Subregional summaries

Central Asia

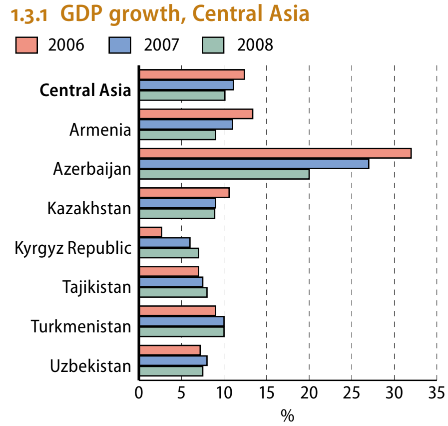
Subregional performance

The *Update* revises up GDP growth projections made in March's *Asian Development Outlook 2007* (*ADO 2007*) for six of the seven countries in Central Asia (not Tajikistan). This lifts the subregional projection to 11.1% from 10.3%. In the first half of 2007, these countries showed evidence of quickening economic activity.

In Azerbaijan, the pickup was driven by the contribution of net exports on the back of an increase in oil production of almost 65% (year on year) in the first half. Kazakhstan's growth is being pushed higher by strong growth in domestic demand, despite a negative contribution of net exports of goods and nonfactor services. Growth in Turkmenistan has been raised on account of strong gas exports. Uzbekistan also continues to benefit from a favorable external environment, with net exports the main contributor to growth.

Domestic demand is the main driver of growth for Armenia and the Kyrgyz Republic—the other two countries with raised forecasts—and for Tajikistan. In all three, disposable incomes continue to be boosted by remittance inflows. Armenia and the Kyrgyz Republic are seeing a greater pickup than expected in private investment activity related to FDI inflows. Tajikistan's outlook remains unchanged though, and energy shortages continue to hurt the mainstay of industry, aluminum. The authorities have ramped up public investment spending, but are relying on external sources. The sector pattern of growth across Central Asia shows that construction- and services-driven activity is continuing to accelerate.

1.3.1 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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Inflation in five countries is on the rise due to rapid monetary expansion resulting from strong foreign exchange inflows and much expanded public spending. The *Update* revises upward the average inflation rate projection for 2007 to 9.7% from 8.6%.

In Azerbaijan, 12-month consumer price index inflation rose to 15.2% in July 2007, driven by a loose fiscal policy, unsterilized interventions in the foreign exchange market, and upward adjustments in administered prices. In Kazakhstan, larger bank borrowing than last year has lifted domestic demand and inflation. Upward adjustments in administered prices were the main factor in raising inflation in Tajikistan. Uzbekistan's officially reported inflation rate for the first half of 2007 was 2.2%, but the findings of a recent International Monetary Fund review mission suggest that although inflation has eased somewhat, 10% is a reasonable estimate. A widening current account surplus (and overall surplus) there continues to exert upward pressure on monetary aggregates.

The subregion's economies (with the exception of Tajikistan) are generally coping with real exchange rate appreciation induced by

strong net foreign exchange inflows. In an environment where most of these inflows are expected to be sustained over the medium term, real appreciation pressures are likely to persist. Since influencing the real exchange rate is impossible beyond the short term, central banks should accord primacy to ensuring low inflation, and not resist an orderly appreciation in nominal exchange rates.

The *Update* revises marginally upward the subregion's projected current account surplus for 2007 to 3.5% from 3.2%. Export growth in the main hydrocarbon-exporting countries (Azerbaijan, Kazakhstan, and Turkmenistan) was strong in the first half of 2007. Uzbekistan, too, is realizing large surpluses in both its trade and current accounts. Export growth is picking up across the subregion but is accompanied by accelerating import demand, yielding widening trade deficits.

Subregional prospects

The external environment is expected to be quite favorable in 2008, yet the pace of domestic reforms to energize the private sector will also be an important determinant. While world energy prices are expected to stabilize, they will remain at relatively high levels, supported by global demand. Accordingly, GDP growth forecasts for most hydrocarbon exporters have been revised upward. Nonenergy commodity prices, in particular base metals, are expected to soften only slightly in 2008 while gold prices are expected to remain high. With larger production capacities being installed, exporters of base metals (Armenia and Tajikistan) and gold exporters (Kyrgyz Republic and Uzbekistan), should see improved export performance.

For the subregion as a whole, the *Update* revises upward the GDP growth forecast for 2008 to 10.1% from 9.4%. But surging foreign exchange inflows with potential inflationary consequences will remain a problem, and the inflation forecast for 2008 is revised up to 9.1% from 7.9%. The average current account surplus as a share of GDP has been adjusted upward from 3.3% to 3.6%, mainly due to higher hydrocarbon exports in several countries; capital inflows will also support a high overall balance.

Country highlights

Armenia

Projected GDP growth for 2007 has been uprated to 11.0% given the better than expected growth for the first half of 2007 of 11.2%, which largely reflected continued expansion in construction and services. Inflation edged up to 4.5% (year on year) in June 2007, strongly suggesting that the central bank will tighten monetary policy further to achieve its end-of-year inflation target of 4.0%. Fiscal policy remains prudent, with an improving ratio of tax revenue to GDP and moderately higher capital expenditure financed from official external assistance.

Exports are recovering from a slump in 2006 but import demand is even stronger, widening the trade gap. Still, the projected current account deficit for 2007 has now been slightly reduced from *ADO 2007*, reflecting larger inward remittances; FDI inflows are likely to cover this deficit.

Azerbaijan

Azerbaijan's GDP growth for this year has also been revised upward,

from 25% in *ADO 2007* to 27%, as is the forecast for 2008, from 17% to 20%. The economy grew at a torrid 36.2% year on year during the first 5 months of 2007, powered by large increases in oil production and exports (as new projects move toward full production), which spurred growth in construction and services.

Full-year inflation, too, is adjusted upward, from 14% to 18%. Excessive expansion in public spending and the money supply has fanned inflation pressures and, as expected, pushed inflation into double digits in January–June 2007. The central bank has tried to tighten monetary policy and is allowing the manat to appreciate gradually, but this by itself is unlikely to rein in inflation.

Of concern is the projected non-oil fiscal deficit as a share of non-oil GDP since the authorities persist with steep increases in current and capital expenditures (Box 1.3.1). With import growth slowing (as import-dependent hydrocarbon projects near completion), the trade and current accounts are posting large surpluses. FDI inflows, which had boosted investment rates in the last few years, are on the wane. Domestic investment has recently registered an uptick, but a sustained improvement will depend on a significant amelioration in the business climate and in governance reforms.

Kazakhstan

The GDP growth projection for 2007 has been raised from 8.6% to 9.0%; the forecast for 2008 is kept at 8.9%. The pickup in growth in the first half of 2007 stemmed from higher oil production and continued strong domestic demand, driven by private consumption and investment spending. Projected inflation in 2007 is adjusted upward to 8.5% from 8.0% in *ADO 2007*. Consumer price inflation eased slightly (8.1% year on year in June 2007) but inflationary pressures stemming from excessive foreign borrowing by commercial banks for onlending remain a major concern. The central bank has tightened monetary policy, raising the discount rate and reserve requirements for foreign currency borrowing.

Central government spending is expected to be higher than in the original budget, but so too is revenue. The planned increase in the non-oil fiscal deficit as a share of non-oil GDP is moderate and within a "prudent band." Export growth has been buoyant and the trade balance is in surplus, but significant deficits in its services and income balance are widening the current account deficit (fully covered by FDI inflows).

Structurally, the Government has taken several initiatives for improving the competitiveness and productivity of the non-oil sector, but the financial sector remains vulnerable to currency and interest rate risks.

Kyrgyz Republic

Growth for this year is now put at 6.0%, from 4.0% earlier, and the forecast for next year is upgraded from 5.0% to 7.0%. The economy grew strongly in the first half of 2007, by 9.2% relative to the same period last year, with good performance from construction and services and a recovery in industry. Consumer price inflation in January–June 2007 was moderate at 4.8%.

