Part 3

Economic trends and prospects in developing Asia

Bangladesh

Growth in gross domestic product (GDP), inflation, and the current account surplus for FY2007 (ended 30 June 2007) came in close to the projections made in March this year, in *Asian Development Outlook 2007* (*ADO 2007*). For FY2008, this *Update* slightly revises down the earlier projection of GDP growth, but foresees higher inflation and a slightly wider current account surplus. The growth and external outlooks remain positive, though curbing inflation remains a challenge. Economic prospects will also depend on the caretaker Government's success in maintaining political stability and broad public support.

Updated assessment

GDP growth remained robust at an estimated 6.5% in FY2007, propelled by rising domestic and external demand. A strong expansion in industry (9.5%) and continued buoyancy in services (6.7%) largely offset agriculture's moderation following its postflood bounceback of the preceding year (Figure 3.1.1). Industry was sustained by strength in manufacturing (up 11.2%), in turn driven by continued growth in external demand for garments. The manufacturing and trade performance sustained steady expansion in services.

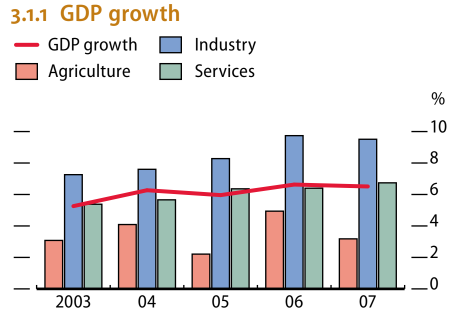
On the expenditure side, growth was underpinned by private consumption. Private investment, aided by growth in bank credit and workers' remittances, also contributed to sustaining economic expansion. But total investment, at 24.3% of GDP in FY2007, declined by 0.4 percentage points compared with the preceding year, on moderation in public investment following downsizing of the annual development program. Net exports of goods and services were a slightly negative factor that subtracted from growth, though by less than in the previous year.

Inflation continued to creep up, to 9.2% in June 2007 on a year-on-year basis, with increases in both food and nonfood prices (Figure 3.1.2). Rising domestic demand pressures, stemming from a steady expansion of income, a large increase in workers' remittances from abroad, and high monetary growth heightened inflationary pressures, as did a further rise in international food and commodity prices. Imported fuel has only a limited impact given its small weight (4%) in the index and low energy intensity of production.

The Government's recent administrative measures to counter inflation, such as investigations of certain businesses suspected of hoarding supplies; measures to regulate stock levels and prices; as well as its encouragement to new importers to enter the market and so induce greater competition, appear to have had no discernible impact on inflation. They have, rather, created uncertainty in the business environment, contributing to price pressures.

Bangladesh Bank gave tightening guidance for monetary policy in FY2007, without adjusting policy rates, reserve requirements, or liquidity ratios, instead relying on open-market operations. Treasury bill yields and

3.1.1 GDP growth



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2007.

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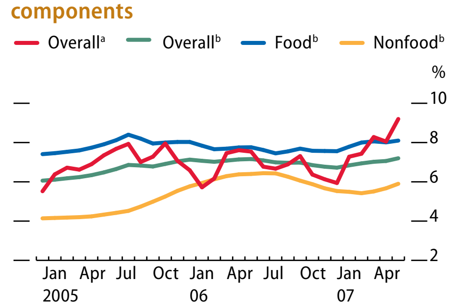
3.1.2 Change in consumer price index and components



[a] Year on year. [b] 12-month moving average.

Source: Bangladesh Bank, *Economic Trends*, July 2007, available: http://www.bangladesh-bank.org, downloaded 14 August 2007.

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bank lending and deposit rates increased only marginally during the year. Broad money (M2) growth reached a record high of 22% in December 2006 (Figure 3.1.3), slowed in subsequent months to 17% in June, but still substantially exceeded the central bank's program target of 14.7%.

