Subregional summaries

Central Asia

Subregional assessment and prospects

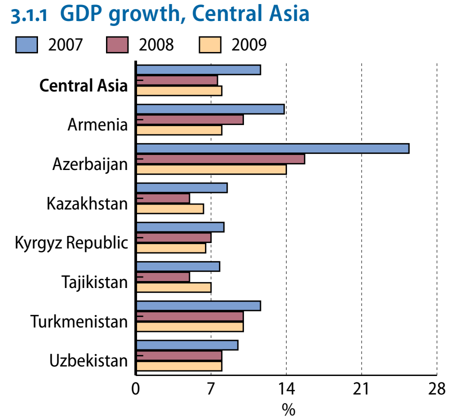
A slowdown is under way in the subregion in an external environment of global financial turmoil as well as rising fuel and food prices (Figure 3.1.1). Among individual countries, Kazakhstan is dealing with the effects of financial contagion from the global credit market turmoil, exacerbated by its past excessive borrowing. The Kyrgyz Republic is experiencing spillover effects of financial turbulence indirectly via its linkages with Kazakhstan's financial sector. For the other countries though, the risk of financial contagion is slight because their access to international capital markets is limited.

Rising fuel prices are having asymmetric effects on countries in the subregion. For the hydrocarbon exporters (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan), the price-driven surge in energy exports has boosted the contribution of net exports to GDP growth. For the hydrocarbon importers, higher costs of fuel imports are exerting downward pressure on their economies.

Increasing food prices, however, are having adverse consequences throughout the subregion. The net food importers (all countries except Kazakhstan and Uzbekistan), must tackle both a food price shock and a food supply problem. Higher food prices severely impact poorer households, which are consuming less and seeing an erosion in their purchasing power. There are also food supply shortages, largely because subregional food exporters have imposed export bans and shortfalls have occurred in domestic production. The two net food exporters are better off because food availability is not an issue. Yet the authorities in these two countries also have to deal with the impact of higher food prices falling disproportionately on poorer people.

In several countries, strong remittance inflows are helping sustain private consumption (Kyrgyz Republic, Tajikistan, and Uzbekistan). Foreign direct investment inflows (Armenia) and ramped-up public

3.1.1 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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This chapter was written by Padmini Desikachar for Central Asia, Anthony Patrick for East Asia, Tadateru Hayashi for South Asia, Sharad Bhandari for Southeast Asia, and Craig Sugden for the Pacific, with contributions from various ADB Resident Mission staff.

spending (Azerbaijan) are supporting investment activity. Nevertheless, across the subregion the expansion in domestic demand is weakening.

Growth in the subregion in 2008 is expected to moderate to 7.6% from 11.6% in 2007. The *Update* expects that the pickup in 2009 predicted in April's *Asian Development Outlook 2008* (*ADO 2008*), will be more muted—it revises downward the projection for 2009 from 8.4% to 8.0%. For the hydrocarbon exporters, Kazakhstan's weaker growth in 2008 will partially offset that group's strong performance in the context of a favorable external environment. In 2009, Kazakhstan's expected recovery will support a fillip in subregional growth, outweighing the likely moderation in Azerbaijan's oil boom. An immediate concern for Azerbaijan is the impact of the recent conflict between Georgia and the Russian Federation on transshipment of Azerbaijani oil exports through Georgia. High prices for natural gas are likely to keep contributing to buoyant growth prospects in Turkmenistan and Uzbekistan, the latter also expected to benefit from continuing high world prices for its other major exports, namely cotton and gold.

Among those economies not exporting hydrocarbons, Armenia, as a landlocked country dependent on land routes through Georgia to the Black Sea coast for its imports, is vulnerable to the fallout from the conflict in the Caucasus. Nevertheless, it is expected to see sustained growth of 8–10% over the forecast period that will likely be driven by construction and services, both partly financed by foreign direct investment. Prior to the outbreak of conflict with the Russian Federation, Georgia was poised to achieve strong growth in 2008. The situation has now changed but quantifying the fallout from the conflict will have to be predicated on a post-conflict needs assessment that is just getting under way. Weaker expansion in domestic demand in the Kyrgyz Republic and the spillover of Kazakhstan's financial problems are likely to result in growth easing there. Tajikistan is likely to see its economic situation improve by 2009 with a return to prudent macroeconomic management.

Inflation was in double digits in June 2008 year on year for all countries in the subregion except Armenia, and even there it was well above the central bank's target rate. It exceeded 32% in the Kyrgyz Republic and 20% in Azerbaijan, Kazakhstan, and Tajikistan. The main drivers were increases in food and fuel prices. Food prices, a category that has the largest weight in overall consumer price index baskets, have surged across the subregion, touching 48.2% in the Kyrgyz Republic and 33.1% in Tajikistan in June 2008. Wheat and wheat products, edible oils, meat, and dairy products have seen the largest price increases. Higher energy prices have also been a contributory factor to overall inflation and to higher food prices (through higher transport costs and fertilizer prices).

To address rising inflation expectations, some central banks are tightening monetary policy. Key policy rates have been raised this year in Armenia and Georgia. Also in these two countries, large foreign exchange inflows have put upward pressure on the currency. A relatively flexible exchange rate policy allowing currency appreciation has helped tamp down inflation pressures somewhat.

Kazakhstan and the Kyrgyz Republic, however, have opted not to raise interest rates out of concern that such a move may affect economic

growth, which has been subdued in part because of a credit crunch faced by banks in these countries. The authorities in Kazakhstan continue to maintain the tenge's peg to the dollar, adopted in late 2007 when the currency came under downward pressure, a strategy that will be in place until the current macrofinancial risks are resolved. The Kyrgyz Republic's authorities are now supporting its exchange rate, which has also come under downward pressure, through interventions in the foreign exchange market. Currently, foreign reserves cover is adequate but further oil price shocks may remove that cushion.

In Azerbaijan, the peg to a currency basket adopted this year is aimed at checking imported inflation. Inflation pressures have been exacerbated by rapid credit expansion and acceleration in manat base money.

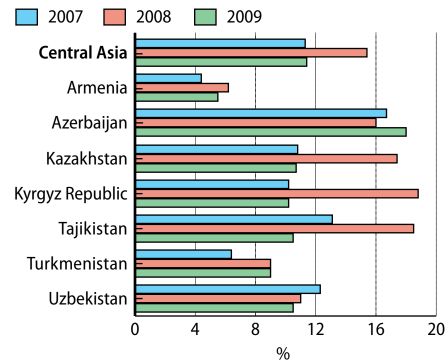
Subregional inflation is expected to remain high in 2008 before easing in 2009 (Figure 3.1.2), determined largely by supply factors. Available forecasts for food prices suggest that wheat prices are likely to fall with better harvests in the large grain-exporting countries of the subregion, but that edible-oil prices will remain high. Energy prices are expected to remain at elevated levels in 2008–2009, reflecting tight supply conditions. With few exceptions, monetary policy frameworks are not robust enough to act countercyclically. The *Update* revises upward the subregion's inflation forecasts for 2008 from 14.4% to 15.4% and for 2009 from 10.2% to 11.4%.

Some countries have introduced fiscal measures to address rising food prices. These include reduced taxes and duties on selected food grains (Azerbaijan, Kyrgyz Republic, and Tajikistan), targeted food subsidies for the poor (Kyrgyz Republic), cash transfers (Azerbaijan), and subsidies for agriculture (Azerbaijan, Kyrgyz Republic, Tajikistan, and Uzbekistan). Some countries have decided to allow a greater pass-through of higher fuel prices. In Armenia for example, a natural gas subsidy that was put in place in 2006 was abolished in May 2008, and partly because of this the fiscal deficit in Armenia is expected to narrow. The Kyrgyz Republic and Tajikistan are, by end-2008, likely to see a widening in their fiscal deficit, and Uzbekistan may see some reduction in its fiscal surplus. Non-oil fiscal deficits as a share of non-oil GDP for Azerbaijan and Kazakhstan are expected to widen.

The subregional current account surplus is climbing because higher prices are boosting the current account surpluses of the hydrocarbon exporters (Figure 3.1.3). Among them, Kazakhstan, which recorded a significant deficit in 2007, is likely to record a moderate surplus in 2008. Azerbaijan's surplus is, however, subject to downside risk because oil transshipments may continue to be affected by tensions in the area. Uzbekistan's surplus is expected to remain high, though decrease moderately.

Among the net importers of energy and food, while hydrocarbon and food prices have adversely affected their current account positions, developments in export performance and remittance inflows have mitigated the impact to varying degrees. Armenia and the Kyrgyz Republic are likely to see a deterioration in their trade and current account balances. Tajikistan's current account position is likely to remain largely unchanged, with a significant part of its imports related to projects financed by the People's Republic of China.

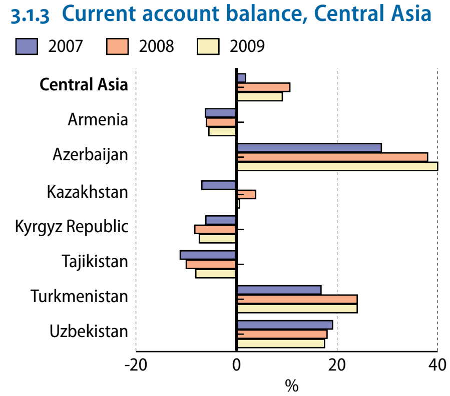
3.1.2 Inflation, Central Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

3.1.3 Current account balance, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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For the fuel and food importers, the main risks are higher than anticipated price increases in these categories. The reserve positions of Georgia, Kyrgyz Republic, and Tajikistan are vulnerable to shocks in fuel and food prices. An oil price shock (Kyrgyz Republic), a food price shock (Tajikistan), or both types of price shock could see these countries' reserve position in terms of months of import cover fall to very low levels, according to recent simulations by the International Monetary Fund (IMF).

Country highlights

Armenia

At 10.3%, Armenia's GDP growth in the first half of 2008 remained robust, albeit somewhat slower than in the first half of 2007. The main drivers were private consumption and investment in the nontradable sectors. On the supply side, the sectors servicing domestic demand—in particular, construction and services—were the main contributors. Downside risks to Armenia's growth prospects have increased with the recent conflict between Georgia and the Russian Federation. Armenia's main trade route runs through Georgia where damage to rail transport infrastructure has disrupted freight traffic.

Inflation pressures have been building up in recent months because of higher international prices for basic foods, removal of the gas subsidy, higher wages and pensions, and rapid monetary growth. For July 2008, the 12-month inflation rate came in at 9.2%. The sources of monetary growth have been unsterilized foreign exchange interventions, cash dedollarization, and rapid credit growth. This has been mitigated to some extent by appreciation of the dram. The authorities have raised the refinancing rate several times this year. The preannounced 3-year inflation target of the Central Bank is 4±1.5%.