Export growth has strengthened, but imports—mainly energy, consumer durables, and capital goods—have outpaced it. In the financial

1.3.1 Resource windfalls—Oil revenue management in Azerbaijan and Kazakhstan

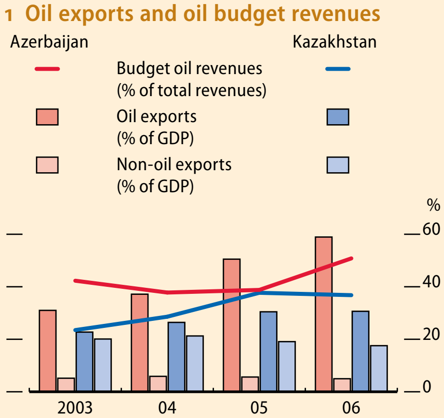
Soaring global commodity prices have produced large windfall revenues for resource-rich economies. Although these revenues have improved external balances, reduced fiscal strain, and accelerated growth, they have also complicated the macroeconomic management of these economies. A major concern in the short run is monetary control. With rigid exchange rate policies limiting nominal appreciation, soaring foreign exchange inflows fuel inflationary pressures. The consequent real appreciation harms the competitiveness of non-oil sectors—a phenomenon known as "Dutch disease"—and thus hampers diversification of the economy. This box explores how two resource-rich economies, namely Azerbaijan and Kazakhstan, have managed their surging oil revenues over the past 4 years.

Following a recovery in 1999, oil prices increased by more than 50% in 2000 to $28 per barrel and stabilized in 2001–2003 at that level. Oil prices have accelerated since 2004, averaging $64 per barrel in 2006. The two countries set up oil funds—the State Oil Fund of Azerbaijan Republic (SOFAR) in 1999 and the National Fund of the Republic of Kazakhstan (NFRK) in 2001. The funds were established with two main aims: to save part of oil revenues for future generations, and to prevent macroeconomic instability arising from the volatility of oil income. The authorities were concerned about political pressure to spend the oil wealth rapidly and inefficiently.

Assets of these funds have been invested in both domestic liquidity assets (deposits and money market instruments) as well as foreign fixed-income and equity instruments, to insulate the domestic economy from potential excess liquidity from oil revenues. The main issue of interest is whether the two funds have achieved their dual objectives.

Due to recent oil price gains, the share of oil in the two countries' exports has increased sharply. Azerbaijan's exports increased to more than 60% of GDP in 2006, up from 36% in 2003, with oil making up more than 90% of total exports (Box figure 1). While Kazakhstan's oil dependency is less pronounced, oil exports still accounted for about 60% of total exports. The increase in oil export revenues between 2003 and 2006 represented 49% of Azerbaijan's and 24% of Kazakhstan's 2006 GDP (Box figure 2). Kazakhstan saved more than 60% of its increased oil export receipts in its oil fund, while Azerbaijan saved 12%.

1 Oil exports and oil budget revenues

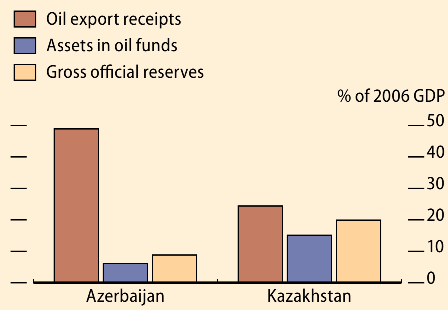


Source: Staff estimates.

Click here for figure data

The two countries also differ in terms of the fiscal arrangements for their oil revenues. Azerbaijan's budget revenues in 2006 soared by 67% relative to the previous year, and half these receipts came from the oil sector (Box figure 1). In Kazakhstan, where fiscal revenues increased by more than 30% in 2006, oil income accounted for 37% of budget revenues.

2 Increase in oil-related indicators 1, 2003–2006



Source: Staff estimates.

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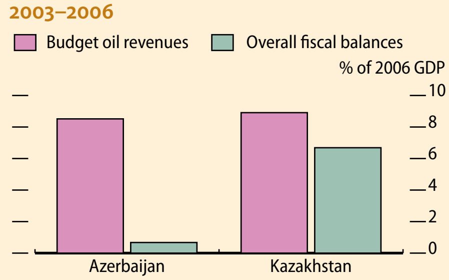
With ample fiscal resources, Azerbaijan accelerated public spending. It loosened fiscal policy noticeably in 2006, and capital spending more than tripled compared with the previous year. Kazakhstan has consistently kept spending below revenue and ran budget surpluses. Its overall surplus rose to 7.5% of GDP in 2006. On average, Azerbaijan used 8% of the increase in oil revenues accruing to the budget to improve its fiscal balance (measured as the ratio of the increase in the fiscal balance to the increase in fiscal oil revenues between 2003 and 2006), while Kazakhstan used 75% for that purpose (Box figure 3).

3 Increase in oil-related indicators 2, 2003–2006



Source: Staff estimates.

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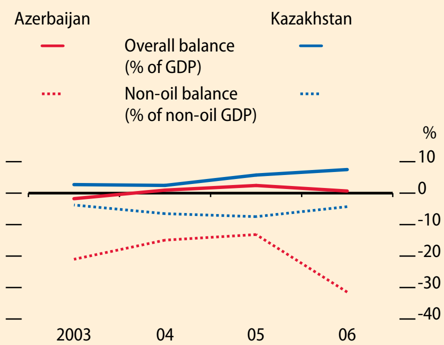
For oil-exporting countries, the ratio of non-oil fiscal deficit to non-oil GDP is a good measure of the true fiscal stance. The Azerbaijan Government's ambitious spending program is reflected in a widening non-oil fiscal deficit in 2006. The non-oil deficit of more than 30% of non-oil GDP exceeds most widely accepted thresholds

1.3.1 Resource windfalls—Oil revenue management in Azerbaijan and Kazakhstan *(continued)*

for medium-term fiscal sustainability (Box figure 4). In contrast, Kazakhstan's non-oil fiscal deficit in 2006 dropped to 4.3% of non-oil GDP, with substantial budget surpluses accumulated in NFRK.

4 Fiscal balances



Source: Staff estimates.

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The two oil funds are differently designed (box table). On paper, Azerbaijan's SOFAR assigns primacy to savings objectives, in the sense that the total amount of outflows cannot exceed inflows in any given year. Yet in practice, a portion of SOFAR funding has been allocated to the state budget to finance public investments. In addition, SOFAR's expenditure policy permits the funding of investment projects outside the state budget, bypassing the public investment program. SOFAR has financed programs assisting internally displaced people, projects for water and irrigation, and has made investments in the Baku-Tbilisi-Ceyhan oil pipeline. These activities have limited SOFAR's saving. Formally, SOFAR attaches low weight to stabilization objectives.

In contrast, Kazakhstan's oil fund emphasizes stabilization but, at the same time, calls for automatic accumulation of oil revenues beyond a predetermined oil price. Although NFRK is allowed to transfer funds to the budget, subject to the president's approval, this rule has never been invoked in the current oil boom. In practice therefore, NFRK has accumulated savings at a brisk rate.

Azerbaijan and Kazakhstan have made significant progress toward transparent management of oil revenues. For example, both countries have already joined the Extractive Industries Transparency Initiative. However, there is still much room for improving oil revenue management, in terms of governance, transparency, integration with the overall fiscal framework, and asset management. Setting up an oil fund by itself does not guarantee either fiscal discipline or commitment to future savings. Only when oil revenues are managed as an integral part of a sound overall fiscal framework, can an oil fund attain its objectives.

The governments in resource-rich Asian countries need to find the right balance between fulfilling development needs (by spending oil revenues), maintaining macroeconomic stability (by stabilizing the impact of oil revenues), and saving part of oil wealth for future generations (by saving oil revenues). Policy makers need to pay close attention to the effects of higher public spending on the real exchange rate and on macroeconomic stability, and should make the best strategic use of windfall revenues for achieving long-term development goals.

Oil funds: Objectives and rules

Fund and date established	Stated objectives	Inflow rules	Outflow rules	Management institutions	Investment abroad	Balance (end-2006)
Azerbaijan State Oil Fund of Azerbaijan Republic (SOFAR), 1999	Greater weight on saving than stabilization	The Government's share in production-sharing agreements with foreign oil companies for post-Soviet oil fields	Withdrawals not to exceed inflows in a given year. Transfers allowed to the budget for public investments. Own investments allowed in projects for refugees, oil pipelines, and water/irrigation.	SOFAR and international asset management companies	60% in liquid assets (cash, money market instruments) 40% in sovereign debt securities	$1.9 billion (17.5% of GDP) *Memo item:* Gross official reserves: $2.5 billion
Kazakhstan National Fund of the Republic of Kazakhstan (NFRK), 2001	Little more emphasis on stabilization than saving	*Stabilization:* Oil revenue above the baseline price. Ad hoc privatization and bonus receipts *Saving:* 10% of baseline budget oil revenues from identified oil companies	Transfers to state and local budgets allowed with president's approval	Central bank and international asset management companies	Stabilization portfolio (25%) in liquid assets Savings portfolio (75%) in sovereign debt securities and shares	$14.1 billion (9.5% of GDP) *Memo item:* Gross official reserves: $19.1 billion

Sources: Economist Intelligence Unit, Azerbaijan and Kazakhstan country reports, various issues; International Monetary Fund reports.

and capital accounts, FDI inflows, particularly from Kazakhstan, have picked up, helping build foreign exchange reserves. Structural reforms have made some progress, particularly in the areas of business regulation, and privatization of energy and banking.