Growth in net foreign assets held by Bangladesh Bank increased substantially, by 52.0% over the year to June 2007 and accounted for about one third of the increase in M2. Growth in credit to the private sector at 15.1% for the year (18.3% in FY2006) was contained partly by erosion in business confidence following the caretaker Government's anticorruption measures. Growth in credit to government expanded rapidly to peak at 35.9% in December 2006 but fell to 13.9% by June 2007, in large part reflecting disbursement of budgetary support from the World Bank.

At 10.6% of GDP, revenue collection in FY2007 was lower by 0.1 percentage point of GDP than the previous year (Figure 3.1.4). Despite a rise in current expenditures, overall spending was held down by reduced development outlays. The fiscal deficit came in on target at 3.7% of GDP: 2.1% financed domestically and 1.6% abroad. Although Bangladesh has high nominal rates for corporate income tax and value-added tax (VAT), it has much lower revenue productivity than most other Asian countries. To achieve the required revenue buoyancy and thereby enhance the tax ratio, it is essential to reform the tax laws and streamline tax administration.

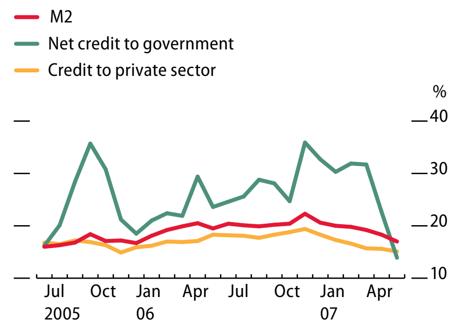
The losses of state-owned enterprises (SOEs) and associated quasi-fiscal obligations pose a significant fiscal risk in the period ahead. In FY2007, the combined net loss of the 44 nonfinancial SOEs was estimated at $613 million, or about 1% of GDP, widening from a $425 million loss in the previous year. Administrative prices of fuel, electricity, and fertilizer, and operations of the government-owned airline caused most of the losses in this area.

A 16–21% upward adjustment in fuel prices in April 2007 helped limit losses at Bangladesh Petroleum Corporation (BPC) to an estimated $460 million (0.7% of GDP) in FY2007. Following the adjustment, domestic prices of the two major products, diesel and kerosene, amounted to 79% of breakeven costs (calculated using July 2007 international product prices). Without any further changes in domestic and international prices, BPC's losses are forecast at $364 million, or 0.5% of GDP, in FY2008.

To facilitate the Corporation's operations, the Government is assuming its overdue bank loans (contracted largely to cover past losses). These will be financed through a $1.1 billion bond to be issued in FY2008, which would provide the banks with an earning asset. However, to avoid re-accumulation of losses at BPC and of nonperforming loans (NPLs) at the four nationalized commercial banks (NCBs), the Government needs to quickly introduce an automatic price adjustment mechanism and improve the Corporation's operating efficiency.

The losses of the Bangladesh Power Development Board should also fall, because the electricity tariff to the distribution companies was raised by 10% in March 2007. However, these companies may pass on only a 5% increase to urban consumers. But switching over to a cost-reflective tariff structure for generation would be more desirable as the annual loss of the Board, even at new tariffs, is estimated at $200 million in FY2007.

3.1.3 Growth of monetary indicators



Source: Bangladesh Bank, *Economic Trends*, July 2007, available: http://www.bangladesh-bank.org, downloaded 14 August 2007.

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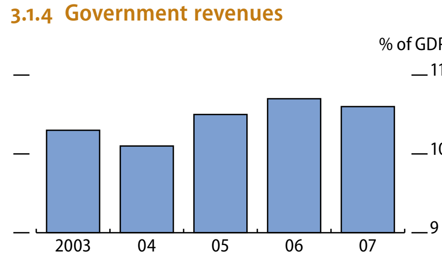
3.1.4 Government revenues



Source: Asian Development Outlook database.

