index of the Ho Chi Minh Stock Exchange fell by about two thirds in 2008 and continued to decline in early 2009. This caused delays in equitization (partial privatization) of state-owned commercial banks and other state enterprises. The drop in stock prices also contributed—along with the cooling of the real estate market and slowdown of economic growth—to an increase in nonperforming loans in bank loan portfolios.

Economic prospects

Near-term economic prospects are clouded by an unusually high level of uncertainty, primarily for two reasons. First, the global financial crisis and economic downturn are likely to reduce FDI and remittance inflows, as well as further crimp exports, foreign portfolio investment inflows, and overall growth. The global slump will also likely weigh on world commodity prices and reduce inflation pressures. The strength and duration of these effects will depend on how long global financial conditions remain weak and how deep and prolonged the global downturn will be.

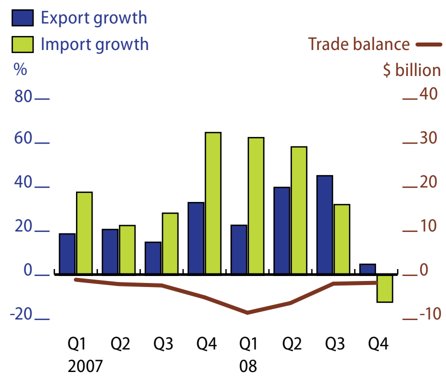
3.31.6 Exchange rates



Sources: State Bank of Viet Nam; staff observations.

Click here for figure data

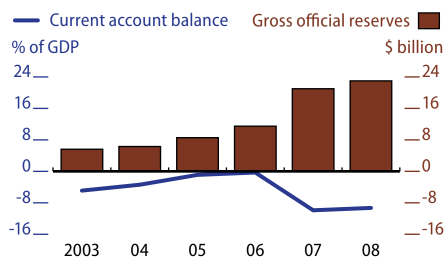
3.31.7 Trade indicators



Sources: General Statistics Office of Viet Nam; International Monetary Fund, *International Financial Statistics* online database, downloaded 27 February 2009; staff estimates.

Click here for figure data

3.31.8 Current account and reserves



Note: Reserves exclude the Government's foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Sources: State Bank of Viet Nam; International Monetary Fund, *Country Report* No. 07/386, available: http://www.imf.org; staff estimates.

Click here for figure data

Second, there is uncertainty about what additional fiscal stimulus the Government might adopt (beside the measures approved in January–February this year). Stimulus measures may well lift growth, but they are also likely to widen the fiscal and current account deficits, and may stoke inflation.

The baseline scenario for 2009 and 2010 assumes that the external environment will evolve in accordance with the expectations of this *Asian Development Outlook*. It further assumes that the Government will take some more fiscal stimulus measures (as well as those approved in January–February) in the total amount of about $1.0 billion in 2009. Furthermore, SBV is seen keeping monetary policy fairly loose, provided that inflation is subdued. Weaknesses in the banking system are not expected to lead to a systemic financial crisis.

Oil output is expected to rise to 15.5 million metric tons in 2009 and remain at that level in 2010. The country's first oil refinery, which started operations in February 2009 and is capable of processing 6.5 million metric tons of crude oil annually, is expected to reach full capacity by August this year.

On the above basis, GDP growth is projected to moderate to 4.5% in 2009 (Figure 3.31.9). Loose monetary policy and the fiscal stimulus will support public consumption and domestically financed investment; net exports are expected to increase. However, private consumption will slacken further because of slower economic activity, higher unemployment, and lower stock and property prices. The expected decline in FDI inflows will lead to a downturn in foreign-financed investment.

Growth is expected to rebound to 6.5% in 2010. With monetary policy remaining loose, the expansion of consumption and domestically financed investment will accelerate as the fiscal stimulus works through the economy. The forecast improvement of global financial conditions and the strengthening of external demand will bring about an upturn in foreign-financed investment and a further rise in net exports of goods and services.

Average annual inflation is forecast to slow to 4.0% in 2009, since GDP is likely to be below its potential level and world commodity prices are expected to be substantially lower than last year's average levels. Inflation will quicken to 5.0% next year on account of loose monetary policy, the expected modest rise in world commodity prices, and the projected rebound in growth.

The fiscal deficit is forecast to widen to 9.8% of GDP this year due largely to an expected decline in government oil revenue, a reduction in base corporate income tax from 28% to 25%, the slowdown of economic growth, and the fiscal stimulus measures. Despite the increase in oil output, oil revenue will fall because world prices are forecast to be much lower this year than last. The fiscal deficit will shrink to 5.3% of GDP in 2010. An expected rise in world oil prices next year (hence oil revenue), and the rebound of economic growth will boost total government receipts. Total spending will come down since no major fiscal stimulus measures are expected next year.