Tajikistan

At 7.3%, economic growth was strong in the first half of 2007, buoyed by higher investment spending and remittance-fueled consumption. Full-year growth is kept unchanged at 7.5%. Energy shortages affected aluminum production. With the pass-through of higher natural gas export prices charged by Uzbekistan and with upward adjustment in electricity tariffs, inflationary pressures are likely to persist for the rest of the year. The *Update* therefore revises upward projected inflation for 2007 from 7.0% to 11.4% (the 12-month rate at end-June 2007 was 9%).

Following debt relief under the Multilateral Debt Relief Initiative, the external debt strategy has taken another turn with the authorities' plan to contract significant amounts of concessional loans to finance infrastructure.

Turkmenistan

Stronger than expected gas exports propelled growth in the first half of 2007, such that GDP growth for 2007 and 2008 is revised upward to 10.0%. At the start of the year, the new Government launched some reforms in education, public health, and social protection, but is keeping the management of hydrocarbon revenues nontransparent and off the budget.

Uzbekistan

The *Update* upgrades projected GDP growth for 2007 from 7.4% to 8.0% and for 2008 from 7.1% to 7.5%. High investment spending and net exports drove first-half 2007 growth of 9.7%. Inflation is expected to be pushed still higher: for 2007 from 9.0% to 10.0% as a sharp increase in net foreign assets has fed monetary expansion. Price pressures are likely to build following large wage and pension hikes of August 2007.

Following negotiations for higher prices in export contracts as well as greater investment, natural gas exports are becoming more important in the export commodity structure. A portion of these receipts is being channeled into the Uzbekistan Fund for Reconstruction and Development.

East Asia

Subregional performance

Growth rates projected for 2007 in all five economies in this subregion have been revised up from those made in *ADO 2007*. Aggregate growth is now put at 8.9%, upgraded from 8.0% in March and close to the vigorous expansion rate of 2006. These figures are dominated by the PRC, where the economy quickened in the first half and the full-year forecast is revised up to 11.2%, the fastest rate in 13 years.

Solid demand for East Asia's manufactured exports helped underpin

economic growth in the first half of 2007. The PRC's exports climbed by nearly 28% in nominal terms from the year-earlier period, about equal to the rapid export growth in 2006, and its imports rose by about 18%. Indeed, strong growth in the PRC's imports has been one reason for robust export gains by other East Asian economies. For example, total exports from the Republic of Korea, the second-biggest economy in the subregion, rose by about 14% in the first half, and exports from Taipei,China increased by nearly 8%. (In both cases export growth moderated from the 2006 pace, partly because of softer global demand for some electronic products.)

Domestic demand generally has strengthened and is adding to growth in the subregion. Both consumption and investment grew rapidly in the PRC in the first half of 2007. Stronger labor markets helped support consumption growth in Hong Kong, China; Korea; and Taipei,China, despite rises in policy interest rates in the latter two economies. In Taipei,China, private consumption is recovering from a weak period in 2006 when credit-card issuers tightened lending after a rise in defaults. Investment in these three economies also picked up in the first half.

Most inflation forecasts for the subregion are revised up, particularly for the PRC, where food prices have increased sharply, in part because of a pig disease that has reduced pork supplies. In the PRC, inflation is now forecast at 4.2% for 2007 (1.8% in *ADO 2007*). Revisions to inflation expectations in several other economies also are influenced by rising food prices. Subregional inflation this year is now put at 3.5%, up from 1.9%. Still, inflation remains low (in a range of 1.6–2.5%) for Hong Kong, China; Korea; and Taipei,China.

The *Update* lifts the PRC's projected current account surplus for 2007 to 10.9% from 8.8% in *ADO 2007*, mainly on the basis of a higher than expected trade surplus. Korea's forecast current account surplus is raised to 0.6% from 0.1% in March, reflecting stronger than anticipated exports. External surpluses are projected for Hong Kong, China; Mongolia; and Taipei,China, at the same levels as forecast in March.

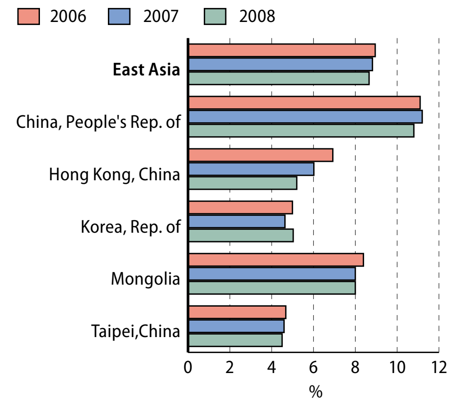
Subregional prospects

The subregional GDP growth forecast for 2008 is uprated to 8.7% from 8.0% in March. For the PRC, the revision is a full 1 percentage point to 10.8%, given the heightened growth momentum of this year. Mongolia's forecast, too, is revised up 1 percentage point, to 8.0%, mainly on expansion of its mining industry and higher government spending. More moderate upward revisions are made for the Hong Kong, China forecast (to 5.4%) and Korea (to 5.0%). The outlook for Taipei,China (growth of 4.5%) is unchanged from March.

Inflation next year is put at 3.3% on a subregional basis, revised up from 2.2% in March. In the PRC, even with slower food price rises, inflation has been revised up to 3.8%. The inflation forecasts for 2008 are also raised for both Hong Kong, China and Mongolia.

All five subregional economies are likely to maintain current account surpluses in 2008. The outlook for the aggregate surplus is raised to 7.9% from 6.9%, due to an upward revision to the forecast for the PRC's current account surplus to 10.5% from 8.9%.

1.3.2 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

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Country highlights

People's Republic of China

Despite efforts by the authorities to damp investment and exports, GDP growth of 11.5% in the first half of 2007 came in at the fastest rate since 1994. Industry again led the way, expanding by 13.6%, with services up by 10.6% and agriculture by 4.0%. Drivers of investment included strong profitability, buoyant sales, and still-low lending rates. Both fixed asset investment and consumption were strong.

On the external side, merchandise exports grew vigorously, pointing to a projected trade surplus of $300 billion this year. Based on the updated assessment of domestic and external demand, the GDP growth forecast is revised to 11.2%, from 10.0% in *ADO 2007*. The current account surplus is now expected to swell to 10.9% of GDP, revised up from 8.8%. Inflation has turned sharply higher (to 6.5% in August), mainly caused by food price increases, prompting a revision in the 2007 forecast to 4.2% from 1.8% in *ADO 2007*. Housing price increases have quickened in many cities, too.

Continued high trade surpluses and capital inflows took foreign exchange reserves to $1.3 trillion in June and have complicated monetary policy. The central bank has continued to take excess liquidity out of the banking system, but has not completely offset capital inflows. The authorities have allowed the yuan's appreciation against the US dollar to accelerate slightly.

Among recent efforts to curtail liquidity and to tame investment, the Government has raised interest rates, hiked commercial banks' reserve-requirement ratio, and cut some export-supportive measures. But the effectiveness of interest rate rises in cooling demand is hindered by seepages of rising foreign exchange reserves into liquidity and by the fact that the economy is still not fully market-based. Incentives for construction, particularly at the local level, also frustrate efforts to limit investment growth.

This year's momentum is likely to carry into 2008, implying further steps to cool the rapid investment expansion. But top priorities remain the creation of jobs and on lifting income growth in lagging regions, underpinning growth in consumption. Investment will also stay high. The gap between export and import growth will probably close a little as the changes regarding exports take effect. GDP growth for 2008 is revised to 10.8%, up 1 percentage point from the *ADO 2007* forecast. The current account forecast is raised to a surplus of 10.5% of GDP.

The sharp increases in food prices seen in 2007 are assumed to ease next year. This would open the way to carry out planned reforms in the pricing of state-controlled sectors such as water, power, and natural gas, foreshadowing tariff increases. On this basis, the inflation forecast for 2008 is raised from 2.2% to 3.8%, but it may surpass this revised forecast.

The booming stock market presents a risk. A sudden sharp fall could leave banks with rising nonperforming loan ratios, which would likely see them tightening lending, with impacts on the broader economy.