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No substantial changes have been made to reduce fertilizer losses. Finally, Biman Bangladesh Airlines, the loss-making state-owned carrier, is to be made a public limited company as a first step in fostering commercial operations, leading to eventual partial privatization.

Exports grew by 15.8% in FY2007, essentially reflecting robust performance in the garments industry (Figure 3.1.5). Concurrently, imports rose by 16.6%. The rise in the trade deficit was more than offset by a 25% surge in officially recorded overseas workers' remittances, owing to an increased number of workers abroad, as well as efforts to bring in remittances through official channels. The current account surplus rose to an estimated $952 million, or 1.4% of GDP, for the year. The capital account, including a large errors and omissions item, shifted to a $541 million surplus from a $486 million deficit a year earlier, mainly reflecting a swing in the short-term borrowing item from large net repayments to large borrowing. International reserves amounted to $5.1 billion in June 2007, a rise of $1.6 billion during the fiscal year (Figure 3.1.6).

The performance of the banking sector improved with liberalization, entry of new private sector banks, and strengthened regulation and supervision. But the financial intermediation cost is still high, with a large volume of NPLs.

The Dhaka Stock Exchange general index surged by 60.5% in FY2007, buoyed by strong domestic institutional buying (Figure 3.1.7). The upward trend in prices was interrupted in early August 2007 as global financial turbulence buffeted many stock markets. However, the index fully recovered and went to new highs by end-August. Market capitalization had already exceeded $7.0 billion by end-June 2007, pushing it to 11% of GDP from a meager 6% a year previously. But the market remains small compared with those of its regional peers, and more company listings are needed for further development.

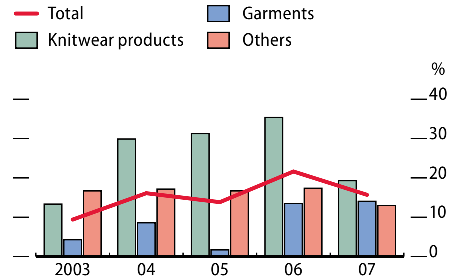
Prospects

Key baseline assumptions for the FY2008 forecast are similar to *ADO 2007*'s: the authorities will continue measures to promote macroeconomic stability with a focus on curbing inflation, raising revenues, and pursuing a more flexible approach to exchange rate management. The spotlight of structural measures will stay on revamping SOEs and fostering financial sector reforms.

The caretaker Government appointed in January 2007 (by the president who postponed Parliamentary elections and stepped down as the head of the caretaker Government) has enjoyed widespread public support for its anticorruption campaign as well as efforts to strengthen the electoral process and advance previously stalled economic reforms. This Government has indicated its commitment to completing electoral reforms by end-2008. Nevertheless, political uncertainty will prevail until new elections are held, slated before end-2008.

GDP growth is forecast at 6.5% in FY2008, lowered slightly from the *ADO 2007* projection because of recent floods, which have fortunately been less severe than those in recent years. Despite the floods, agriculture is expected to show growth of 2.8%, slightly less than last year. Rising

3.1.5 Growth in exports and components



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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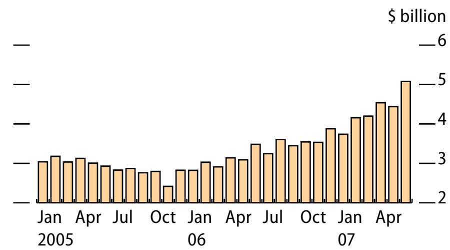
3.1.6 Gross international reserves



Source: Bangladesh Bank, *Economic Trends*, July 2007, available: http://www.bangladesh-bank.org, downloaded 14 August 2007.