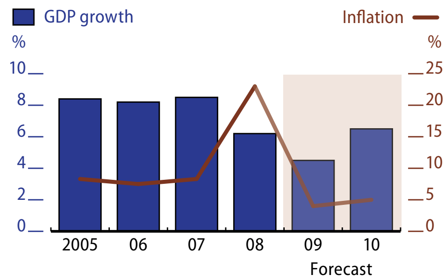
Because of the wide fiscal gap, the stock of public and publicly guaranteed debt will jump to 45.8% of GDP in 2009 from 39.7% in 2008 (Figure 3.31.10). It will fall to 45.1% of GDP in 2010 on account of the

3.31.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.5	6.5
Inflation	4.0	5.0
Current account balance (share of GDP)	-11.5	-9.7

Source: Staff estimates.

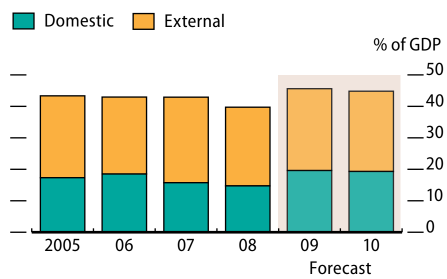
3.31.9 Growth and inflation



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

Click here for figure data

3.31.10 Public debt



Sources: Ministry of Finance of Viet Nam; staff estimates.

Click here for figure data

smaller fiscal deficit and larger nominal GDP. The public debt burden should therefore remain moderate.

The current account deficit is forecast to widen to 11.5% of GDP in 2009. The start of domestic processing of oil, weak external demand, and lower export prices will reduce exports. Imports will decline even more than exports due to lower import prices, a steep drop in imports of refined oil products, and the economic slowdown. The narrowing of the trade deficit will be more than offset by smaller remittance inflows resulting from the anticipated worsening of the economic situation in origin countries. FDI inflows will decline as well, and inflows of foreign portfolio investment will remain small because of tight global financial conditions, increased economic uncertainty, and heightened risk aversion among investors. The overall balance of payments is likely to be in deficit this year.

In 2010, the current account deficit is expected to narrow to 9.7% of GDP. Higher external demand and export prices will boost exports, and remittance inflows will pick up, but these increases will be partly offset by an increase in imports due to a rise in import prices and the rebound in domestic economic growth. Inflows of FDI and foreign portfolio investment will climb, on the back of improved global financial conditions and investor sentiment. The overall balance of payments will return to surplus.

Risks to the forecasts posed by the uncertain external environment are tilted to the downside. As for domestic risks, if the Government takes more ambitious fiscal stimulus measures than the baseline scenario assumes, growth will be higher, the fiscal and current account deficits will be wider, public debt will be greater, and inflation may be steeper than in that scenario. As in the first half of 2008, higher inflation and a wider current account deficit may fuel inflation, cause capital flight, and create downward pressure on the dong. High inflation and exchange rate instability would have an adverse impact on economic growth over the medium term. Weaknesses in the banking system present a further downside risk (Box 3.31.1).

In the medium term, GDP growth is likely to pick up to 7–7.5%, driven by strong FDI inflows. Viet Nam remains an attractive destination for FDI despite the macroeconomic turbulence it experienced in 2008 and the serious economic difficulties it faces in the near term. Indeed, new FDI commitments more than trebled to $64.0 billion in 2008 from $20.3 billion in 2007 (Figure 3.31.11). Although actual FDI inflows are projected to decline this year, they are expected to rebound in 2010 and remain buoyant over the medium term. A government decision in October 2008 to allow full privatization of certain state enterprises, in particular through their sale to foreign investors, will likely spur further FDI inflows.

Development challenges

Due to rapid economic growth, Viet Nam was able to reduce unemployment and poverty considerably in recent years. The current economic slowdown, however, is undoing some of these gains (Box 3.31.2).

In the short term, the Government can bolster sagging growth through expansionary macroeconomic policies. However, expansionary

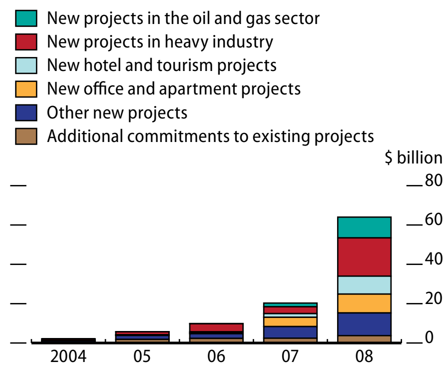
3.31.1 Banking vulnerabilities

Viet Nam has a large number of banks, many of which are fairly small. Some banks have a low capital-adequacy ratio, have made insufficient provisions for bad loans, and are vulnerable to shocks. According to the State Bank of Viet Nam, the share of nonperforming loans in bank loan portfolios increased to 2.1% at the end of 2008 from 1.5% a year earlier.