The *Update* revises upward the projection for inflation in 2008 to 6.2% and in 2009 to 5.5%. Fiscal policy remains prudent and supportive of monetary policy in controlling inflation. Slower export growth and a pickup in import growth contributed to the widening trade deficit in the first half of 2008. The *Update* revises the projections for the current account balance for 2008 from a deficit of 4.5% of GDP to 6.0% of GDP, and for 2009 from 4.9% to 5.5% of GDP. Areas of reform implementation include enhancing tax administration and developing the capital market, with tax incentives for firms listing on the stock exchange.

Azerbaijan

GDP growth in the first half of 2008 came in at 16.5%, with both oil and non-oil sectors performing strongly. Non-oil sector growth was led by expansion in construction, and by wholesale and retail trade. In the third quarter, the downside risk to the GDP growth forecast for 2008 (15.7%) increased suddenly because of the conflict in Georgia and the knock-on effect on oil transshipments from Azerbaijan. It remains to be seen whether the pumping of oil will be accelerated in the remaining months of the year when the situation normalizes.

The forecast for 2009 is revised downward from 18.0% to 14.0% because the expansion in oil production is expected to flatten and public

spending, previously sustaining non-oil growth, will begin losing steam. The *Update* also revises upward inflation forecasts for 2008 and 2009 from 13.0% and 12.0%, respectively, to 16.0% and 18.0%. Inflation picked up to 20.2% year on year in June 2008, due to acceleration in food prices (27.9%), very high public spending, and growth in money supply.

High public expenditure growth is increasing the demand for nontradable goods and putting upward pressure on the real exchange rate. Also of concern is the rapid credit growth financed from external borrowing by banks and expansion in manat base money. The authorities have recently introduced a currency basket arrangement to contain imported inflation.

Two opposing factors are in play as regards current account projections. One, hydrocarbon prices will remain at elevated levels. Two, oil exports may be at risk because of continuing tensions in the subregion. In this climate of uncertainty, the *Update* retains April's projections for the current account surplus for 2008 and 2009 of 38.0% and 40.0% of GDP, respectively.

Georgia

GDP growth in the first half of 2008 was strong, coming in at 9.3% year on year. The agriculture sector performed well. Industrial growth was sustained by mining and construction, offsetting subdued performance in manufacturing. Consumer price inflation remained in double digits (11.3% in June year on year), due to international food and energy price increases, utility tariff hikes, and growth in money supply stemming from expansion in credit and capital inflows. Food price inflation came in at 13.3% in June, year on year. Fuel price increases have been passed through and associated transportation costs have gone up.

Exchange rate management has become more flexible. Monetary growth acceleration on account of foreign exchange inflows has been contained through limited, sterilized interventions. The nominal effective exchange rate appreciated by 10.3% year on year in July. Fiscal sterilization was being undertaken by accumulating government deposits with the National Bank of Georgia. Early this year, a fiscal responsibility framework was put in place that committed to saving revenue "overperformance"—the Future Generations Fund and the Stable Development Fund have been established to absorb the surplus and privatization proceeds.

The situation has now changed because of the conflict with the Russian Federation in early August 2008. However, until an assessment of the economic fallout is made, meaningful numbers cannot be assigned to projections.

Kazakhstan

The *Update* maintains April's GDP growth forecasts for 2008 and 2009 at 5.0% and 6.3%. While high oil prices have paved the way for a strong contribution from net exports, the credit crunch has crimped domestic demand, with weakening investment and household demand. The credit crunch followed an episode of excessive external borrowing by private banks. This is reflected in the performance of industry subsectors (other than mining and quarrying) where growth has slowed markedly,

particularly in manufacturing and construction. Mining and quarrying grew strongly, led by crude oil, coal, and gas. Agricultural growth remains robust in contrast to that elsewhere in the subregion.

Soaring inflation is the paramount concern, with inflation touching 20% in June 2008 year on year, propelled by higher food prices and public sector wage increases. The authorities responded by banning wheat exports (but this ban was lifted by 1 September). The National Bank of Kazakhstan has had to maintain a balance between promoting growth in light of the credit crunch and checking monetary growth to rein in inflation. It has opted to lower the refinancing rate and the minimum reserve requirements.

The *Update* revises estimates for 2008 and 2009 of the current account from deficits of 5.6% and 4.1% of GDP, respectively, to surpluses of 3.8% and 0.6%, reflecting higher world prices for oil and metals. The trade and current account balances were in surplus in the first quarter. A part of oil revenue is being channeled to the National Fund, which is projected to grow substantially to $32.8 billion by year-end. The structural reform agenda is focused on enhancing banking sector supervision to ensure that episodes of excessive private sector foreign currency borrowing that precipitated Kazakhstan's financial crisis last year do not recur.

Kyrgyz Republic

The *Update* revises downward the GDP growth projections for 2008 and 2009, from 7.6% to 7.0% for 2008, and from 7.6% to 6.5% for 2009. GDP growth slowed to 7.1% in the first half of 2008 from 8.8% in the same period the previous year, reflecting spillovers from neighboring Kazakhstan through the trade, investment, and remittance channels. Hydropower production in 2008 was cut back due to low water levels in Toktogul water reservoir. These factors are expected to bear down on the Kyrgyz Republic's growth prospects in the near term.

The *Update* revises upward the projections for inflation, from 12.0% and 10.0% in 2008 and 2009 to 18.8% and 10.2%, respectively. The first half of 2008 saw a strong acceleration in consumer price inflation (32.3% in June, year on year), with food price inflation running at 48.2%. The Government has responded by subsidizing bread and flour purchased by the poor. The authorities are also focused on ensuring that monetary and exchange rate policies help contain second-round effects of food and energy price increases, and are resisting downward pressure on the currency that emerged in late 2007.

The *Update* revises the current account deficits for 2008 and 2009, which are now projected at 8.3% and 7.4%, respectively. Differences with April's *ADO 2008* projections and time series arise because the National Bank now factors in reexports into its estimates and projections.

Tajikistan

Tajikistan is currently following a staff-monitored program of IMF that aims to provide a framework for macroeconomic stability. Following a poor harvest, growth of the agriculture sector for 2008 is expected to decline, and industrial production has been hit by winter electricity shortages. The *Update* has therefore lowered GDP growth projections for 2008 and 2009 to 5.0% and 7.0%, respectively. High inflation has reduced

purchasing power and adversely impacted private consumption, although stronger remittance inflows have had a mitigating effect. Inflation accelerated to 25.3% in June, year on year, with food price inflation reaching 33.1%. Prices of bread and wheat have doubled in the 12 months to June 2008. Meat prices are also up because of livestock deaths caused by the severe winter. The annual contract price of natural gas imports from Uzbekistan is up by 50%. Higher fuel prices have added to food transportation costs. The *Update* revises the inflation projections for 2008 and 2009 from 17.0% and 10.0% to 18.5% and 10.5%, respectively.

Food shortages and high prices have affected an estimated 2 million people, with those living in rural areas particularly hard hit. Targeted support for the poor will need to be combined with a prudent fiscal policy to restore macroeconomic stability in the short term.

The *Update* expects a somewhat better current account outturn than projected in April, as part of the authorities' strategy of winding down unsustainable imbalances. It forecasts the deficits to be narrower than earlier indicated, down from 15.3% and 11.1% of GDP in 2008 and 2009 at 10.0% and 8.1%, respectively.

Turkmenistan

A severe winter yielded a poor crop harvest and in turn led to supply shortages, offsetting the positive impact of higher hydrocarbon revenues. Inflation pressures are building up from increases in the prices of public transport, petroleum, and food—the prices of these items are controlled but have been adjusted upward in recent months. Monetary policy was loose in 2007 with a significant increase in directed credits contributing to a sharp increase in reserve money and broad money growth. In early 2008 however, greater access to foreign exchange in the lead-up to exchange rate unification and repayment of agricultural loans resulted in a deceleration of growth in money supply.

The *Update* substantially raises the projection for the current account balance for 2008 to 24% of GDP, on the basis of higher gas exports. An IMF mission has noted that hydrocarbon revenues are being treated as off-budget revenues and have urged reform of hydrocarbon revenue management to enhance fiscal discipline and transparency. Until recently, the dual exchange rate regime saw a parallel market exchange rate that was four to five times more depreciated than the official exchange rate. In a step toward currency reform, the exchange rate was unified in May 2008. For the benefits of exchange rate unification to be realized however, other linked reforms, including financial sector liberalization, will be necessary.

Uzbekistan

The *Update* raises projected GDP growth for 2008 from 7.8% to 8.0% and for 2009 from 7.2% to 8.0%. The main growth drivers in the first quarter of 2008 were a favorable external environment for commodity and non-commodity exports, acceleration in hydrocarbon-related foreign direct investment inflows, and strong remittance inflows from the Russian Federation. These drivers are expected to remain in place over the projection period. Inflation is forecast to moderate in 2008, with limited pass-through of higher world food prices, tight monetary and fiscal policies, and sterilization through accumulation of government deposits

at the central bank. Price controls of basic food items and restrictions on some food exports have resulted in lower food inflation than elsewhere in the subregion.

Fiscal tightening through scaling back public investment has helped offset the effects of exchange rate interventions to induce depreciation, but there is concern that this has been at the expense of public investment that could have helped improve public goods provision. Wage and salary increases will be a source of inflation pressures in 2008. More recently, the authorities have eased their efforts to induce nominal depreciation. In IMF's assessment, the sum continues to be undervalued and the authorities need to allow appreciation to check inflation. The current account surplus will remain buoyed by a large trade surplus. Export growth fueled by price and volume increases will outpace import growth over the forecast period, in part attributable to the trade policy regime.

East Asia

Subregional assessment

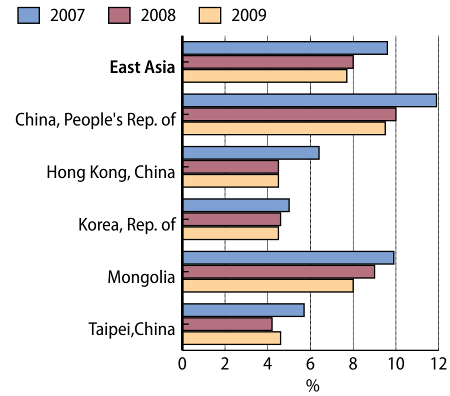
After expanding by more than 9% in 2006 and 2007, economic growth in East Asia is projected to decelerate to 8.0% this year (Figure 3.1.4), in line with the forecast made in *ADO 2008*. The growth projection for the People's Republic of China (PRC), the biggest economy in this subregion, is maintained at 10.0%. Softening demand for the PRC's exports and policy tightening by the authorities have trimmed growth from high levels (11.9% in 2007). Forecasts for Hong Kong, China and Taipei,China also are unchanged from *ADO 2008*. The outlook for growth in the Republic of Korea (hereafter Korea) and Mongolia has weakened a little and their growth forecasts are lowered.