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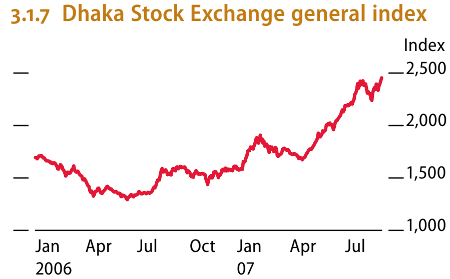
3.1.7 Dhaka Stock Exchange general index



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

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official development assistance and larger private flows are expected to raise investment, including in power generation. The conditions for the expansion of industry remain favorable because of a likely continued uptrend in export-oriented manufacturing and new capacity in textiles, garments, light engineering, and power. Services seem set to climb in line with the steady expansion in industry.

This *Update* raises the inflation projection for FY2008 to 7.0% from the 6.0% in *ADO 2007* because of heightened pressures in the second half of FY2007. Bangladesh Bank's monetary policy statement, announced in mid-July 2007, set an objective of limiting inflation to a range of 6.5–7.0% in FY2008. The statement noted that the central bank would review the need for adjusting its policy instruments. Maintaining a cautious monetary policy stance will be a challenge since the recent flooding has occurred at a time of high monetary expansion and rising inflation. Nevertheless, achieving the upper end of the range appears feasible, though it would represent a marginal improvement over FY2007.

The strength of the external sector in FY2008 is likely to be sustained, with strong growth in overseas workers' remittances offsetting the rising trade deficit. Although the ending of the quota arrangements in garments and textiles has so far had a positive impact on Bangladesh, the country still runs the risk of facing tough competition in its two largest markets—the European Union and the United States (US)—as the "safeguard quota" provisions on the People's Republic of China expire at end-2008. To retain competitiveness, Bangladesh needs to cut lead-times for delivering garments, upgrade labor skills, and improve its infrastructure.

The thrust of the FY2008 budget is to create a stable environment for accelerated economic growth. In FY2008, although revenue is projected to rise to 10.8% of GDP, higher expenditure, caused by a rise in development spending, is forecast to widen the fiscal deficit to 4.2% of GDP. Strong efforts to meet the revenue target will be needed because any greater bank borrowing to finance planned expenditure would push reliance on banking system finance to a level that would undermine monetary control and accelerate inflation.

Between the introduction of a flexible exchange rate regime at end-May 2003 and end-June 2006, the taka depreciated: by 17% against the US dollar and by 11.5% in terms of the real effective exchange rate (Figure 3.1.8). This has supported growth in exports and remittances. But in FY2007, because of higher foreign exchange inflows from a notable improvement in the current and capital accounts, the taka appreciated slightly against the dollar and by 2.5% in real effective terms. Given comfortable reserves, the central bank is in a position to allow some greater flexibility in the exchange rate in line with market trends, intervening only to correct disorderly movements.

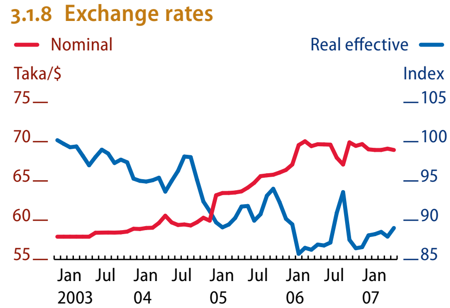
Bangladesh faces various risks that could derail these projections. Political uncertainty, however, is the key one. The outlook will depend crucially on the caretaker Government's success in maintaining political stability with broad public support until the elections are held. Any material setback on the political front would undermine business confidence and negatively affect investment and growth.

3.1.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	6.5	6.5	7.0	6.5
Inflation	7.0	7.2	6.0	7.0
Current acct. bal. (share of GDP)	1.0	1.4	0.2	1.0

Sources: Bangladesh Bureau of Statistics; staff estimates.

3.1.8 Exchange rates



Source: Bangladesh Bank, *Economic Trends*, July 2007, available: http://www.bangladesh-bank.org, downloaded 14 August 2007.