The authorities need to make further progress in rebalancing the economy, i.e., by reducing reliance on exports and investment in favor of private consumption. This could lessen vulnerability to external shocks and ease environmental strains. Policy measures have yet to have much

impact; growth in the trade surplus and investment outpaced retail sales growth in the first half of 2007.

Republic of Korea

Growth in this economy picked up from 4.0% in both the fourth quarter of 2006 and the first quarter of 2007, to 5.0% in the second quarter of this year, lifted by strong exports, improving growth in investment, and a gradual increase in consumer spending. This upward trend is likely to continue through the second half of 2007 and into 2008. The stronger than expected export performance augurs well for further gains in industrial activity and business investment. A steadily strengthening labor market (the seasonally adjusted unemployment rate was 3.2% in August, down from 3.5% a year earlier) is helping support the recovery in consumption. Both business and consumer confidence is rising. Consequently, GDP growth forecasts are revised up slightly, to 4.6% for this year from the *ADO 2007* level of 4.5%, and to 5.0% for 2008 from the previous forecast of 4.8%.

The Bank of Korea raised its overnight call-rate target in both July and August (to 5.0%) to preempt inflation pressures and to prevent a bubble from forming in the property market. Inflation is projected at 2.5% this year (2.4% in *ADO 2007*) and 2.6% in 2008 (unchanged from the March forecast), at the bottom of the central bank's 2.5–3.5% target range. The won/dollar exchange rate has continued to appreciate moderately, helping curb inflation pressures generated by robust domestic demand. Reflecting stronger than expected exports, the current account surplus for 2007 is now projected at 0.6% of GDP (0.1% in *ADO 2007*); the forecast for the 2008 current account surplus is maintained at 0.1%.

Taipei,China

Economic growth was 4.6% in the first half of 2007, slightly stronger than expected. In the second quarter, growth picked up to 5.1%, driven by a 12.5% jump in private fixed investment, particularly by semiconductor companies. Investment is expected to expand further in the second half, but not at the brisk pace seen in the April–June period. Private consumption edged higher during the first half, recovering from weak levels in 2006 after a tightening in consumer credit that followed a bursting of a credit-card bubble. Consumption is expected to strengthen further in the second half, supported by rises in incomes and employment and by firm asset markets.

As a result of the pickup in investment and consumption, domestic demand contributed 40.0% of the GDP expansion in the first 6 months compared with just 7.0% in the year-earlier period. The GDP growth forecast is nudged up to 4.6% for 2007, from 4.3% in March, and the 2008 projection is maintained at 4.5%.

The monetary authorities raised the benchmark discount rate further in the first half, in part because of concern about rises in wholesale inflation even as consumer inflation stays low. For 2007, the consumer price index is projected to rise by an average of 1.6% (accelerating from just 0.6% in 2006), and by 1.5% in 2008, unchanged from *ADO 2007* predictions. The outlook for the current account outcome is still for surpluses of 6–7% of GDP this year and next.

Hong Kong, China

This economy, heavily influenced by trends in the PRC, expanded by a faster than expected 6.3% in the first half of 2007. Growth was broad-based, with external trade gathering strength and domestic demand accelerating. Exports of goods and services rose by about 11.0% in real terms in the second quarter of the year. Services benefited both from buoyant financial market activity, much of it related to capital raising by PRC companies, and from the strength of trade and tourism.

Private consumption spending picked up, supported by rising incomes and a strong labor market (the seasonally adjusted unemployment rate fell to 4.1% in July, a 9-year low). Construction also recovered somewhat, after an extended period of contraction, and investment in equipment was strong. The GDP growth forecast for 2007 is raised to 6.0% from 5.4% in *ADO 2007*, and for 2008 to 5.4% from 5.2%.

Budget initiatives that exerted downward pressure on some prices helped keep inflation to 1.5% in the first 6 months. Prices of food imported from the PRC have been rising, and therefore inflation in the second half will be higher than in the first. For all 2007, the inflation projection is raised marginally to 1.7% from 1.6%, and for next year to 2.5% from 2.3%. The forecast is maintained for a current account surplus of nearly 10.0% this year, rising slightly in 2008.

Mongolia

The least developed economy in the subregion, Mongolia is benefiting from strong global demand for its minerals (mainly copper and gold), good weather last year that is helping agricultural production, and growth in construction, transportation, and telecommunications. Government spending has increased on infrastructure and on social assistance programs, buttressed by rising public revenues from the minerals industry. GDP growth forecasts for both 2007 and 2008 are revised up by 1 percentage point, to 8.0%.

Inflation has been higher than expected owing to rising prices for imports of food from the PRC and petroleum products from the Russian Federation, which increased its petroleum export tariff. Price pressures have also been fueled by high rates of expansion in public spending and in broad money supply. The inflation forecasts are raised to 7.5% from 6.0% in *ADO 2007* for both this year and next. Mongolia is still projected to have current account surpluses equivalent to about 2.0% of GDP in both years.

South Asia

Subregional performance

Economic growth in South Asia, which expanded sharply by about 8.7% in 2005 and 2006, is now projected to moderate slightly to 8.1% in 2007. (*ADO 2007* had forecast a slightly more abrupt deceleration to 7.7%.) This revision reflects primarily a larger than projected expansion in India, which accounts for 80% of South Asia's GDP, of 8.5% instead of 8.0%. Little or no change was made in forecasts for the other large economies—Pakistan and Bangladesh. Sri Lanka also stays unchanged,

with 6.1% growth in 2007, because agricultural growth cannot repeat its strong post-tsunami recovery, and because tourism and related services are suffering from many governments' travel warnings. Nepal has yet to enjoy a "peace dividend" from favorable political developments in 2006; growth is estimated at 2.5% in 2007, slightly lower than had been expected in *ADO 2007*.

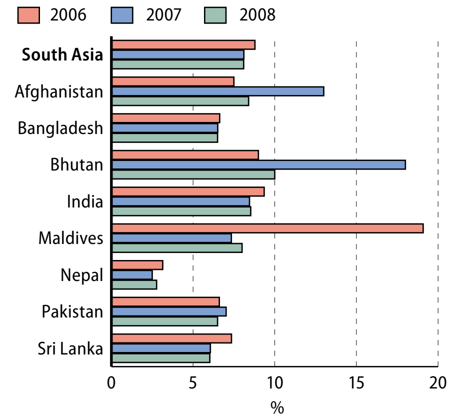
The services sector has been the main driver of growth in South Asia. Its shares of GDP in Bangladesh, India, Pakistan, and Sri Lanka were 49%, 55%, 53%, and 56% respectively in 2006, which is significantly larger than in other countries relative to their respective levels of per capita income and land area. Services in the subregion has been performing well recently, with sector output growing by 10.5% in 2006 led by trade, and transport and communications. The smaller industry sector also expanded rapidly, with sector growth up by 10.1% buoyed by manufacturing. South Asia's agriculture sector grew by 2.7% during the year.

Although inflation has been moderate, it is an issue in some countries—primarily Bangladesh, Pakistan, and Sri Lanka where projections for inflation in 2007 have been nudged up. Despite declining oil prices in the latter part of 2006, upward pressures prevail because weaknesses in subregional agricultural production and higher global prices are pushing up food inflation, while strong domestic demand has made it difficult to rein in nonfood price increases. Most central banks have tightened monetary policy and have managed to reduce demand pressures a little. In the *Update*, subregional inflation is projected at 5.7%, up slightly from the 5.5% forecast in *ADO 2007*.

South Asia's current account deficit is now projected at 1.9% of GDP in 2007, somewhat narrower than the 2.2% deficit foreseen in *ADO 2007*. The trade deficit is widening in most countries as strong domestic demand sucks in imports. However, heavy gains in workers' remittances often help compensate, as do larger services exports in India.

Such remittance inflows have increased substantially in recent years, reaching 14.2% of GDP in Nepal in 2007, 8.6% in Sri Lanka, and 7.7% in Bangladesh in 2006. They have generally boosted consumption rather than investment, and partly explain the consumption-dominated demand structure in South Asia. Capital inflows, especially foreign direct investment, have significantly increased in India and Pakistan because of their growth prospects. In all countries, current account deficits have being readily financed and international reserves have increased.

1.3.3 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

The South Asian subregion is expected to grow by 8.1% in 2008. This outlook is based on the assumptions of ongoing tight monetary policies, normal agricultural production, maintained fiscal discipline, and continued structural reforms. With robust demand for capital goods to solve production capacity bottlenecks and heavy spending to relieve infrastructure constraints, investment is expected to spark growth on the demand side. On the production side, industry is seen adding growth impetus to largely services-driven economies.