Merchandise exports in US dollar terms grew robustly in the first half of 2008 (by about 22% in the PRC and close to that in Korea and Taipei,China). Demand for the subregion's manufactured products generally remained strong in developing economies, but softened in industrial countries. Import growth surged (by about 31% in the PRC and 29% in Korea) and outpaced that of exports, largely owing to higher global prices for oil and other raw materials. Consequently, trade surpluses fell in the first 6 months of 2008 from year-earlier levels in the PRC; Korea; and Taipei,China. The trade balance in Mongolia turned to a deficit in the first half of this year and Hong Kong, China's trade deficit widened.

Over the course of the first half, GDP growth generally slowed. For some of the economies, this mainly reflected a tapering off in consumer demand, as accelerating inflation eroded spending. Investment growth also eased in April–June, the result of higher costs for many industrial inputs, the deteriorating international economic environment, and, in the case of the PRC, government measures to cool investment and inflation.

Inflation has accelerated at a faster rate this year than was foreseen in *ADO 2008*, with higher prices for food and oil the leading causes. The subregional forecast is revised up by more than 1 percentage point to 6.1%, significantly faster than the 3.9% seen in 2007 (Figure 3.1.5). The 2008 forecasts are raised for all economies. Monetary policy has been

3.1.4 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

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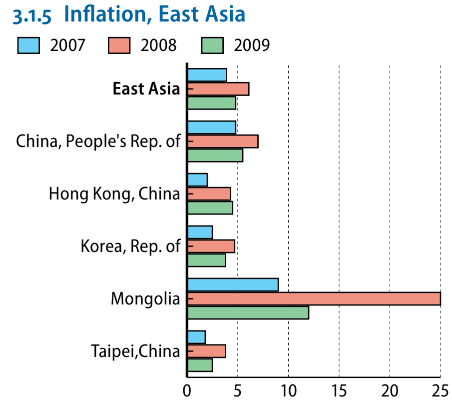
3.1.5 Inflation, East Asia



Sources: Asian Development Outlook database; staff estimates.

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tightened in most economies to curb inflation pressures. Consumer inflation started to ease around midyear in the PRC after good harvests and a recovery in pork production.

A substantial current account surplus (6.2% of GDP) is still expected for the subregion. This is a downward revision from *ADO 2008*, and compares with a surplus of 8.9% in 2007. Korea and Mongolia are expected to record deficits on their current accounts.

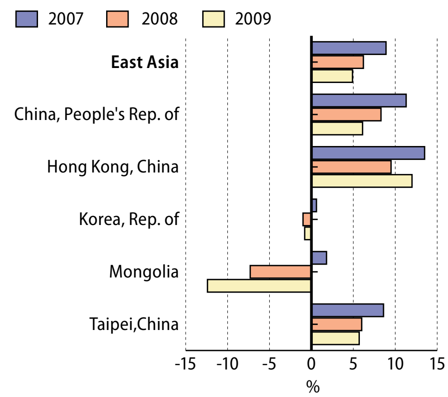
Subregional prospects

Subregional growth next year is forecast to moderate further to 7.7%. Forecasts are lowered from *ADO 2008* for all economies, mainly on account of the deterioration in the global economic and financial outlook. Growth in the PRC is expected to ease to 9.5%, reflecting a smaller trade surplus and slowing investment growth. This will relieve some of the pressures on resources, energy, and the environment that arose during the years of 10%-plus expansion.

Inflation is forecast to decelerate next year to 4.8% on a subregional basis (revised up from 4.2% in *ADO 2008*). This would still put inflation at double the rate recorded over the 5 years 2003–2007.

The subregional current account surplus is expected to decline to 4.9% of GDP in 2009 (Figure 3.1.6), in a downward revision from 6.7% in *ADO 2008*, mainly owing to an expected reduction in the PRC's surplus as its trade surplus declines further. Korea and Mongolia are projected again to record deficits in their current accounts.

3.1.6 Current account balance, East Asia



Sources: Asian Development Outlook database; staff estimates.

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Country highlights

People's Republic of China

Softening external demand and the impact of policy tightening trimmed GDP growth to a still-rapid 10.4% in the first half of 2008. Weaker economic growth in industrial countries and a reduction in PRC tax rebates on exports clipped growth in merchandise exports to 22% in the first half from a year earlier. Import growth (about 31%) outpaced that of exports (22%), and the trade surplus fell.

Rapid growth in fixed asset investment has been damped by rising prices for fuel, power, and raw materials; a halving in the nominal growth of industrial enterprise profits; a slowdown in the property market owing to credit tightening; government directives to reduce fixed asset investment in some industries; and the softening in demand for exports. Real fixed investment growth slowed to about 15% in the first half, from 22% in the prior-year period. Private consumption was strong in the January–June half, despite a pickup in inflation. Retail sales in real terms grew by about 14%, supported by growth in real incomes.

This strength in private consumption, combined with the slowing in investment and exports, is starting to achieve the authorities' sought-after rebalancing in the structure of demand.

Inflation quickened to 7.7% in the first 7 months of 2008, driven mainly by rising food prices. Consumer inflation started to ease after April, but the producer price index continued to accelerate. The Government moved to curb price pressures by, among other measures, selling grain from reserves and strengthening its price controls.

Rapidly growing foreign direct investment and speculative capital inflows boosted foreign exchange reserves to $1.8 trillion by June 2008, even as the trade surplus fell. The central bank increased bank reserve requirements six times between end-2007 and July 2008 and issued bills to drain excess liquidity from the banking system. These efforts, plus guidance to banks to adopt informal credit quotas, curbed lending. The yuan appreciated by 7.3% against the US dollar in nominal terms between end-2007 and July 2008, a little faster than in 2007. Concerned that this might attract more speculative capital inflows and harm exporters, the Government tightened capital controls in August.

The authorities have indicated they will put more emphasis on maintaining economic growth and employment generation in the second half of 2008 and in 2009, and this is likely to mean that some administrative controls on bank lending are loosened. Fiscal policy is expected to remain slightly expansionary. Reaching the Government's inflation target could require an increase in interest rates.

Rising production costs and softening external demand are forecast to trim export growth this year and in 2009, while faster growth of imports than exports will reduce the trade surplus in both years. Growth in real fixed asset investment is projected to slow in the forecast period, too, partly a result of government policy tightening over recent years. Private consumption growth, in contrast, is projected to pick up, supported by rising incomes.

Taking these factors into account, the GDP growth forecast for 2008 is maintained at the 10.0% made in *ADO 2008*. The forecast for 2009 is revised down to 9.5% from 9.8%, because of smaller trade surpluses and slower investment. Growth at that level in 2009 would be in the 9–10% range considered by various studies to be the economy's potential rate of growth, one that does not put undue strains on energy, natural resources, the environment, and inflation.

On the basis of lower merchandise trade surpluses, as well as a continuing deficit in services trade, the forecast for the current account surplus is revised down to 8.3% of GDP in 2008 and to 6.1% in 2009. Food price inflation is expected to decline to single digits later this year, which will bring down overall inflation. Administered fuel and power prices will rise further, though. The inflation forecast for 2008 is revised up to 7.0%, the highest since 1996, from 5.5% in *ADO 2008*, and the projection for next year is raised to 5.5%, from 5.0%.

Hong Kong, China

After solid expansion in the first quarter of 2008, the economy contracted by 1.4% on a quarter-on-quarter basis in the April–June period. GDP grew by 5.8% in the first half of the year. Real growth in exports slowed to 4.9% in the second quarter, nearly half the rate of the first quarter. Although the labor market remained firm, consumer spending was moderated by rising inflation, a falling stock market, and deteriorating global economic prospects. GDP growth is expected to slow further in the second half. The 2008 full-year forecast is maintained at 4.5%. For 2009, the forecast is edged down to 4.5%, based on the weaker outlook for major economies and the likely easing of growth in the PRC.

Higher prices for food, energy, and private housing rents lifted

inflation to a higher than expected 5.1% in the first 6 months, with the rate accelerating to 6.3% in July. The authorities took several fiscal steps to limit inflation, including waivers on public housing rents and private housing rates (or taxes), temporary increases in welfare benefits, and a one-time grant to subsidize household electricity costs. Inflation in full-year 2008 is now expected to average 4.3% and in 2009, 4.5% (both revised up from *ADO 2008*). Substantial current account surpluses (9.5% this year and 12.0% next) are still forecast.

Republic of Korea

Growth decelerated from 5.8% in the first quarter of 2008 to 4.8% in the second, putting the January–June economic expansion at 5.3%. This solid result was fueled by external demand: exports of goods and services rose in real terms by 12.2%, with gains in shipments to Asia and the Middle East more than offsetting sluggish exports to the US. Imports in real terms rose by 8.8%. However, domestic demand weakened sharply. Consumption was eroded by rising inflation, slowing growth in real incomes, and high household debt. Investment was hit by soaring costs of raw materials and energy and by generally weak business sentiment. Private consumption fell in the second quarter relative to the first, investment in construction declined in both quarters, and investment in machinery and equipment softened.

On the supply side, manufacturing, supported by exports, maintained robust growth, particularly for semiconductors, video and communications equipment, and machinery. But services sector growth sagged, as did employment growth.

Inflation averaged 4.3% in the first half and hit a 10-year high of 5.9% in July, well above the Bank of Korea's 2.5–3.5% target. Core inflation (excluding energy and agricultural products) doubled from a year earlier, to 4.6% in July. The central bank, moving to contain inflation expectations, raised its policy interest rate in August by 0.25 percentage points to 5.25%. The authorities also intervened in the foreign exchange market to support the won, which has weakened against the US dollar and added to import-price pressures.

In the second half of 2008, private consumption will likely remain soft and export growth is expected to slow. The GDP growth forecast for all 2008 is revised to 4.6% (down nearly a half percentage point from *ADO 2008*).

A deterioration in the global outlook for 2009 has led to a downward revision in the 2009 forecast to 4.5% (from 5.2% in April). Inflation will be higher than previously expected (it is now forecast at 4.7% for this year and 3.8% in 2009). Higher prices paid for imported oil and other raw materials will cut the trade surplus and push the forecast current account deficit to 1.0% of GDP this year. The deficit next year is projected at 0.8%.

Mongolia

Favorable weather conditions for agriculture and high global prices for copper and gold exports are supporting growth. Large increases in civil service wages and in social welfare outlays have also contributed to growth in domestic demand this year. External demand has been bolstered by continuing economic growth in the PRC, Mongolia's main

export market. GDP growth picked up to 10.2% in the first 3 months of 2008. Higher prices for imported food (food makes up 41% of the consumer price index) and fuel pushed up inflation to 24.6% in the first half of the year, and it reached 32.4% in June. This rapid rate is expected to restrain growth in overall consumption, and the GDP growth forecast for 2008 is lowered by half a percentage point, to 9.0%. Expected slowing growth in the PRC in 2009, combined with policy tightening by the Mongolian Government to rein in inflation, will likely bring GDP growth down next year to about 8.0% (revised down from 9.0% in *ADO 2008*).