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People's Republic of China

GDP growth reached 11.5% in the first half of 2007, buoyed by exports, investment, and consumption. The authorities redoubled efforts to rein in investment and exports, such as increasing interest rates, banks' reserve requirements, and taxes on some exports, but to date, these steps have had limited impact. This *Update* raises the GDP growth forecast, made in *Asian Development Outlook 2007* (*ADO 2007*), to 11.2% for 2007, and 10.8% for 2008. Inflation has risen, mainly the result of a run-up in food prices. The inflation projection is lifted to 4.2% this year and 3.8% in 2008, but there is a risk that the actual outturn could be higher still.

Updated assessment

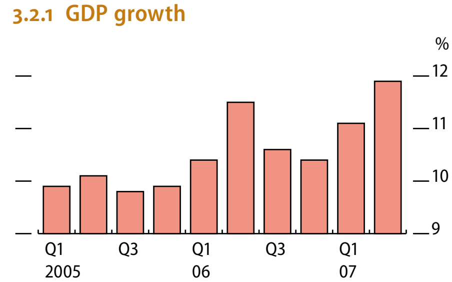
GDP growth accelerated in the People's Republic of China (PRC) from 11.1% in the first quarter of 2007 to 11.9% in the second (Figure 3.2.1), fueled by a widening trade surplus, by galloping investment across the board, and by buoyant private consumption. Growth of 11.5% in the first half of the year was at its fastest rate since 1994, despite measures by the authorities to constrain investment and exports. On the supply side, growth was again led by industry (especially heavy industry), where value added rose by 13.6% in the first half, faster than services' 10.6% and agriculture's 4.0%. Strong momentum in the real economy is underlined by an upward revision of 2006's GDP growth rate, which is now placed at 11.1%.

Underlying drivers of investment, including strong profitability, buoyant sales, and still-low lending rates, remained strong. With industrial profits improving by about 42% in the first 5 months of this year, growth in fixed asset investment accelerated to 28.7% in the second quarter from 26.0% in the first (Figure 3.2.2). Investment administered by local governments grew by 28.1% in January–June, nearly double the equivalent central government rate, suggesting that efforts by the center to tighten investment at the local level have as yet had little impact. Strong profit growth in industries such as steel, electricity, chemicals, and oil processing continues to encourage investment in these sectors. Factors underpinning profits are rising productivity in manufacturing and low, government-controlled prices for domestically produced energy and resources, with the costs of environmental degradation not being internalized by polluters.

Supported by government policies to boost the rural economy, investment in agriculture surged by 37.5% in the first 6 months, faster than that in industry (29.0%), and services (24.6%). Provincial governments have strong incentives to maintain rapid investment, partly since local fiscal revenue depends heavily on receipts of value-added tax, which are boosted by new investment projects.

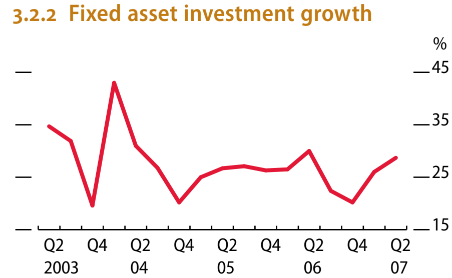
Reflecting the pickup in consumption, retail sales grew by 15.4% in the first half, up from 13.4% in the year-earlier period (Figure 3.2.3). Two main factors are driving consumption growth. One is rising incomes,

3.2.1 GDP growth



Source: China.org.cn, available: http://www.china.org.cn/e-news/index.htm, downloaded 31 August 2007.

3.2.2 Fixed asset investment growth



Sources: CEIC Data Company Ltd., downloaded 31 August 2007; staff estimates.

supported by enterprise profits, salary increases for civil servants, higher minimum wages for some employees, and policies to stimulate the economy in rural areas. Urban and rural incomes in real terms rose by 14.2% and 13.3%, respectively, in January–June (Figure 3.2.4). The second is that, as central and local governments pay more attention to social security and increase investment in education, health care, and low-cost housing, some households may be encouraged to release savings and spend more. Consumers stepped up spending on big-ticket items, such as housing and automobiles. Sales of automobiles jumped by 36.7% in the first 6 months of the year, albeit from what is still a low base.