However, the asset classification system used by most banks in Viet Nam tends to underestimate the nonperforming loan ratio. The ratio for the entire banking sector would most likely be higher if all banks adopted a more stringent classification system. That share is likely to rise further in 2009 in the context of slowing economic growth and depressed asset prices.

Nonetheless, the probability of a systemic banking crisis is low. The central bank is strengthening prudential regulation and supervision of banks and has suspended the licensing of new banks so that it can focus on supervising the existing ones. If a bank becomes financially distressed, the central bank is likely to provide liquidity support to that bank or initiate its merger with another bank (or do both), to ensure that the problem bank does not cause a systemic crisis.

3.31.11 New foreign direct investment commitments



Source: General Statistics Office of Viet Nam.

Click here for figure data

fiscal policy is likely to raise the fiscal deficit and the public debt burden. The Government may find it difficult to rein in the fiscal deficit later, both because of larger interest payments, and because of likely resistance to higher taxes and lower spending. Domestic financing of the fiscal deficit will increase money supply or crowd out private investment, or both, and may fuel inflation and hinder growth in the medium term. External financing of the fiscal deficit will increase the external debt burden. Expansionary monetary and fiscal policies, and increased external debt service, will widen the current account deficit (which is already quite large) and may destabilize the macroeconomic situation again.

It is therefore important that the Government strike a balance between stimulating growth and keeping the fiscal and current account deficits in check, as it tries to counter the impact of the global financial crisis and economic slump. Achieving this balance requires the Government to be particularly careful in taking additional fiscal stimulus measures, and to avoid spending on low-return public investment projects. It should prioritize social assistance to the unemployed and the poor, as well as support for small and medium-sized enterprises, and export-oriented industries. It could also make greater efforts to facilitate implementation of FDI projects and speed up the disbursement of official development assistance. Further increasing exchange rate flexibility would help prevent expectations of a sharp devaluation that can arise from a large current account deficit.

A major medium-term economic challenge for Viet Nam is to ratchet up growth without fueling inflation and increasing the current account deficit. To this end, the Government needs to intensify its efforts to raise the efficiency of the economy and ease supply-side constraints on growth, notably by removing infrastructure bottlenecks, improving the legal and regulatory framework for private sector development, strengthening public administration, and increasing the supply of skilled labor.

Restructuring state enterprises is crucial for raising the efficiency of the economy, since they employ a substantial proportion of available resources but do not use them very efficiently. These entities need to be restructured and their involvement in noncore businesses curtailed in order to utilize scarce resources more efficiently and to improve productivity. It is also important to subject them to hard budget constraints and to maintain adequate control over their finances to limit the Government's contingent liabilities. A decision by the Government in February 2009 to restrict state enterprise investments in noncore businesses (especially in financial companies) was a step in this direction.

The experience of the transition countries of Central and Eastern Europe and the former Soviet Union shows that privatization of state enterprises can lead to their restructuring and improved efficiency, though it is neither a necessary precondition for, nor does it guarantee, successful restructuring. Hence, even if market conditions are currently unfavorable for such privatization, the Government should accelerate restructuring of state enterprises, and, as soon as market conditions improve, speed up their privatization.

3.31.2 Unemployment and poverty

Viet Nam has generated millions of new jobs in recent years. The number of employed people rose from 37.8 million in 1999 to 44.2 million in 2007. The unemployment rate in urban areas fell from 6.7% in 1999 to 4.6% in 2007, despite substantial labor migration from rural to urban areas. The poverty rate dropped from 37.4% in 1998 to 16.0% in 2006, based on household survey data. According to the World Bank, the proportion of people living on less than $1 a day based on purchasing power parity (PPP) fell from 16.9% of the total population in 1999 to 4.0% in 2007, and the proportion of those living on less than $2 a day (PPP) declined from 65.9% to 32.9%.

Last year, however, the unemployment rate in urban areas rose to an estimated 5% as growth slowed and many firms cut jobs. Anecdotal evidence suggests that unemployment and underemployment increased in rural areas too, although agriculture performed relatively well. Many people from rural areas who were employed in cities but lost their jobs moved back. In addition, high inflation pushed many low-income households into poverty.

Unemployment and underemployment are likely to increase further and more households may fall into poverty this year, as growth continues slowing. Therefore, the Government should ensure that the poor and unemployed get assistance in the fiscal stimulus measures.