Expansionary monetary and fiscal policies have fueled inflation (money supply expanded by 56% in 2007, and the budget recorded a small deficit in the first half compared with a significant surplus in 2007). A depreciation of the togrog against the currencies of the PRC and the Russian Federation, sources of much of the country's food and oil imports, added to price pressures. The Bank of Mongolia has raised both its policy interest rate and commercial bank reserve requirements in an attempt to curb inflation. Nevertheless, the inflation forecast for 2008 is raised to 25% and for 2009 to 12%, both revised up from *ADO 2008.*

The surge in import prices sharply widened the trade deficit in the first half of 2008 and is expected to push the current account into deficit, equivalent to 7.3% of GDP this year and 12.4% in 2009, compared with small surpluses forecast in April. Reflecting the deterioration in the current account and the acceleration of inflation, Fitch Ratings in June 2008 downgraded, to stable from positive, the outlook on Mongolia's B+ long-term foreign and local currency ratings.

Taipei,China

Economic growth slowed sharply from 6.3% in the first quarter to 4.3% in the second, as private fixed investment fell and private consumption growth eased in the face of rising prices and a declining stock market. Net exports accounted for nearly all the second-quarter expansion. Growth in the second half is projected to weaken from the first half's 5.3%, reflecting forecast weakness in both external demand and consumer spending. The growth forecast for all 2008 is maintained at 4.2%.

For 2009, the forecast is revised down by 1 percentage point to 4.6%, mainly because external demand will be weaker than was projected in April. As expected at that time, economic links with the PRC are strengthening and this should support some pickup in growth from this year, as will planned additional public infrastructure spending. Current account surpluses are still expected in both years, but the forecasts are downgraded to 6.0% of GDP this year and 5.7% in 2009 largely because of the weaker international economic environment and higher prices for imported oil and raw materials.

Inflation accelerated to 3.9% in the first half of 2008 and hit 5.9% in July, the highest in 14 years. It was driven mainly by rising prices of imported energy and food as well as by some damage to domestic food crops from bad weather. The monetary authorities continued to raise the benchmark discount rate in small steps, to 3.625% in June, a 16th consecutive quarterly rate rise, aiming to contain inflation expectations and achieve positive real interest rates. The inflation forecast for 2008 is raised to 3.8% (from 2.3% in *ADO 2008*) and for next year to 2.5% (from 1.6%).

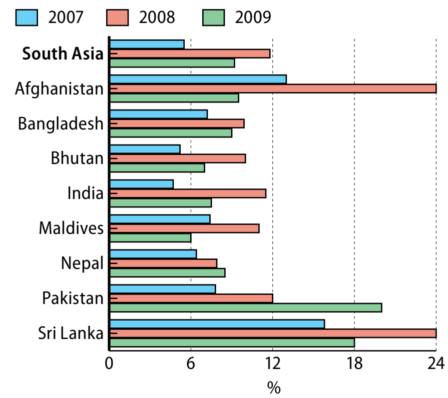
South Asia

Subregional assessment and prospects

As with many countries in other subregions of developing Asia, surging inflation, deteriorating current account balances, worsening fiscal balances, declining local currencies, and belated monetary tightening have hit South Asia in the first few months of 2008. Elections in the next year or so will complicate the economic response.

Inflation in South Asia accelerated in 2008 (Figure 3.1.7), reaching double digits by midyear. Food price inflation is a special concern because food consumption is a very high proportion of consumer spending: it is especially high for the very poor, and is affected by the adjustments in administrated fuel prices (through, for example, higher costs of transportation and for operating farm equipment). The weakening of local currencies against the US dollar in India and Pakistan in 2008 has contributed to inflation pressures, exacerbating the rise in global commodity and other import prices.

3.1.7 Inflation, South Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

The fiscal measures taken to mitigate the impact of import prices on inflation included reductions in import duties or domestic trade taxes on fuel and food in Bangladesh, India, Nepal, Pakistan, and Sri Lanka. Fuel products are subsidized in major South Asian countries (but were eliminated in Sri Lanka in 2006), and subsidization of food grains and fertilizers has been stepped up.

These measures have put heavy fiscal pressure on South Asian countries, and in the absence of fiscal space, budget balances have deteriorated. If all unfunded and unaccounted liabilities of governments are included, South Asia's fiscal deficit as a share of GDP is now estimated to worsen to around 8% of GDP in 2008 from 5.2% in 2007. Off-budget liabilities are likely to increase for state-owned oil and electricity companies, which are incurring losses from the effect of administrated prices despite some upward adjustment of domestic fuel prices in response to the higher world prices.

In addition to the fiscal measures, food exports have been restricted in several countries to secure the domestic food supply. India has banned the export of wheat since September 2007, and added non-basmati rice and edible oil to the export ban in 2008. An export tax has also been imposed on basmati rice. Bangladesh and Nepal restricted food exports in May and April 2008, respectively, and Sri Lanka applied a price floor for rice exports.

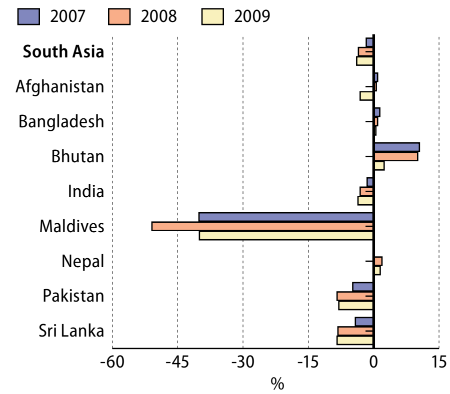
Central banks have started to tighten monetary policy more decisively. India and Pakistan lifted policy rates and cash-reserve ratios, and Sri Lanka raised the yield on government securities. Bangladesh is the exception as it is keeping an accommodative policy to facilitate economic recovery from natural disasters in 2007. Countries with currency pegs, including Bhutan, Maldives, and Nepal, however, have less room for active use of monetary policy to address increasing inflation pressures.

High food and oil prices have the potential risk of generating serious balance-of-payments problems. Since most countries in South Asia are net importers of food and fuel, they suffered from higher import costs and a worsening of their terms of trade, resulting in deterioration in their trade balance and pressures on their foreign exchange reserves.

The impact on the current account has, so far, been relieved by strong performance in services exports (India and the Maldives) and robust workers' remittances (Bangladesh, Nepal, and Sri Lanka). Nevertheless, the current account deficit for the South Asia subregion is projected to be wider in the *Update* than expected in April: the deficit is expected to be 3.5% of GDP in 2008 (revised from 2.5%) and further deteriorate to 3.9% (Figure 3.1.8) in 2009 (revised from 2.8%). Slowdown or reversal of capital inflows in the wake of current economic problems in some South Asian countries is a concern.

Despite efforts to tighten macroeconomic policies, inflation in South Asia is now expected to escalate to 11.8% in 2008 before moderating to 9.2% in 2009. Elections expected in 2008 and 2009 in the subregion may, however, delay price adjustments and subsidy cuts, which could worsen fiscal balances further. Tighter credit conditions and higher interest rates will likely damp investment, and slow economic growth. GDP growth for the South Asia subregion is expected to slow from 8.6% in 2007 to 7.1% in 2008 and decelerate further to 6.7% in 2009 (Figure 3.1.9).

3.1.8 Current account balance, South Asia



Sources: Asian Development Outlook database; staff estimates.

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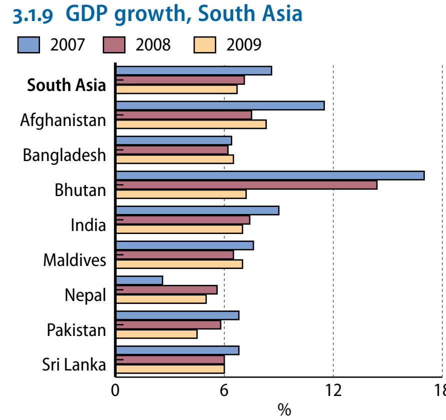
Country highlights

Afghanistan

The effects of drought will likely hit agriculture, in turn dragging the forecast for GDP growth in FY2008 (ending 20 March 2009) lower to 7.5% (from 9.0% in *ADO 2008*). Assuming normal weather, growth in FY2009 is expected to be 8.3%.

A 49% increase in food prices as well as higher prices of imported fuel took year-on-year inflation to 33% in June 2008. Nonfood prices rose by around 10%, indicating that high inflation is largely the result of exogenous factors (poor harvest, and high international food and fuel prices) rather than macroeconomic policies. For FY2008, projected average inflation is revised to 24.0%. The sharp increase in global wheat prices (50–100% from a year earlier) has aggravated poverty in Afghanistan, as wheat is a large part of the consumption basket of the poor and wage hikes lag far behind increases in wheat prices.

3.1.9 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

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To reduce the impact of food inflation, the import tax on both wheat and wheat flour has been eliminated and the tax on edible oil has been reduced from 3.5% to 2.5%. Softening in wheat and other commodity prices, improved rainfall, and a better domestic harvest as well as moderation in global fuel prices—all of which are forecast—are expected to bring inflation down to 9.5% in FY2009. Dealing with the worsening domestic security situation, creating a base for sustainable economic growth, phasing out the opium economy, and overcoming infrastructure bottlenecks, notably electricity, remain key challenges for the economy.

Bangladesh

Growth in GDP (6.2%) and the level of the current account surplus (0.9% of GDP) in FY2008 were close to the earlier projections made in *ADO 2008* in April this year, as the economy showed resilience in recovering from the natural disasters of the first half of the year. However, inflation rose, averaging 9.9% for the year. Higher global oil prices pushed up oil subsidies, causing fiscal pressures to grow. The

caretaker Government (appointed when parliamentary elections were postponed in January 2007) has undertaken economic reforms, pursued a marked anticorruption effort, and pushed through important electoral reforms in preparation for elections expected by end-2008.

For FY2009, this *Update* maintains the earlier 6.5% projection for GDP growth, but expects higher inflation than forecast in April (9.0% rather than 8.0%) and a somewhat lower current account surplus (0.5% instead of 1.0% of GDP).

Bhutan

In FY2007 (ended June 2007), GDP growth rose to 17.0%, pulled up largely by the start of operations at the 1,020-megawatt Tala hydropower plant. As full output from Tala has come on line as expected, the growth outlook of 14.4% in FY2008 and 7.2% in FY2009 (as given in *ADO 2008*) is maintained. The consumer price index increased to 8.9% (year on year) in the April–June quarter of 2008. Given the parity peg between the currencies of Bhutan and India, price movements are very similar, and in view of what is happening in India, Bhutan's inflation forecast is now revised upward to 10.0% in FY2008 and to 7.0% in FY2009.