External demand was strong, too, in the first half. Merchandise exports rose by 27.6%, much faster than import growth of 18.2%, lifting the trade surplus to $112.5 billion (Figure 3.2.5). Temporary factors probably helped boost exports, including the decision by many firms to bring forward export shipments to before the imposition of midyear government measures to help limit the trade surplus. Import growth was damped by high global prices for commodities such as oil and agricultural products.

The growth rate for some exports could slow in the second half: from 1 June 2007, an export tariff was imposed on 142 products, while export tax rebates were reduced or abolished in July for 2,831 items. The aim is to rein back the growing trade surplus and at the same time ease strains on the environment by reducing goods production that requires high inputs of energy and natural resources, and that causes high levels of pollution. Accordingly, the Government has taken steps to curtail lending to polluting industries. Exports are forecast to grow by 20% and imports by 16% in the second half of 2007, resulting in a record full-year trade surplus of around $300 billion, up more than 60% from 2006.

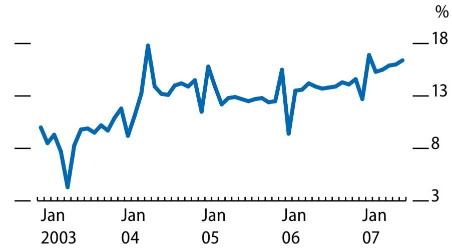
Based on the updated assessment of domestic and external demand, the full-year 2007 GDP growth forecast is revised to 11.2%, from 10.0% in *ADO 2007*. The current account surplus is now expected to swell to 10.9% of GDP, revised up from 8.8%.

Rapid economic growth in the first 6 months of 2007 helped create 6.3 million jobs in urban areas, 70% of the year's urban employment goal. The Government has introduced free training and subsidized job-search services, and plans to revitalize efforts to find work for laid-off workers, retired armed forces personnel, and others who find it difficult to integrate into the formal job market.

An upturn in inflation, mainly caused by food price increases, is raising concerns. The consumer price index rose by 3.9% in the January–August period from a year earlier, exceeding the 3.0% target set by the central bank for all of 2007. In August, inflation reached 6.5%. Rising global grain prices was one reason for the spike in food prices. Another is an outbreak in the PRC of a pig disease that caused shortages, and pushed up prices, of pork. The producer price index rose by 2.4% in the first 6 months, well below the pace of consumer prices, since despite high international prices for oil and other raw materials, many of their domestic prices are controlled by the Government. The net effect of the higher than expected food prices has led to a revision in the full-year inflation forecast to 4.2% from 1.8% in *ADO 2007*.

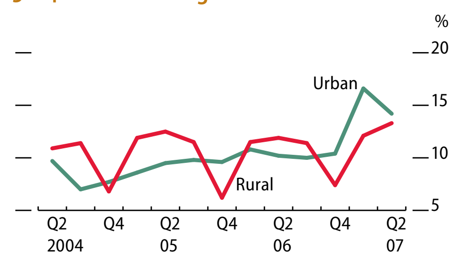
Rising stock and property values also pose challenges: these markets

3.2.3 Retail sales growth



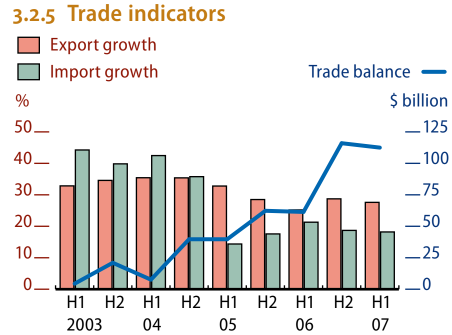
Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.4 Real income growth



Sources: National Bureau of Statistics, *China Statistical Abstract 2007*, and *China Monthly Economic Indicators*, various years.