Inflation is set to moderate to 5.4% in 2008, assuming that agriculture

has normal rainfall. There are, however, risks. Excess demand pressures may continue, despite efforts at tightening monetary policy. In Bangladesh, India, and Nepal, larger than expected reductions in fuel subsidies would further lift the prices of domestic petroleum products, and hence inflation, by more than forecast. Volatility in international oil prices is, of course, another risk.

South Asia's current account deficit is projected at 2.1%, essentially unchanged from *ADO 2007*. The forecast deficits for Pakistan and Sri Lanka have been widened, but that for India narrowed. Financing current account deficits has not been an issue, though the fallout from the turmoil in global credit markets may crimp some sources of capital inflows and raise the cost of debt financing.

Country highlights

Afghanistan

GDP growth in the licit economy decelerated to 7.5% in FY2006 (21 March 2006–20 March 2007), as drought affected agricultural production more than previously anticipated. Inflation, measured by the consumer price index for Kabul, subsided to 4.8% in March 2007, with declining rents mitigating the impact of higher food and energy prices. The fiscal deficit (including grants) improved to 2.7% of GDP as a result of stronger revenue collection, and execution of development expenditures improved significantly.

For FY2007, GDP growth is now projected to recover to 13%: agriculture is strongly rebounding, and construction and services continue their rapid expansion. Inflation is now put at 5.9%, on rising transportation costs and energy prices. The licit economy still largely depends on reconstruction work funded by foreign aid. Creating a sustainable economic base, phasing out the large illicit economy (opium production rose again substantially in FY2006, despite intensified counter-narcotics efforts), and reinvigorating security remain challenges.

Bangladesh

GDP growth was sustained at 6.5% in FY2007 (July 2006–June 2007). Expansion in industry and services compensated for moderate growth in agriculture. Industrial growth was driven by strong external demand for textiles and clothing, benefiting from the termination of quota arrangements at end-2004. Exports grew significantly in FY2007, due to robust performance in garments, but they were outpaced by even faster-growing imports, widening the trade deficit. Increased workers' remittances offset the trade deficit to maintain a current account surplus.

Despite flooding in August 2007, the growth momentum is expected to continue in FY2008, since conditions for the expansion of industry and services remain favorable. The external sector is also likely to maintain its strength with vigorous growth in exports and workers' remittances. The textile and clothing sector may, however, face tougher competition as the PRC's safeguard quota in the EU and US markets expires at end-2008.

Curbing inflation is an ongoing challenge, but the major risk to the economy lies in political disruption. The caretaker Government's success in maintaining stability and broad public support, until elections are held, is probably the single biggest risk factor for the economy.

Bhutan

This economy is experiencing structural changes both in economic and political dimensions. The phased commissioning of the 1,020 megawatt Tala hydropower project since July 2006 will eventually double electricity export capacity to India. Accordingly, GDP growth is expected to double to 18% in 2007, significantly boosting government revenue. Although Tala should reduce dependence on foreign aid, other economic issues remain. The most pressing is the need to promote private sector activity to create employment, especially for growing numbers of young entrants to the labor force. In the political sphere, Bhutan is scheduled to change from a monarchy to a two-party democratic system in 2008, though this is unlikely to have a major economic impact.

India

Robust growth momentum continues with GDP growth for FY2006 (April 2006–March 2007) estimated at 9.4%, the highest in 18 years. Manufacturing growth has caught up with that in services and has emerged as a driver of accelerated growth, led by increasing investment demand. GDP growth is expected to moderate to 8.5% in FY2007, as rising interest rates damp consumption expenditure, but investment will continue to expand, supported by a robust long-term outlook. Inflation, given by the wholesale price index, fell to 4.4% in July 2007, reflecting the influence of monetary measures on demand pressures.

Despite a widening trade deficit, expansion in the invisibles surplus is expected to limit the current account deficit to 1.6% of GDP in FY2007. Large net capital inflows have resulted in a marked appreciation of the rupee in the first quarter of FY2007, and monetary aggregates also rose steeply. Effective August, the central bank tightened monetary policy by raising banks' cash ratios and adopting tighter external borrowing limits for domestic companies.

Maldives

The economy rebounded sharply in 2006 from the post-tsunami contraction, with GDP growth of 19.1%. GDP is projected to rise by 7.3% in 2007, as the bounceback effect from large restoration activities and the return of tourists fades. While large reconstruction projects are included in the government budget, government consumption also rose due to policies to increase public sector wages and continue power and water subsidies in Malé. Although a delay in planned capital expenditure narrowed the fiscal deficit to 7.3% of GDP in 2006, the wide gap between expenditure and revenue cannot be sustained in the medium term. The 2007 budget will result in a very high fiscal deficit of 27% of GDP if it is implemented as planned.

Nepal

Nepal is yet to enjoy any "peace dividend" from political developments since April 2006 when parliamentary government was restored following a nationwide peaceful movement against the former regime. Revised estimates for GDP have the growth rate for FY2007 (17 July 2006–16 July 2007) decelerating to 2.5% from 2.8% in FY2006, because of renewed political unrest and adverse weather affecting the agriculture sector,

which still accounts for about two fifths of GDP. GDP growth in FY2008 is projected to improve only marginally to 2.8%.

Inflation moderated to 6.4% in FY2007 from 8.0% in the previous year. Although the impact of upward adjustments in petroleum prices and the increased value-added tax rate in FY2005 has subsided, food prices rose sharply as a result of low agricultural production. Imports continued to increase faster than exports in FY2007, but increased workers' remittances helped offset the larger trade deficit, and the current account surplus narrowed to 0.5% of GDP.

Pakistan

Underpinned by strong domestic demand, growth in GDP in FY2007 (July 2006–June 2007) was robust at 7%. It was supported by a recovery in agriculture and continued expansion in manufacturing and services. A slight deceleration to 6.5% is penciled in for FY2008. This is despite an expansionary government budget and policies to raise agricultural productivity and boost industrial investment. Inflation declined only a shade to 7.8% in FY2007. Monetary tightening measures controlled core inflation, but shortages in the supply of some food items, even with the overall strong recovery of agriculture, pushed up food prices.

Fiscal policy was expansionary in FY2007, with public expenditure 19.5% higher than the previous year, but a strong revenue performance kept the fiscal deficit to FY2006's level of 4.3% of GDP. The trade deficit widened: even though the growth in imports decelerated in FY2007, that of exports slowed even more, attributable to the poor performance in textiles and clothing in the wake of increased post-quota competition in global markets as well as a slowdown in several nontextile categories. Burgeoning workers' remittances limited the current account deficit to 5.2% of GDP. Pakistan is receiving large private capital inflows from abroad, including FDI, which have fully covered growing current account deficits and raised foreign exchange reserves.

Sri Lanka

GDP growth accelerated to 7.4% in 2006, despite the intensified conflict between the Government and the Liberation Tigers of Tamil Eelam (LTTE) since August 2006. The stock index lost about 10% in the first half of 2007, partly because business confidence has fallen since LTTE attacks and partly because the interest rates on treasury bills have risen sharply.

Consumer price inflation reached a peak of 18.6% year on year in March 2007 when the central bank was tightening monetary policy. The *Update* now projects inflation to average 14.5% in 2007, partly due to increases in fuel prices to limit subsidies. The fiscal deficit (including foreign-funded projects) is targeted at 9.1% in 2007. No changes are made to *ADO 2007*'s growth forecasts of around 6% in 2007 and 2008.

Southeast Asia

Subregional performance

Aggregate GDP growth in Southeast Asia is now forecast at a brisk 6.1% for 2007, revised up a half percentage point from *ADO 2007*. Four of the

major economies in the subregion—Indonesia, Malaysia, Philippines, and Singapore—are performing better than expected. Only Cambodia's growth projection has been lowered from March, and then by just a touch. If the outturn for the subregion comes in as forecast, this would be above the average of 5.6% over the past 5 years.