With Tala's hydropower exports to India, the current account balance switched from deficit into a large surplus amounting to 10.5% of GDP in FY2007. No change is made to the *ADO 2008* projections (surplus of 10.1% of GDP in 2008 and 2.4% in 2009).

India

Recent developments are challenging India's strong growth performance of recent years. Emerging capacity constraints, continued rapid expansion in credit, and partial pass-through of global commodity price increases have triggered steep domestic inflation and consequent monetary tightening. Growth in the April–June quarter of the FY2008 (ending in March 2009) slowed to 7.9% from the 9.2% seen in the first quarter of FY2007, the slowest rate of growth since FY2004. Inflation reached 12.6% toward mid-August. A widening trade deficit, moderating capital inflows, and some depreciation in the rupee are features of current developments. The main problem, however, consists of large fiscal imbalances being created by the escalation in oil and other subsidies and by other unbudgeted liabilities.

The inflation forecasts for FY2008 and FY2009 are revised upward in the *Update* to 11.5% and 7.5%, respectively. Growth is seen edging down from 7.4% in FY2008 to 7.0% in FY2009. How well the Government addresses the difficult issues of oil and other subsidies, so as to maintain macroeconomic stability, and the longer-term adoption of structural reforms, is key to fulfilling the country's enormous potential.

Maldives

Economic growth for 2008 is revised to 6.5%, from the 8.0% projected in *ADO 2008*, owing mainly to reduced construction activity. Due to a significant revenue shortfall, the Government has committed itself to reducing current expenditures by 20% and has decided not to start any new capital project for which contracts have not yet been awarded. The consumer price index, mainly reflecting the escalating costs of food and

fuel, rose by 15.5% (year on year) in June 2008. Average inflation for the year is now forecast at 11.0%.

Given an expansive fiscal policy, very high import dependency, and rising fuel and food prices, the current account deficit widened to the equivalent of 40.1% of GDP in 2007. The impact of these underlying circumstances strengthened in 2008 and the current account deficit is projected to deteriorate further to 50.9% of GDP this year.

Nepal

The political situation offers ground for cautious hope, but remains fragile despite successful constituent assembly elections as well as elections for president and prime minister. GDP growth rebounded to 5.6% in FY2008 (16 July 2007–15 July 2008) from 2.6% in FY2007 due to a weather-induced recovery in agriculture. The growth revival was also aided by continued expansion of services. Industrial growth, however, declined to 1.8% from 3.9% due to the impact of power and fuel shortages and labor tensions. Assuming normal weather conditions, greater political stability, and improved power and fuel supplies, GDP is forecast to grow by about 5% in FY2009.

As a result of sharp increases in food and oil prices, year-on-year inflation rose to 13.4% in mid-July 2008. Average inflation in FY2009 is revised in this *Update* to 8.5% from the 6.5% April forecast (and higher than the 7.9% average of the previous year). Higher remittances and tourism receipts helped more than offset a widening trade deficit to generate a current account surplus of 1.9% of GDP (after a deficit of 0.1% in the previous year). For FY2009, the current account surplus is now projected at 1.5% of GDP, supported by sustained growth in remittances and tourism receipts.

Pakistan

The surge in global oil and food prices and domestic policy uncertainties in a turbulent political year put heavy stress on the economy in FY2008. This was reflected in a slowdown in growth, a buildup in inflation, much larger fiscal and current account deficits, a weakening currency, and a large drop in foreign reserves. Increased risk perception was seen in a downgrading of credit ratings, a rise in sovereign bond spreads, a slide in capital inflows, and declining access to international capital.

With continued high oil prices, an ongoing power deficit, and tightened demand management policies to correct macroeconomic imbalances, economic growth in FY2009 is put at only 4.5%, while the current account deficit estimated at 8.0% of GDP will be little changed from a year earlier. High inflation will persist (averaging 20.0% compared to 12.0% in FY2008) as domestic fuel, food, and power subsidies are rationalized. While macroeconomic imbalances are expected to shrink, they cannot be eliminated in the short term.

Sri Lanka

The economy grew by 6.8% in 2007. Growth was forecast to be slightly lower in *ADO 2008*, at around 6.0% in both 2008 and 2009, mainly due to the global slowdown affecting Sri Lanka's key export markets. No change in these forecasts is made in the *Update*. Point-to-point inflation

hit 18.8% in December 2007, driven mainly by food prices. In 2008, the Government increased fuel prices several times to allow a pass-through of international oil price increases. Electricity tariffs were also revised in 2008, reflecting cost pressures on thermal power generation.

These administered price rises have pushed up inflation, which reached 28.2% by end-June. Reflecting this, average inflation for 2008 is now projected at 24.0% in 2008, compared with the 16.2% forecast made in *ADO 2008*. While global prices of food and oil are expected to moderate in 2009, wage increases in the public and private sector (public sector wages and pensions are partially inflation indexed) indicate that demand pressures will remain high. The forecast for inflation in 2009 has been raised to 18.0% from 14.0% in *ADO 2008*.

Sri Lanka's balance of payments is under serious pressure, in large part due to high global oil prices. On the positive side, growth in energy demand appears to be slowing, in response to higher prices, and workers' remittances remain high. Nevertheless, the current account deficit has markedly widened and is now projected to increase to 8.2% of GDP in 2008 (up from the 4.3% estimated in *ADO 2008*). Indeed, it may be even wider if the growth of non-oil imports (running at 25% year on year in June 2008) does not slow.

The central bank has intervened to keep the Sri Lanka rupee from depreciating so far in 2008; this policy helps limit inflation pressure but could lead to a rapid depletion of the relatively low level of gross official reserves. Weak industrial-country growth will continue to slow Sri Lanka's garment exports. The *Update* projects the current account deficit to remain high at 8.4% of GDP in 2009.

Southeast Asia

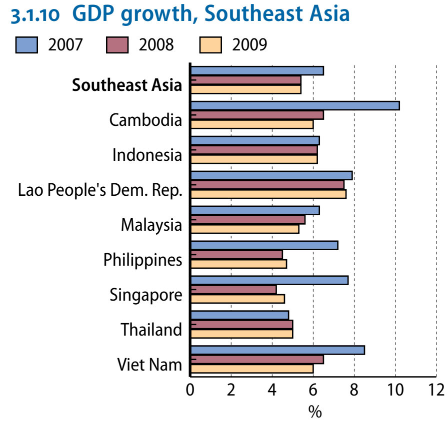
Subregional assessment

Aggregate GDP growth in Southeast Asia is now expected to decelerate to 5.4% in 2008, somewhat lower than 5.7% rate projected in *ADO 2008*, and significantly slower than the 6.5% growth achieved in 2007 (Figure 3.1.10). The impact on economic growth of the weaker external environment and sharp increases in fuel and food prices has varied among the countries, according to their economic states before the rise in prices, their dependence on imports of these products, and policy options available to them. Among the larger economies, growth projections for the Philippines, Singapore, and Viet Nam are revised down significantly. The projection for Thailand has not changed, while those for Indonesia and Malaysia are nudged up.

Inflation has accelerated at a faster pace than expected, and inflation forecasts for this year are marked up sharply for the subregion, from 5.7% to 9.4% (more than double the actual rate seen in 2007). Forecasts for all the countries are raised, to rates that are the highest in more than a decade for some. The pace is particularly fast in Viet Nam, where the rise in fuel and food prices added to the expansionary monetary and fiscal policies in the last several years.

The external current account surplus as a share of subregional GDP is now projected at 4.7%, revised down from 5.8% in *ADO 2008*.

3.1.10 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

The surpluses in Indonesia and Thailand are projected to be narrower, the former because of strong domestic demand as well as higher costs of imports, the latter on large import requirements for fuel. In the Philippines, weak electronic exports, in addition to large fuel and food imports, have contributed to a downward revision to the current account surplus. Viet Nam's deficit is projected to widen. Its imports in the first half rose strongly in part on expectations of a devaluation of the dong, as well as purchases ahead of impending higher import taxes. In contrast, the surplus has been larger than expected in Malaysia, which has benefited from higher fuel and nonfuel commodity prices.

The variation in economic performance can partly be explained by the countries' dependence on imported commodities. Net exporters of commodities have benefited from the improvement in terms of trade and consequent support to incomes and consumption. Indonesia and Malaysia are net exporters of energy as well as some other nonfuel commodities. Thailand imports fuel, but is a significant exporter of agricultural commodities. Viet Nam turned into a net fuel importer this year as its imports of petroleum products exceeded its exports of crude oil. Like Thailand, it is a large exporter of agricultural commodities. The Philippines is a net importer of both fuel and food.

Indonesia, Malaysia, and to a lesser extent Viet Nam subsidize domestic fuel prices, and these countries provide some form of subsidy for food, especially rice, as well. This has cushioned the impact of higher prices on consumers. However, the increasingly heavy fiscal burden of subsidies, combined with their distortionary effect on efficient use of energy and allocation of resources, prompted these countries to raise domestic prices to align them more closely with international prices.

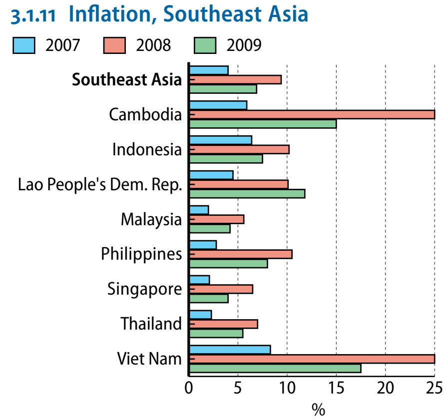
Fiscal policy has been tightened in Viet Nam to reduce demand-side pressure on inflation, and funds have been reallocated from administrative and capital expenses toward food subsidies and assistance to the poor. In Indonesia, where the cost of fuel subsidies has climbed, spending on social and development programs has been squeezed so as to meet fiscal targets. Malaysia's fiscal deficit is set to widen this year with an increase in subsidies, while Singapore recorded a larger surplus in the fiscal year ending March 2008 than initially projected. In the Philippines and Thailand, higher receipts from import tariffs and taxes (including those on fuel), have helped finance some of the assistance to the more vulnerable segments of the population. Monetary policy has been tightened in all the larger countries except Malaysia. Reflecting the intensity of inflation pressures, the extent of the tightening is most severe in Viet Nam, followed by Indonesia, Philippines, and Thailand.

Subregional prospects

Next year's subregional growth forecast is marked down to 5.4% from 6.0% in *ADO 2008* as the rise in consumer prices, as well as generally tighter monetary policies, damp spending growth. Downward revisions are substantial for the Philippines, Singapore, and Viet Nam.