3.2.5 Trade indicators



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various years.

continued to boom in the first half of the year. After several years of dull performance, stock prices started to soar in 2006 when a long-standing issue concerning the future of state-owned nontradable shares was resolved in a way that eased market concerns. Excessive liquidity in the financial system and relatively unattractive bank deposit interest rates have also been key factors. The Shanghai A-share index (for shares available to domestic investors) nearly doubled in the first 8 months of 2007, after a 130% leap last year (Figure 3.2.6). To curb market speculation, the authorities in May raised the stamp duty on stock transactions and brought in measures to curb the use of bank loans for stock market speculation. These steps had limited impact. After an initial decline, the A-share index rebounded to reach a new record high by end-July, and was largely impervious to August's turbulence in global credit and equity markets.

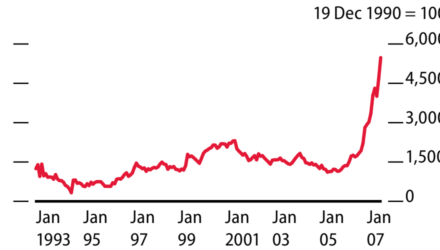
Housing prices have accelerated in many cities this year (and rose at double-digit rates in some, including Beijing and Nanjing) due to excessive liquidity and a surge in demand. Sales of new houses nationwide jumped by 22.5% in the first half.

Persistently high trade surpluses and capital inflows have further boosted foreign exchange reserves, complicating monetary policy. Reserves reached $1.3 trillion by end-June, up by $266 billion in 6 months (Figure 3.2.7). The trade surplus ($122.5 billion) and actual foreign direct investment (FDI) (up 12.2% to $31.9 billion), accounted for 54% of the total foreign exchange accumulation in the first half of 2007, while non-FDI capital inflows contributed 46% (against just 3.0% in 2006). The main reason for much higher non-FDI inflows was repatriation of the substantial proceeds from initial public offerings of shares by PRC banks and companies launched mainly in the Hong Kong, China stock market. The authorities are concerned that capital inflows are being used to speculate in domestic stock and property markets, and on a greater appreciation of the yuan.

The People's Bank of China, the central bank, has continued to drain excess liquidity from the banking system but has not completely offset capital inflows. Broad money supply (M2) grew by 18.5% in July from a year earlier (Figure 3.2.8), above the central bank's target of 16.0%. Bank lending also is strong: loan growth was 16.5% at end-July (Figure 3.2.9). The authorities allowed the yuan's appreciation against the US dollar to accelerate slightly in nominal terms to 4.4% in the second quarter of 2007 (year on year), from 3.7% in the first and 2.8% in all of 2006 (Figure 3.2.10).

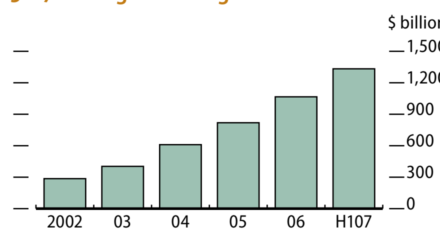
Among its efforts to curtail liquidity and to tame investment, the Government took several financial measures in the first 9 months of 2007, including further increases in interest rates (the 1-year benchmark lending rate was raised from 6.12% to 7.02%; Figure 3.2.11.) and in the commercial banks' reserve-requirement ratio (from 9.5% to 12.5%; Figure 3.2.12), in addition to the imposition of export tariffs and the cuts in export tax rebates. These measures built on successive steps taken over recent years. But the effectiveness of interest rate rises in cooling demand is hindered by seepages into liquidity of rising foreign exchange reserves and by the fact that the economy is still not fully market-based. Incentives, particularly at the local level, to build more production plants and real

3.2.6 Shanghai stock exchange index, A-share



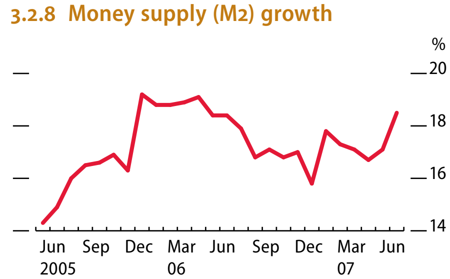
Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.7 Foreign exchange reserves