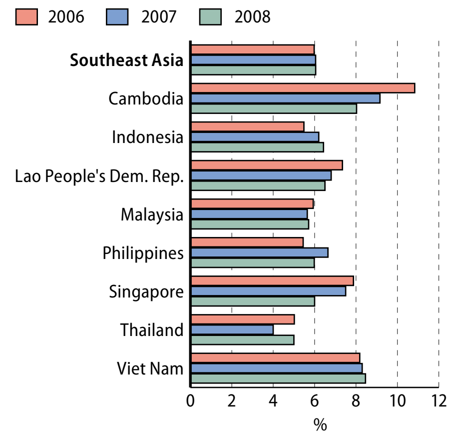
Stronger than expected domestic demand, especially in private consumption, accounts for most of the upward revision. In several economies, the levers of growth shifted from net exports in 2006 to domestic demand this year, but with Thailand an important exception. Exports have generally decelerated in line with lower US growth; softness in global demand for electronic products; and, for the oil-exporting economies of Indonesia, Malaysia, and Viet Nam, a softening in world prices and declines in domestic oil production. However, exports are cushioned by a rise in nonfuel commodity prices and trade with non-US markets, particularly the PRC and India. The extent of export deceleration has thus varied with the economies' relative diversification in terms of markets and products.

The expansion of private consumption this year reflects rising incomes in some countries, including incomes for producers of agricultural commodities; buoyant remittances (especially in the Philippines and Viet Nam); and lower interest rates. Public expenditures on development projects have supported investment growth in Indonesia, Malaysia, and Viet Nam. In the Philippines, public construction investment surged in the first half of the year (although such robust growth might not be sustained) and investment in durable equipment picked up for the first time in 2 years. Both private consumption and investment in Thailand have been damped by political and policy uncertainties.

Projections for the subregion's external current account surplus have been revised up to 7.0% of GDP in 2007 from 6.1% expected in *ADO 2007*. This reflects in part softer growth in imports in Thailand (commensurate with sluggish investment) and in the Philippines (mirroring the import intensity of weaker electronics- and garment-export industries). In Viet Nam, the current account is expected to record a significant deficit this year, as against a small surplus projected in *ADO 2007*. Although exports have benefited from Viet Nam joining WTO in January 2007, capital equipment imports have climbed rapidly on robust investment, and purchases of intermediate goods have stepped up as industrial production expands.

In most countries, current account surpluses and capital inflows exerted upward pressure on domestic currencies in the first half of 2007 but this might not continue through the second half because of uncertainties in international financial markets. Inflation pressures subsided more than expected, partly a result of currency appreciation and of better harvests in some countries. The effects of one-time factors that raised inflation in 2006 (administered fuel price increases in Indonesia and Malaysia and a hike in the value-added tax rate in the Philippines) also subsided. In Viet Nam, by contrast, inflation has increased more than expected, on both strong domestic demand and damage done to the food supply by drought, avian flu, and other livestock diseases. Overall, the subregional inflation forecast is downgraded to 3.8% from 4.2% in *ADO 2007*.

1.3.4 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

The forecast for 2008 subregional growth is uprated to 6.1% from 5.9% in *ADO 2007*. Three economies—Indonesia, Philippines, and Singapore—are projected to grow faster than in *ADO 2007*, based partly on their stronger than expected upward momentum this year. Aggregate growth at this rate would be the same as that expected for 2007. Accommodative monetary and fiscal policies in most countries are likely to support growth. With inflation pressures subsiding, there is scope to maintain low interest rates. Fiscal policies can also remain modestly stimulative, considering the general decline in public debt ratios.

Countries vary in their ability to pursue expansionary macroeconomic policies. Fiscal stimulus in the Philippines will depend on continued progress on tax collection. Viet Nam has less need for expansionary policies since growth is already high and policies are focused more on structural reforms to enhance competitiveness. In Thailand, despite substantial scope for expansionary policies, much of the impetus to growth is likely to come from a hoped-for reduction in political and policy uncertainty after the elections scheduled for end-2007.

Inflation is forecast to remain stable in the subregion in 2008 (at around 3.8%) on the expectation that world commodity prices will decline and domestic currencies will remain strong. With economic growth projected to edge higher in 2008 from this year in the three biggest economies—Indonesia, Malaysia, and Thailand—their current account surpluses are expected to decline somewhat. An upturn in the global electronics cycle would benefit those with a heavy weight in this area, i.e., Malaysia, Philippines, Singapore, and Thailand. This is likely to be offset to some degree by the expected decline in world nonfuel commodity prices. Subregionally, imports are projected to rise in line with stronger domestic demand and the exchange rate of domestic currencies, and in Viet Nam, continued reductions in tariffs.

Country highlights

Indonesia

GDP growth is on a gradual upward trend and is set to exceed 6% this year for the first time since the 1997–98 crisis. The 2007 forecast is revised up to 6.2% because private consumption and investment were stronger than expected in the first half. With the effects of the sharp October 2005 increase in fuel prices receding during 2006, and a consequent fall in inflation, the central bank has cut its policy interest rate significantly.

Domestic demand has taken over as the main driver of GDP growth. Private consumption is picking up on the back of lower interest rates and improved sentiment. A steady acceleration in bank lending and potential benefits from the new Investment Law have also contributed to stronger investment growth. The current account surplus is set to decline as domestic demand strengthens.

These trends are seen continuing in 2008, assuming steady progress in reforms to improve the investment climate. GDP is projected to increase by 6.4%. Inflation will likely remain around 6% on average. The current account surplus is expected to fall to just below 1% of GDP as world commodity prices moderate and domestic demand strengthens further.

Malaysia

The growth outlook has improved for 2007 following a stronger pickup in private consumption, supported by increases in incomes, better prices for agricultural commodities, and stable interest rates. Consequently, GDP is now projected to expand by 5.6% this year, revised up from 5.4%. Resilient domestic demand has offset some of the drag on GDP from weak electronics exports. Public investment has risen with the implementation of development projects under the Ninth Malaysia Plan. Inflation has fallen significantly as the impact of an 18–24% increase in retail fuel prices in March 2006 subsided. The current account surplus is likely to decline to 11.9% this year from a high 16.3% in 2006.

Next year's GDP growth forecast is maintained at 5.7%. The fiscal stimulus to public investment, a boost in civil service incomes, and benign monetary conditions should support domestic demand. Inflation in 2008 is put at 2.5%, the same as this year. Imports are projected to outpace exports, contributing to a further decline in net exports and a slightly smaller current account surplus as a share of GDP than in 2007.

Philippines

The projection for 2007 GDP growth is upgraded sharply to 6.6% from 5.4% in *ADO 2007*. This economy grew much faster than expected in the first half, with gains in net exports, private consumption, and government spending. Remittances from overseas workers continue to support residential real estate investment and private consumption, providing a strong impetus to overall growth. Government spending surged ahead of elections in May.

Investment in durable equipment grew in the first 6 months of this year, for the first time in 2 years. With a tepid rise in imports, net exports contributed significantly to growth. Buoyed by remittances and a narrower trade deficit, the current account surplus is set to rise to 5.4% of GDP in 2007, revised up from 3.2% projected earlier. Inflation pressures have subsided significantly with a stronger currency and receding effects of an increase in the value-added tax rate in early 2006. The 2007 inflation forecast is downgraded to 2.9% from 4.8%.

For 2008, the GDP growth forecast is revised up to 6.0% from 5.7% in *ADO 2007*. Consumption should remain underpinned by remittances. Government spending on infrastructure is projected to support growth in construction, and private investment shows signs of picking up following improvements in the fiscal position and lower inflation. The 2008 inflation forecast is revised down to 3.5% from 5.0%, assuming normal weather patterns, and the current account surplus is now projected to be around 5% of GDP, raised from the *ADO 2007* prediction.

Singapore

This economy grew by 7.6% in the first half of 2007, faster than anticipated in *ADO 2007*. Financial services and tourism performed strongly, driven in part by buoyant economies throughout the subregion. Construction activity surged, supported by a boom in high-end apartment building as well as new office and retail projects and two large resorts. The GDP growth forecast for 2007 is raised to 7.5% from 6.0%

in March. Growth is projected to ease to 6.0% in 2008 (revised up a half percentage point from *ADO 2007*).

Despite buoyant domestic demand, inflation pressures are less than expected. The 2007 inflation forecast is trimmed to 1.2% from 1.6%. Inflation is expected to edge higher from the second half of 2007, in part because of an increase in the goods and services tax from July 2007.

Furthermore, a strong labor market (the unemployment rate was just 2.4% in the second quarter) and rising rents are likely to engender upward pressure on costs for businesses. The inflation forecast for 2008 is revised up slightly to 1.2%. Weaker than expected growth in imports has prompted a revision in the 2007 current account surplus forecast to 28.5% from 27.0% of GDP, although the 2008 projection is maintained at 27.0%.