The inflation forecast is revised up from 4.7% in *ADO 2008* to 6.9%. Inflation is generally expected to moderate from levels reached this year (Figure 3.1.11). Tighter policies to restrain demand, particularly in

3.1.11 Inflation, Southeast Asia



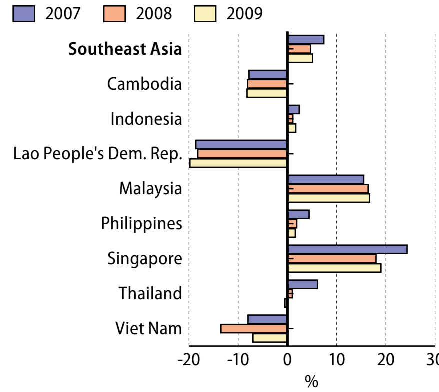
Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Viet Nam with evidence of demand-side pressures, should help suppress inflation pressures.

The current account surplus is projected at 5.1% of GDP next year, trimmed from 5.5% in *ADO 2008*. Surpluses are revised up for Indonesia and Malaysia, and Viet Nam is now expected to post a narrower deficit. Narrower surpluses are projected for the Philippines and Singapore (Figure 3.1.12). Thailand is now forecast to record a deficit.

3.1.12 Current account balance, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Country highlights

Indonesia

The economy is on track to achieve 6.2% growth this year, slightly higher than projected in *ADO 2008*. Growth has been broad-based, with private consumption and fixed investment recording healthy increases, and a modest contribution from net exports. On the supply side, investments in the plantation sector and favorable weather benefited agriculture. Industry slowed in the first 6 months however, reflecting low investment in manufacturing, rising wages, and inflexible labor laws. Services continued to provide the main impetus to growth. Next year, growth is forecast to remain at 6.2%, supported by higher government spending and somewhat firmer consumption as inflation subsides.

The current account surplus is expected to fall to 1.1% of GDP in 2008, more than projected in *ADO 2008*. While exports rose strongly with help from higher commodity prices, imports rose even faster with the increase in import prices and sturdy domestic demand. The surplus is forecast to rise to 1.7% of GDP next year.

Inflation has accelerated to well above the 4–6% target set by the central bank, driven by high food and energy prices as well as strong domestic demand. Administered fuel prices were increased in May to reduce fiscal pressures from fuel subsidies. Leaning against inflation, the central bank raised its policy rate by 125 basis points in May–September. Inflation is expected to average 10.2% this year, before slowing to 7.5% in 2009 (both revised up from *ADO 2008*).

With subsidies likely to increase to almost 30% of government expenditures, even after the hike in fuel prices, some social and capital spending has been scaled back to meet the budget deficit target. The Government increased food subsidies and provided cash assistance for the poorest households.

Malaysia

GDP growth has slowed more moderately this year than expected. Higher international prices of commodities have improved the terms of trade, supporting incomes and demand. An accommodative monetary policy and expansionary fiscal policy have also supported growth. Private and public consumption remain strong, reflecting the effect of higher commodity prices on rural incomes, stable labor markets, the rise in civil servants' salaries in July 2007, spending on March elections, and declining real interest rates. Fixed investment, however, rose modestly in the first 6 months because of economic and political uncertainties. GDP growth this year is forecast at 5.6%, revised up slightly. With the external environment remaining soft, more moderate commodity prices, and

limited room for a fiscal stimulus, growth next year is now projected to decelerate to 5.3%.

The current account surplus for this year and next is projected to be wider than previously expected, largely reflecting the positive effects of higher prices on exports of commodities such as natural gas and palm oil.

Inflation has accelerated significantly faster than projected in *ADO 2008* on higher prices of food and fuel. The Government raised prices of gasoline and diesel in June to reduce the cost of subsidies. Bank Negara Malaysia has kept its policy rate unchanged to August, expecting slower economic growth to temper inflation. There is so far little evidence of a spillover of fuel and food prices into general inflation. The inflation forecast is raised to 5.6% this year and to 4.2% in 2009.

Philippines

Economic growth this year is projected at 4.5%, downgraded from 6.0% in *ADO 2008*. The economy has been hurt by the sharp increase in global food and fuel prices and the deceleration in global growth, since it relies heavily on imports of fuel and food to meet domestic needs. High prices, coupled with weak consumer sentiment, have damped consumption spending in spite of strong growth in remittances from overseas workers. Export growth has weakened, partly reflecting the country's dependence on electronic products and the downtrend in the global technology cycle. Growth in 2009 is now forecast to remain moderate at 4.7% on weakness in external demand, but supported by remittances and higher government expenditures.

Inflation is projected to be higher than in *ADO 2008* for this year and next. The Government does not subsidize fuel, except for a modest subsidy on diesel for public transport. Rice, however, is subsidized. Core inflation, which strips out unprocessed food and fuel, has also risen suggesting that inflation pressures have broadened. The central bank raised its policy rates in June–August to stem inflation, which is now projected to reach 10.5% this year before moderating to 8.0% in 2009.

The current account surplus is projected to be smaller in 2008 and 2009 than previously expected. A combination of weak exports together with rising fuel and food imports has contributed to a larger trade deficit. Remittances, and to a lesser extent revenues from business process outsourcing, have supported the current account.

Higher prices of fuel and food reversed some of the gains in poverty reduction achieved in the last few years. The Government is using higher receipts from value-added tax on petroleum products to fund cash transfers and subsidies to protect the poor from falling deeper into poverty.

Singapore

Growth in the first half of this year decelerated sharply to 4.4% from 7.7% in full-year 2007. Among the major sectors, manufacturing growth slowed, with a contraction in the second quarter, mainly reflecting weaker external demand for pharmaceutical and electronics products. Trade, financial services, and construction also slowed from their cyclical peaks last year, but continued to expand significantly. Transport and storage showed sustained growth as shipping-container throughput continued to

rise at double-digit rates. Increases in employment contributed to growth in private consumption, and fixed investment remained strong. Domestic demand is likely to slow with a deterioration in terms of trade and softness in labor markets, but it should be supported by a modest fiscal stimulus and ample domestic liquidity. GDP growth is now projected at 4.2% this year, compared with 5.2% in *ADO 2008*, before picking up modestly to 4.6% in 2009 (also revised down).

Inflation accelerated to 7.5% in the second quarter and averaged 7.1% in the first 6 months, reflecting higher prices of food, fuel, and housing. Price pressures are likely to moderate as economic growth slows. The effect of an increase in the goods and services tax in July 2007 should also taper off starting in the second half of this year. Commodity prices are expected to increase at a slower rate next year, and the authorities' maintenance of the policy to allow a gradual appreciation of the Singapore dollar's nominal effective exchange rate is forecast to damp imported inflation. This year, inflation is projected to average 6.5%, up from 5.0% expected previously, before moderating to 4% in 2009.

The current account surplus declined sharply in the first 6 months of 2008, although at 15% of GDP, it remains large. The lower surplus reflects primarily movements in the trade surplus. Non-oil domestic exports, which account for about three fourths of domestic exports, contracted. Imports, in contrast, rose by 21%, partly a result of a 5% rise in import prices. External demand is expected to remain soft into next year. However, the likely slowdown in imports in line with softer exports and domestic demand should support the current account surplus at around 18–19% of GDP this year and next.

Thailand

Growth has decelerated over the course of the year as rising political tensions undermine business and consumer sentiment. GDP is projected to expand by about 5% this year and next, but the forecasts are subject to strong downward risks because of the political uncertainties. The 2009 forecast is revised down slightly on expected sluggish global trade and higher domestic interest rates.

Inflation has risen faster than expected in *ADO 2008*, reaching an 11-year high of 9.2% in July before easing in August. Producer prices increased at a much faster pace, so inflation pressures are likely to persist. The central bank raised its policy interest rate by 25 basis points each in July and August to 3.75%. Inflation is now projected at 7% this year, revised up from 4% in *ADO 2008*, before moderating to 5.5% in 2009.

The current account surplus is forecast to narrow to 1% of GDP, from 3% projected in *ADO 2008*, as the boost to agricultural exports from higher prices is offset by the rise in the value of fuel imports. Export growth is expected to ease in 2009. At the same time, public infrastructure investment should pick up, if the political environment allows. That will contribute to growth in imports and a larger trade deficit. Tourism receipts will also be dented by the political uncertainties and travel warnings. The current account next year is forecast to turn a small deficit, the first in 4 years.

To mitigate the impact of inflation on the poor, the Government released stocks of rice at low prices, eliminated excise tax on gasoline

and diesel, and cut or eliminated charges on some utilities and public transportation for 6 months from August. The fiscal deficit is expected to widen to 2.4% in 2009, from about 1.8% this year, if government spending increases as planned.

Viet Nam

The growth projection for this year is revised to 6.5% from 7% in *ADO 2008*. Government anti-inflation measures have restrained rapid growth of investment and halted expansion of construction activity. These measures are likely to continue into 2009, and external demand is expected to soften, trimming GDP growth to 6%, also less than previously projected.

The current account deficit is seen widening significantly this year to 13.5% of GDP, compared with 10% forecast previously. Exports rose at a robust 32% in the first half, as higher commodity prices more than offset the decline in volume of oil and some other products. Imports surged by 60%, reflecting higher purchases of petroleum products and precautionary imports on impending higher tariffs on some goods and expectations of currency devaluation. The 2009 current account deficit is forecast to be narrower than this year's gap and than the *ADO 2008* projection. Export growth is likely to moderate on declining oil output and soft external demand, but the rise in imports will also decelerate as aggregate demand softens and imports of oil decrease.

Inflation this year is now expected to hit 25%. Price pressures intensified in the first half, driven by loose monetary and fiscal policies in the past several years, higher global prices for fuel and food, as well as some shocks to agricultural production. The Government subsidizes domestic fuel prices, but these were raised in July to reduce the burden on fuel importers and the budget. A depreciation of the dong also added to inflation pressures.

The State Bank of Viet Nam has implemented increasingly stringent measures to combat inflation and restore macroeconomic stability. Fiscal policy has also tightened, and investment by state enterprises has been pulled back. At midyear the economic situation started to improve. The anti-inflation measures are projected to bring down inflation to 17.5% in 2009, but still higher than forecast in *ADO 2008*.

The Government has raised the allocation for assistance to poor households to cope with the effects of higher inflation.

Other economies

Cambodia

The near-term economic outlook has deteriorated as a result of weaker growth in the US (the main market for Cambodia's garment exports), higher fuel and non-fuel commodity prices, and continued US dollar weakness. Clothing exports to the US have increased only slightly this year and exports to the European Union have contracted. Construction activity appears to be slowing. Robust tourism and a good rice harvest support growth, now forecast at 6.5% for 2008 and 6% next year, both revised down from *ADO 2008*.

The forecasts for the current account are revised to slightly narrower deficits this year and next compared with *ADO 2008*. Exports are

expected to remain weak, although imports are also likely to rise at a slower pace. Inflows of foreign direct investment and aid are seen keeping the overall balance of payments in surplus.