Thailand

The projections for growth remain the same as in *ADO 2007*. GDP growth is expected to slow to 4.0% this year, the lowest rate in 6 years, as domestic demand has weakened. Political and policy uncertainties have undermined consumer and business sentiment. The external side has performed better than expected, with both agricultural and industrial exports posting broad-based gains, while imports have risen at a modest rate, in part suppressed by weak domestic demand and a decline in oil imports.

The current account surplus is expected to increase to 3% of GDP compared with 1.3% projected in *ADO 2007*. Inflation pressures have moderated substantially, and the 2007 forecast is revised down to 2.0%.

Assuming political and policy uncertainties are reduced in the aftermath of elections scheduled for late 2007, GDP growth is expected to accelerate to 5.0% in 2008, as projected in *ADO 2007*. Consumer and business confidence will likely revive and the new government is expected to continue with the public infrastructure program. Domestic demand should be supported by reductions in interest rates in 2007.

Inflation is anticipated to rise modestly (to 2.5%, unchanged from *ADO 2007*) as domestic demand picks up. Projected firm global growth should prop up exports, in spite of lower commodity prices and the strength of the baht since 2005. The current account surplus is projected to narrow as imports increase faster with stronger domestic demand.

Viet Nam

Strong economic momentum has been underpinned by closer integration with global markets that culminated in WTO membership in January this year. The projections for GDP growth in 2007 and 2008 (8.3% and 8.5%, respectively) have not changed from March.

Vigorous growth of industry and services has more than offset the weaker performance of agriculture, affected by drought, avian flu, and other livestock diseases. Demand growth has been broad-based, partly driven by buoyant liquidity and expansionary fiscal policy. Private consumption and investment are expanding robustly.

Inflation pressures remain high though, and the projections for 2007 and 2008 have been revised up (to 7.8% and 6.8%, respectively). Much of the inflation reflects strong overall demand, but the adverse effects of weather and livestock disease on food supply have also contributed.

The projections for the current account have been revised to deficits for both 2007 and 2008 from small surpluses expected in *ADO 2007*. Export growth moderated in the first half of 2007 and imports rose faster than expected.

Other economies

Cambodia continues to consolidate its rapid economic growth based on agriculture, construction, clothing, and tourism. Double-digit GDP growth was recorded from 2004 to 2006, with last year's rate revised up to 10.8%, from the 10.4% estimated in *ADO 2007*. Partly as a result of this higher base, the growth forecast for 2007 is edged down to 9.2% from 9.5%. For 2008, the outlook has become somewhat clouded by increasing competition in clothing export markets from the PRC and Viet Nam. The 2008 GDP forecast is lowered by 1 percentage point to 8.0%. The expected deceleration in economic activity has led to a slight narrowing of forecast current account deficits.

The Lao People's Democratic Republic is benefiting from growth in mining (gold and copper) and hydropower, both attracting significant foreign direct investment, and from infrastructure development. Improvements in the trade and investment climate are planned by the Government as part of its effort to join WTO. GDP growth forecasts are maintained at 6.8% for 2007 and 6.5% for 2008. Inflation has slowed, despite an acceleration in broad money growth, and is expected to average about 5% this year and next.

In Myanmar, GDP growth is expected to continue at a moderate pace and the current account to be supported by natural gas exports. A sharp hike in the price of fuel in August 2007 and higher prices of rice are likely to keep strong pressure on inflation.

The Pacific

Subregional performance

The aggregate growth projection for the 14 Pacific developing member countries in 2007 is revised down to 3.5% from 4.5% in *ADO 2007*, mainly because a rebound in Timor-Leste (the subregion's third biggest economy) has not been as strong as expected, and political instability has led to a deeper than expected contraction in the Fiji Islands (the second largest economy). Tonga's economy, too, is set to contract.

The downgrade in the outlook comes despite a higher growth projection for Papua New Guinea (the largest economy). Although the aggregate forecast is revised down, this year is still expected to exceed subregional growth of 2.6% in 2006 (revised down from 3.1% in *ADO 2007*). The subregional inflation projection for 2007 is raised to 4.7% from 3.5%, primarily in anticipation of the pass-through of exchange-rate depreciation and earlier increases in international oil prices.

Subregional prospects

For 2008, aggregate growth is revised up to 3.2% from 2.8% in *ADO 2007*. This follows an upgrading of economic growth prospects for Papua New Guinea. That would put subregional expansion next year close to

this year's modest level. Fiji Islands and Tonga are expected to resume growth in 2008, albeit at low levels. Timor-Leste, which is recovering from a slump last year, will grow more moderately next year. Subregional inflation is projected to decelerate to 3.2% next year, slightly below the earlier projection.

Recent events have highlighted governance challenges in the subregion. Papua New Guinea and Timor-Leste experienced some violence linked to national elections earlier this year, while episodes of serious civil unrest occurred last year in Solomon Islands, Timor-Leste, and Tonga, and a military coup took place in the Fiji Islands. The macroeconomic management responses undertaken, together with international support provided to most of these countries as well as relatively high export prices, point to the likelihood of these economies growing in 2008. But the underlying weaknesses in governance and the associated constraints to growth remain to be treated.

Growth prospects in the Pacific are also crimped by underinvestment in physical infrastructure and human capital, and insufficient support for private sector-led development. High government wages bills are key causes of the underinvestment, as they compress expenditure on essential goods and services, and on capital works. This constraint has intensified in several economies where public sector wages have been hiked.

A more supportive approach to private investment is required to realize the potential for growth. Continued action to raise the responsiveness of governments to business and community needs, and to enhance accountability, is central to improving public policy and making better use of public resources. Gains in these areas are in turn critical to averting future episodes of civil disorder and political instability.

Country highlights

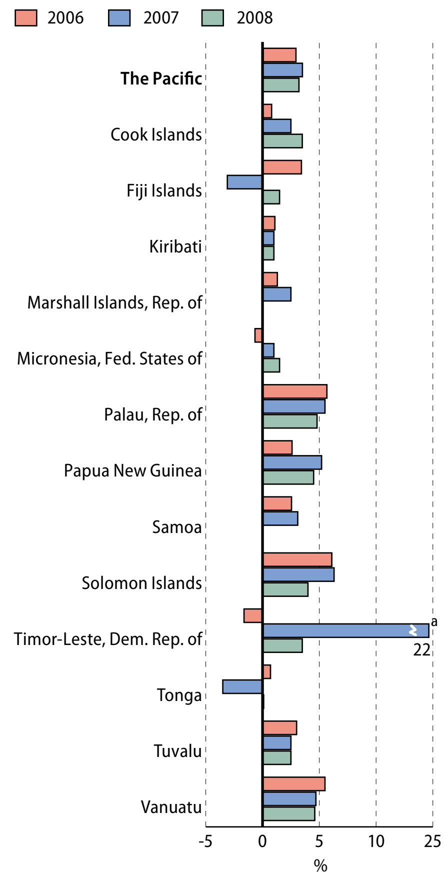
Fiji Islands

The *ADO 2007* forecast, for a decline of 2.3% in output, is revised to a sharper contraction of 3.1%. This reflects an updated expectation of a fall, rather than slight growth, in sugar production, linked to a progressive reduction in preferential prices paid by the European Union; a sharper than forecast drop of 10% in tourism earnings following the military coup in December 2006; a decline in clothing production as the industry continues to adjust to the loss of trade concessions; and a reduction in crop production caused by flooding early this year.

Building and construction is still forecast to contract by around 20% as a result of reduced public and private investment, exacerbated by the introduction of a credit ceiling on home loans. Business confidence remains low and the retail sales outlook is gloomy. The *ADO 2007* inflation forecast of 3.0% in 2007 is revised up to 4.1%, partly because of the floods (which raised food prices) and the pass-through of earlier increases in oil prices.

Falls in sugar and clothing exports are expected to more than offset rises in exports of fish, forestry products, and mineral water, with the result that exports, according to official estimates, will decline by 2.6%. Merchandise imports are projected to fall by about 2.0% because of the damping effects of the economic contraction and tighter macroeconomic policies. A rise in personal remittances should go some way toward

1.3.5 GDP growth, The Pacific



[a] Non-oil GDP.

Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

cushioning a drop in official transfers and tourism receipts, but the current account deficit may exceed 20% of GDP in 2007.

The central bank has taken several measures to protect declining foreign exchange reserves: it set a credit ceiling on commercial bank lending in November 2006; has tightened exchange controls; and has raised its lending rate to commercial banks. Nonresidents' access to domestic financing is restricted. These steps are buttressed by fiscal measures aimed at containing the budget deficit (exclusive of asset sales) to 2.1% of GDP, most notably through a 5% pay cut for public servants. Yet despite macroeconomic tightening, foreign reserves fell to the equivalent of 3.5 months of import cover by the middle of this year, from 3.7 months at end-2006. The external position remains fragile and may compel the monetary authority to contemplate external borrowing.