Inflation is widely believed to have accelerated this year, although official data have not been published, pending a revision to the method for calculating the consumer price index. Higher prices for domestically produced food have contributed to rising inflation. The 2008 inflation forecast is raised sharply to 25%, and the 2009 forecast to 15%. The authorities have implemented measures to restrict credit and absorb liquidity emanating from a rise in foreign exchange reserves, including restrictions on bank credit to real estate, an increase in the minimum reserve requirement for banks, and less restrictive controls on capital outflows.

There are indications that higher inflation, especially of food prices, has set back efforts to reduce poverty. Preliminary evidence suggests that as many as 2 million people may have slipped below the poverty line, in addition to 4.5 million already in poverty. The Government is implementing emergency food assistance and targeted support to farmer groups with subsidized seeds and fertilizer, among other measures, to increase output and protect the poor.

Lao People's Democratic Republic

GDP growth projections for this year and next are revised down slightly to 7.5% and 7.6%, respectively, from *ADO 2008*. Exports have weakened on the back of a softer external environment. The country continues to benefit from construction of large hydropower and mining projects, and the new Phu Kham copper and gold mine is already contributing to growth. Tourist arrivals are expected to increase by 12% this year.

Current account deficits are expected to be wider than projected in *ADO 2008*, primarily reflecting weaker exports, imports to build hydropower and mining projects, and higher fuel import costs. Significant inflows of foreign direct investment for the projects, as well as official development assistance, finance the deficit. International reserves increased to $711 million, or about 5.6 months of imports, as of May 2008.

The central bank has allowed the kip to appreciate against the Thai baht and the US dollar to contain imported inflation. Broad money supply has grown rapidly, reflecting increased net foreign assets in the absence of effective policy instruments to sterilize these inflows. Inflation projections are revised up to 10.1% this year and 11.8% for 2009. The impact of higher food prices on poverty is mitigated by the significance of the subsistence economy. Rice, for example, is produced mainly for own consumption, insulating consumers from the potential adverse impact of higher international rice prices.

Myanmar

Cyclone Nargis in early May caused large-scale casualties, with an official death toll of 84,000, 54,000 people listed as missing, and 19,400 injured. The disaster caused widespread destruction to homes and infrastructure. Industrial sites, agricultural land, salt farms, and fishing vessels also suffered extensive damage. The total value of damages and lost output is estimated at about $4.1 billion.

In spite of the high human costs, the cyclone is expected to reduce GDP growth modestly. The economic losses are estimated to be about 2.7% of the officially projected GDP in 2008. Inflation was estimated at around 37% in 2007. The damage may further increase inflation pressures, and reconstruction will put upward pressure on demand for labor and construction materials. The expenditure impact of the cyclone will also add to fiscal pressures from high oil and food prices.

The cyclone is likely to increase the country's import bill and may hurt some exports, particularly shrimp. Higher imports are likely to be offset by increasing revenues from natural-gas exports. Such revenues have supported a rising current account surplus, which in 2007 was estimated at $1.1 billion. The current account is expected to continue to stay in surplus, contributing to larger international reserves.

The Pacific

Subregional assessment

The aggregate growth projection for 2008 is revised up from that made in April in *ADO 2008* by almost half a percentage point, to 4.8% (Figure 3.1.13), mainly because of stronger than expected growth in resource-rich Papua New Guinea and Solomon Islands. Their upgraded growth projections more than offset a downgrade in the outlook for six of the 14 Pacific developing member countries attributable to the loss in spending power caused by higher oil and food prices. The projected subregional growth of 4.8% would be the highest since the mid-1990s.

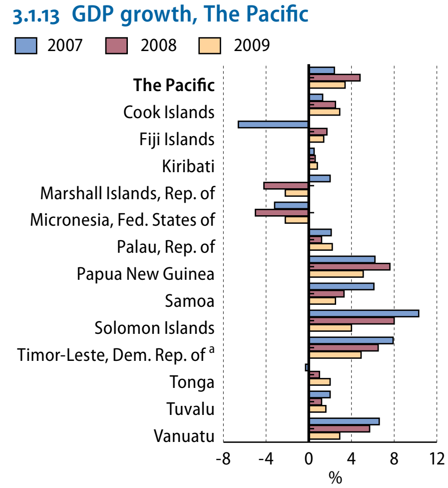
Higher global oil and food prices have led to an upward revision in inflation projections for all the Pacific economies. The forecast for subregional inflation this year is raised to 8.7% from 5.0% in *ADO 2008*, even though some countries have adopted measures to suppress the rise in consumer prices, from the sale of subsidized rice to price restraints on government-owned electricity utilities.

The rise in world oil prices poses greater economic and social risk than the rise in food prices. High transport costs arising from remoteness and the dependence on diesel in electricity generation mean that petroleum products account for a larger share of national expenditure than imported rice and wheat. Moreover, there is little potential to substitute other fuels for imported petroleum products, while in most Pacific islands the local foods (such as sweet potato, cassava, taro, breadfruit, and bananas) provide substitutes for imported rice and wheat.

Higher prices for food and other essentials are seriously hurting vulnerable groups, who need assistance. An earlier estimate by the Asian Development Bank that an additional 5% of the population of some Pacific nations could fall into poverty this year now appear conservative. Those living in urban squatter settlements, those lacking their own fertile land, and those living in remote areas are the most exposed.

Impacts are likely to be most severe in the harsh environments of the atolls, notably in Kiribati, Republic of the Marshall Islands, and Tuvalu. Efforts to adjust to the higher prices, such as by reducing the oil intensity of the economies and by raising local food production, also need to be stepped up.

3.1.13 GDP growth, The Pacific



[a] Non-oil, non-United Nations GDP.

Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

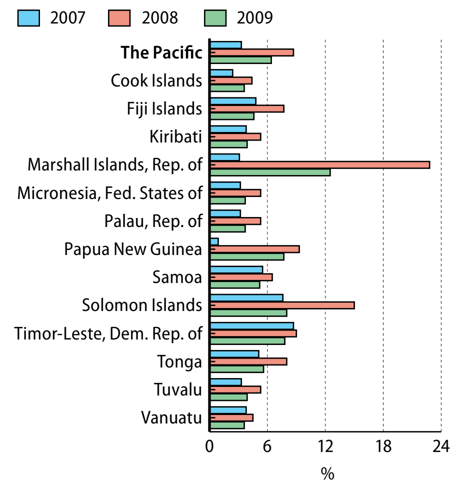
Aggregate growth is expected to slow to 3.4% in 2009, little changed from the *ADO 2008* forecast. Growth projections for Papua New Guinea and Solomon Islands for 2009 are upgraded from April, but both countries are still expected to expand at a slower pace than this year. The rise in inflation has damped economic prospects in other Pacific economies. Subregional inflation is projected to remain high at 6.4% in 2009 (Figure 3.1.14), up from the earlier projection of 4.0%.

Whether even these subdued projections can be achieved depends on how well the countries respond to elevated oil and food prices. The subregion's limited capacity to improve the implementation of public policy and the sometimes extensive operations of governments were under strain even before the price shocks. The high prices will further test the capacity to reach consensus on new directions (such as adopting social safety nets for the disadvantaged, helping the adoption of energy-efficient lighting, and prioritizing agricultural extension services and rural infrastructure) and to mobilize the resources needed to implement new initiatives (such as by reducing civil service wage bills to fund social safety nets).

Past difficulties of achieving cost savings in government operations to fund new initiatives suggest that the private sector will need to share some of the responsibility for a response to high prices. Policies that have the potential to help resolve these challenges include increased competition in infrastructure that could lower fares and charges, and private sector engagement in energy conservation and renewable energy projects.

Australia's adoption in August 2008 of a seasonal employment scheme for a total of 2,500 workers from Kiribati, Papua New Guinea, Tonga, and Vanuatu offers new income-earning prospects for the subregion in 2009. The scheme, which will operate on a pilot basis for 3 years, follows a similar one operated by New Zealand, and acts to build on the already important economic contribution made by remittances and overseas work.

3.1.14 Inflation, The Pacific



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Country highlights

Fiji Islands

A moderate economic recovery has continued and the GDP growth projection for 2008 is upgraded marginally to 1.7%. Tourist arrivals have picked up (by 14.5% in the first 5 months of this year), although fare and accommodation discounts adopted to attract tourists will keep revenues flat. Political uncertainty following the December 2006 military coup continues to suppress business confidence. Fiscal policy has tightened slightly, with a small surplus of 1.4% of GDP recorded over the first 3 months of 2008.

Commercial bank lending to private businesses rose by 7.7% in the 12 months to May, half the rate recorded a year earlier. Business surveys point to a weakening in business confidence in the first half of 2008, while the number of new registered taxpayers showed a year-on-year decline of 11.0% as of June. Personal remittances in the first 5 months of 2008 were down 22.3% from a year earlier, a continuation of the downward trend evident in 2007. Contributing factors are likely to be the lower US dollar, weakening in the US labor market, a rising cost of living

in remitting economies, and a reduced presence of Fiji Islands' security personnel in the Middle East.

Merchandise exports rose by 24.2% in the 5 months to May 2008. The robust showing was led by a rise in exports of sugar and mineral water. These gains were overshadowed by a rise in merchandise imports, due in part to high oil prices, and the trade deficit widened. Reserves were 3.9 months of import cover as of end-July.

High oil and food prices have put added pressure on communities already suffering from a lack of jobs and low growth in incomes. The interim Government that was installed after the coup responded to the high prices with a package of fiscal measures aimed at providing immediate relief, including the removal of duty and value-added tax on many basic food items, increases in the tax-free income threshold, and subsidies to bus operators. Nevertheless, inflation rose to 5.9% by June 2008, with the food subgroup reporting a 9.4% rise, and transport prices rising by 6.8%. The inflation forecast for 2008 is lifted to 7.7% from the *ADO 2008* projection of 4.6% and the 2009 forecast is revised up by about 1 percentage point to 4.6%.

The Reserve Bank of Fiji maintained a generally tight monetary policy stance, given pressures on foreign reserves and the rise in inflation. A credit ceiling on commercial banks remains in place, although provision has been made for special approvals of loan requests to priority sectors to ease the impact of the ceiling. However, in an effort to keep import prices down, the central bank allowed commercial banks to enter into forward foreign exchange contracts with local importers of food staples to hedge against future price increases.

The GDP growth projection for 2009 is lowered slightly to 1.4%, from 1.6%. The interim Government postponed elections initially intended for March 2009. This decision is expected to further erode investor confidence, constrain assistance from development partners, and add to the impetus for skilled labor to emigrate.

Papua New Guinea

This economy continues to benefit from high export prices for oil, minerals, and tropical agricultural products. The GDP growth forecast for 2008 is upgraded from 6.6% to 7.6%. Nonmining and non-oil GDP growth is projected at 7.1%, up from an initial projection of 6.5%. The growth upgrade is driven mainly by the higher prices of exports. There has also been a notable increase in construction activity as new mines develop, while improved world prices for tree crops, such as cocoa and copra, have boosted household incomes and spending in many rural areas. Higher levels of government expenditure and continued growth in private sector credit have also supported economic expansion.

The strength of domestic demand was evident in a further rise in lending to the private sector, of 35.3% in the year to June 2008. Strong demand is raising formal private sector employment, which rose by 8.4% over the 12 months to March 2008. The fiscal operations of the national Government for the 5 months to May 2008 show an overall budget surplus of 1.6% of GDP, reflecting higher revenues (particularly from mining and oil) that more than offset higher expenditures.

Longer-term prospects received a boost in May 2008 when the

Government signed an agreement with developers of a proposed liquefied natural gas (LNG) project. If the developers proceed, LNG production could begin in 2014 and has the potential to double GDP, albeit at the potential expense of agriculture (because the LNG exports are likely to result in an appreciation of the real exchange rate and reduce the competitiveness of agriculture).

The high oil and food prices have hit vulnerable groups, particularly those living in squatter settlements in urban areas and rural households that lack surplus agricultural produce for sale. Moreover, a landslide blocked road access to the Highlands region for several weeks from mid-April, which caused food shortages for over a quarter of the country's population.

The Government has sought to ease the impact of high prices by reducing or removing taxes on petroleum products, but so far has declined public calls for fuel subsidies, given their adverse effect on fiscal sustainability. Nevertheless, inflation is projected to rise to 9.3% in 2008, well up on the *ADO 2008* projection of 5.2%. This significant revision reflects both an increase in external and internal price pressures stemming from the high oil and food prices, and higher domestic demand pressures from the commodity price boom. These factors are projected to keep inflation higher than originally projected in 2009, at 7.7%.

After a near 50% rise in the US dollar value of official reserves in 2007, they have stabilized in 2008. At end-May, gross international reserves were sufficient for 10.3 months of total import cover and 15.2 months of nonmineral import cover. The current account surplus for 2008 is projected at 1.7% of GDP.

GDP growth is forecast at 5.1% for 2009, with nonmining and non-oil GDP expected to grow by 4.8%. The upgrade in the overall growth projection from 4.6% is based on expectations that prices for exports will be stronger than forecast in *ADO 2008*. The Ramu nickel-cobalt mine and the Hidden Valley gold mine are scheduled to start production in late 2009. Initiatives by the Government to rehabilitate and develop infrastructure, drawing on its surge in mining and oil revenues, will support growth.

Democratic Republic of Timor-Leste

The economy has continued to recover from the widespread civil unrest of 2006, which was triggered by tensions within the security forces. Most internally displaced persons, who accounted for as much of 10% of the population in 2007, have returned to their homes.

The value of the country's Petroleum Fund, established to hold income from offshore oil and gas production for future generations and to provide a permanent stream of revenues to the government budget, increased by $1.3 billion in the first 7 months of 2008 to $3.3 billion. A midyear supplementary budget more than doubled the Government's budget contribution to $773 million, an allocation that for the first time exceeded the sustainable income of the Fund.

This increase in planned expenditure, presented as a step to avoid civil instability and to foster development, raised concerns that the savings held in the Fund might be insecure. Rapid spending of the savings is seen as having the potential to create the "resource curse"

evident in many resource-rich countries. Doubts were also expressed as to whether the Government could indeed spend the additional funds effectively, as recent budgets have been substantially underspent because of tight capacity constraints.

Some of the additional expenditure is to be used to create an economic stabilization fund. In response to the rise in world rice prices, the Government has acted as a buyer and seller of rice at subsidized prices, and this policy is to be extended via the new fund. However, the policy is likely to inhibit the nascent formal business sector from rice trading, and to suppress the price of basic foods, which reduces farmers' incentives to raise production. There is also a concern as to how to help those who are so cash poor that they cannot afford even subsidized rice.

The economy is on track to reach the *ADO 2008* growth projection for non-oil GDP of 6.5%. The corresponding growth projection for 2009 remains at 4.9%, although this is likely to be exceeded if the Government manages to spend the additional withdrawals planned from the Petroleum Fund.

Even with the benefit of rice subsidies, food price inflation was 13.8% in June and the overall rate was 7.0%. Sales taxes and import duties were both reduced and a sales tax on hotel, restaurant, bar, and telecommunications services was lowered. Nevertheless, inflation is projected at 9.0% in 2008, up from *ADO 2008's* 7.0% forecast because of the higher than expected oil and food prices, and is revised up to 7.8% for 2009.

Other Pacific economies

Samoa

GDP growth is now projected at 3.3% in 2008, revised up from 3.0% in *ADO 2008*. Private remittances rose by 16% in the 12 months to June 2008, and tourism revenues increased by an estimated 6% over the period, both suggesting that growth will be a little higher than was forecast.

Prices of local goods continue to rise sharply, mirroring the jump in prices of imported food items such as rice, flour, and milk. High food and oil prices and an expansionary budget that is generating inflation pressures have led to an upward revision in the inflation forecast for 2008 to 6.5% and for 2009 to 5.2%. The GDP growth projection for 2009 is trimmed to 2.5%.

Samoa's umbrella body for nongovernment organizations has called for fuel subsidies, but the Government favors a longer-term response, which focuses on developing public infrastructure, health, and education. The central bank has urged commercial banks and government lending agencies to reduce loan interest rates and to emphasize lending for business development that could increase supply.

Solomon Islands

The GDP forecast has been raised to 8.0% for this year, from 6.0% in *ADO 2008*. This follows the uprating of production forecasts by the central bank for all major export commodities. Log exports are now projected to increase by over 10% in 2008, fish output by nearly 30%, palm oil production by around 40%, and copra production by 30%. Modest growth in cocoa production is also expected. However, the strong

expansion in logging is unsustainable because the forest resources are nearly exhausted.

Inflation has also been stronger than expected, hitting 18% in August. Pressures appear widespread, but are particularly acute for imported food and fuel. The inflation forecast for 2008 is revised up to 15%, reflecting the accelerating inflation so far this year and strong economic growth. In the first half of the year, the Government eliminated duties and taxes on rice and encouraged the substitution of local root crops for rice. It is also planning a program to raise domestic rice output.

External reserves and import cover have fallen significantly since end-2007, largely as a result of a higher import bill. External reserves came down from the equivalent of about US$118 million at end-2007 to US$104 million in July, and import cover from over 5 months to around 3 months over the same period.

A decline in logging rates is expected to slow overall economic growth from 2009. The GDP growth forecast for next year has nevertheless been revised up to 4.0% because of an upgrade in forecasts for fisheries and agriculture. The inflation forecast for 2009 is increased to 8.0%, reflecting higher forecasts for growth and commodity prices.

Tonga

This economy is on track to meet the 1.0% growth forecast for 2008, after contracting by 0.3% in 2007 (revised from a 3.5% contraction reported in *ADO 2008*). Reconstruction work needed for sections of the central business district damaged during riots in November 2006 is supporting growth. Tourist arrivals are projected to increase by 10% in 2008, and the National Reserve Bank of Tonga has adopted an expansionary stance by lifting credit ceilings and by reducing bank-reserve requirements. Growth of 2.0% is still forecast for next year.

The inflation forecasts for 2008 and 2009 have been revised up to 8.0% and 5.6%, respectively, a result of high oil and food prices and Tonga's heavy import dependence. As an immediate response to high prices, the Government removed some import duties. Even then, inflation accelerated to 12.0% in March 2008.

Vanuatu

Developments in 2008 are in line with the *ADO 2008* forecasts for growth of 5.7%. Commercial bank lending to the private sector rose by 29.0% in the 12 months to June. Demand for credit was particularly strong for construction and for house purchases, but lending to the tourist sector declined by 18.3%. Tourist arrivals rose by a moderate 5.4% in the first 5 months of the year. The growth projection for 2009 is lowered to 2.9%, given the erosion of consumer spending power by high prices.

The current account deficit has remained wide as merchandise imports greatly outweigh merchandise exports. However, Vanuatu has built up its foreign exchange reserves (US$125 million at June 2008, up 15.1% from a year earlier) largely because of foreign investment in real estate and finance. Import cover in the first half of the year remained high at around 8 months.

The forecast for inflation is revised up to 4.5% this year and to 3.6% in 2009, reflecting high oil and food prices. Inflation has picked up over

the past year but remains relatively low compared with that in other subregional economies (it was 3.9% in the second quarter of 2008).

Others

The economy of Nauru is still expected to contract by 2.4% this year. The Australian refugee-processing center, which had generated some jobs and demand for support services, was closed in March. Phosphate exports are running at around 500,000 metric tons a year and world phosphate prices have risen, but the gains for Nauru are limited by contractual arrangements that locked in prices at lower levels. GDP growth is expected to resume at 1.5% in 2009 (a continued contraction was forecast in April), supported by higher phosphate prices as new contracts come into force and by official assistance to which the Government of Australia has committed itself. Food prices have increased in line with those in Australia, its major supplier, and by June were 4.0% higher than a year earlier. The inflation forecasts are raised to 4.5% for 2008 and 4.0% for 2009.

The Republic of the Marshall Islands declared a “state of economic emergency” on 3 July 2008 to address problems caused by soaring inflation, now projected at 22.8% this year. This declaration aims to fast-track a reduction in energy usage and hence the demand for imported oil. Government cost-cutting measures were implemented and appeals made to donor countries and regional lending agencies for financial support. The rapid rise in inflation is projected to cause the economy to contract by 4.2% in 2008 and by 2.2% in 2009, compared with previous forecasts of slight GDP growth.

Rising costs of fuel and transportation have also reduced spending power in the Cook Islands. The GDP growth forecasts for this year and next are revised to about 2.5%, down about 1 percentage point from *ADO 2008*. High fuel prices largely account for the increased inflation forecasts for 2008 and 2009, of 4.4% and 3.6%, respectively.

The economic outlook remains weak in import-dependent Federated States of Micronesia, Kiribati, Palau, and Tuvalu, where sharp increases in fuel prices have pushed up inflation. The economy of the Federated States of Micronesia in 2008 is expected to contract more than was expected in April. Its Government is promoting the use of local food instead of imported rice, meats, and canned food. Budget pressures have intensified in Kiribati, with debts of public enterprises rising, particularly at the electricity utility. In Palau, uncertainty surrounding the outcome of negotiations with the US on its soon-to-expire financial assistance package continues to damp the economy. Tuvalu is facing increasing subsidy demands from public enterprises; for example, the direct subsidy to the electricity corporation in 2008 is expected to be triple that in 2007.

Growth projections for these smaller Pacific countries have been revised down, mainly because high prices, notably of oil, have accelerated inflation and eroded consumer spending power. Inflation forecasts are revised up.