Next year, economic growth is expected to resume at a rate of about 1.5%. Tourism income is forecast to pick up as visitor numbers rebuild and price discounting by hotels eases. The country's only gold mine, which closed late in 2006, is restarting operations, and increased sugar production is anticipated as industry restructuring moves forward.

Papua New Guinea

This economy is a producer of gold and copper and a net exporter of oil, with mining and oil generating 13% of GDP and 80% of exports. High world prices for these resources have led a turnaround that has now spread more broadly through the economy. GDP growth of 5.2% is projected for 2007, up from *ADO 2007*'s 4.5%. The growth revision reflects a rise in projected growth of nonmining sectors (mainly agriculture and services), from 4.2% in *ADO 2007* to 5.2%. These sectors are buoyed by generally high prices for agricultural exports and improved business and consumer confidence. The weighted average price of agricultural, forestry, and fishing exports rose by an unexpectedly high 23.3% over the first quarter of 2007.

Employment (outside copper, gold, and oil extraction) rose by 4.1% over that quarter, with higher employment recorded in all regions and most sectors. The broad-based nature of the economic strengthening was evident in a 9.8% rise in credit to the private sector in the first 4 months of 2007, led by increased lending to the services sector and to households. However, the improvement in the business climate was set back by a government decision to cancel mobile telephone licenses issued to two foreign firms and instead reserve market rights to a domestic operator.

Papua New Guinea's inflation rate is forecast to average 4.8% in 2007, revised up from 3.0% in *ADO 2007*. Year-on-year inflation accelerated from 1.8% at end-2006 to 4.4% in March 2007. Price pressures are attributable to a depreciation in the kina and the pass-through of previous increases in world oil prices. A rise in import prices, coupled with higher domestic demand, lifted imports and lowered the trade surplus in the first quarter, contributing to the first current account deficit in 2 years. Gross foreign reserves remained high at $1.7 billion as of end-April (9.5 months of nonmining imports). One concern was an increase in government expenditure in the lead-up to national elections in July, against a background of a higher than expected underlying inflation.

Crude oil production is expected to fall in 2008 due to the natural

decline in output from existing fields. This development is forecast to trim overall economic growth to 4.5%. Nonetheless, this projection is an upgrade from *ADO 2007*, reflecting an expectation of higher mining output on the fact that mining companies have invested to raise production and to extract higher-grade ores. Inflation is expected to ease next year as the currency steadies.

Democratic Republic of Timor-Leste

The economy has revived this year, after the economic contraction in 2006 caused by an outbreak of civil unrest. Spending has been stimulated by the presence of international personnel to support national elections and peacekeeping efforts, by high international prices for coffee (the country's main non-oil export), and by increased public outlays. Budget reports for the first half of the fiscal year (ended 30 June 2007) show that recurrent spending was slower than scheduled, but still faster than a year earlier. Capital and development spending increased to almost three times the year-earlier amount. Total bank deposits, and loans and advances, increased by 3.2% and 4.7%, respectively, in the first quarter of 2007 from end-2006 levels.

Parliamentary elections in June resulted in a new coalition Government, but civil unrest broke out again in August. The need to manage tensions and internal policy differences is likely to complicate government efforts to introduce economic and public-sector initiatives needed to ensure sustained growth in the non-oil economy. Government receipts from the offshore oil and gas industry are rising, but this energy production generates little direct employment in Timor-Leste. The Petroleum Fund, established to save the Government's oil and gas revenues and to generate long-term investment income to fund the budget, increased to $1.4 billion, or almost three times non-oil GDP, at end-June, double the level of a year earlier.

Forecast growth in the non-oil economy for 2007 is revised down from *ADO 2007* to a still-high 22%. Inflation, above expectations in the first quarter of this year mainly because of a rise in food prices caused by a shortage of rice, is now forecast at 8.0% for the whole year, revised up from 5.0%. Economic growth in 2008 is projected to slow from this year's rebound, largely on the basis that civil unrest eases, allowing for a decline in the international presence. A pay increase for public servants and government efforts to raise the rate of investment spending are projected to help achieve moderate growth of 3.5%.

Other Pacific economies

Samoa

This economy is expected to achieve the growth forecast of *ADO 2007* (3.1%), with economic activity stimulated by preparations for the 2007 South Pacific Games in August–September 2007, major public sector projects, rising tourist numbers, and high levels of remittances. As of May 2007, bank lending was up by about 25% from a year earlier. Monetary policy was tightened slightly in response to early signs that sustained growth may be overheating the economy—as of May official foreign reserves of $72.9 million, or 3.9 months of imports, were below the central bank's target of 4.0 months of import cover, and underlying

inflation had risen to 5.0%. The full-year inflation forecast has been lifted to 5.0%.

Solomon Islands

The new estimate of 6.3% growth in 2007, revised up from 5.0% in *ADO 2007*, largely reflects an acceleration in the (unsustainable) harvesting and export of logs, as well as faster expansion in palm oil production. The external position is bolstered by strong export growth and inflows of donor grants to finance development projects, including relief and reconstruction projects in response to a tsunami in April that killed 52 people and displaced thousands of others. The tsunami itself is not expected to have a major impact on growth as the affected areas account for only a small share of the economy, and any lost production is expected to be more than offset by increased aid flows.

Foreign reserves in mid-August 2007 were $114.5 million, covering more than 4.5 months of imports of goods and nonfactor services. Inflation is expected to stay at about 8.0%. The *ADO 2007* forecast of an easing in growth in 2008 to 4.0% is maintained. This deceleration reflects a slowdown in logging, linked to the ending of export duty exemptions.

Tonga

The outlook for this economy has deteriorated. It is now forecast to contract by 3.5% in 2007, a revision from *ADO 2007* when flat GDP was foreseen. Factors include a substantial early-2007 fall in remittances, indications that low export prices will reduce plantings of squash (the main agricultural export), and a decline in tourism following riots in the capital in November 2006. These developments add to underlying weakness arising from a downturn in the fishing industry and a near 20% cut in civil service staffing in mid-2006.

On the upside, the currency has steadied, which eased inflation to 3.8% by end-March, about half the rate recorded in mid-2006. The inflation projection for 2007 is revised down to 5.0%, from the *ADO 2007* forecast of 10.0%, reflecting progress in stabilizing both the budget and the balance of payments. An overall budget surplus of 2.0% of GDP is estimated for 2007; reserves were $43.7 million (4.7 months of import cover) at end-March. The economy is expected to recover slowly and be virtually flat in 2008.

Vanuatu

Growth of 4.7% looks set to be achieved in 2007, with tourism-related activities receiving an additional boost from the introduction of new flights to Vanuatu by Air New Zealand and Solomon Airlines. The Government's fiscal position is strained, as expected, by the impact of substantial civil service wage increases, bringing the wages bill up to over half total government expenditure and crowding out capital spending. Inflation is still expected to be around 2.5% this year. In 2008 both GDP growth and inflation will be similar to this year's rates.

Others

In the Cook Islands, growth has picked up from 2006 and is now forecast at 2.5% for this year (revised down from 3.2% in *ADO 2007*). Value-added

tax receipts to May 2007 were 11.4% higher than a year earlier. Visitor arrivals also increased, spurred by a Cook Islands series of the television show "Survivor" and the opening in April of direct flights from Los Angeles to Rarotonga. Pearl exports are expected to improve this year as new pearl farms in Rakahanga come into production. However, the fish catch is down for the second year in a row.

Expected growth this year for the Republic of the Marshall Islands is revised down from 3.5% to 2.5% as a result of cuts in public service staffing. An increase in grant-funded government capital expenditure is helping support economic growth. Additional growth stimulus will come from the reopening, in August 2007, of an upgraded Majuro tuna-loining plant under new management, 3 years after it closed because of financial difficulties. The plant is expected to employ about 650 local workers when it becomes fully operational in December. Inflation is put at 3.1% in 2007, revised upward from 2.4% because of transport cost increases.

In Nauru, the economy is still expected to contract in 2007, but the outlook for next year has improved, since secondary mining of phosphate is scheduled to start then and additional government revenues are expected from offshore fishing rights. Donor-funded construction works are also expected to help the economy recover.

The growth and inflation forecasts for the Federated States of Micronesia made in *ADO 2007* are unchanged. Palau is also expected to achieve the solid growth forecast made for this year. Growth is projected to remain low in Kiribati and Tuvalu.