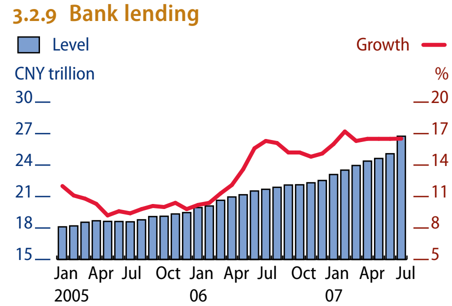
Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.8 Money supply (M2) growth



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.9 Bank lending



Source: National Bureau of Statistics, *China Monthly Economic Indicators*, various years.

estate projects also frustrate efforts to limit investment growth. Measures to liberalize investment from the PRC in the Hong Kong, China stock market could help curb rises in foreign exchange reserves, and form a stepping stone to broader liberalization of capital account outflows.

The rapid economic growth and buoyant corporate profits helped boost fiscal revenue by 30.6% in the first half of 2007, when fiscal expenditure grew by 22.7%. The surge in receipts and a slowdown in public infrastructure spending should help keep the budget deficit this year to less than 1% of GDP. Reflecting changes in spending priorities, outlays on rural development, education, social security, and health care all rose by 28–36% during January–June. The Government announced in March that it is developing a plan for state-owned companies to pay dividends (instead of reinvesting profits, one reason for the rapid growth in investment).

Prospects

The faster than expected growth momentum built up this year is expected to carry into 2008. Further steps to cool the rapid investment expansion are likely and the Government will put more emphasis on improving energy efficiency and on cutting pollution. But top priorities remain the creation of jobs for nearly 8 million rural surplus workers migrating to cities each year, and on lifting income growth in lagging regions and areas. Moreover, fiscal spending looks set to increase in 2008 with more public investment slated for education, health care, and rural development.

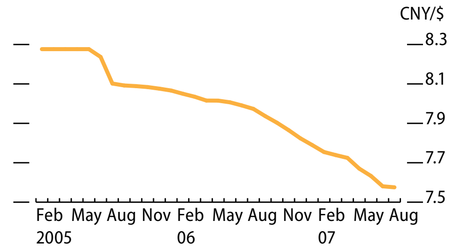
On the demand side, rising incomes and improvements to the social security system are projected to underpin growth in consumption. Investment will stay high, supported by local governments that want to generate employment and develop their cities, by banks willing to lend, and by enterprises eager to expand and maintain earnings growth. The gap between export and import growth will probably close a little as the changes to export tariffs and export tax rebates take effect.

GDP growth for 2008 is revised to 10.8%, up 1 percentage point from the *ADO 2007* forecast (Figure 3.2.13). The current account surplus is seen rising to 10.5% of GDP (Figure 3.2.14), revised up because of a sustained high merchandise trade surplus and a narrower deficit in services trade. On the production side, agriculture should be strengthened by policies to lift rural incomes and to improve rural infrastructure, and services will be supported by the summer Olympics. But industry is again expected to contribute the lion's share (about two thirds) of GDP growth in 2008.

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, which will probably mean tariff increases by these utilities. On this basis, the inflation forecast for 2008 is raised from 2.2% to 3.8% (Figure 3.2.15).

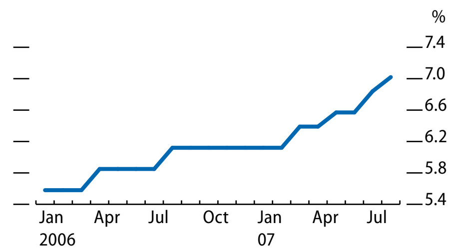
Significantly higher inflation than forecast would, however, pose a risk to the outlook. Adverse weather would lower domestic grain production, at a time that imported grain prices are high. Furthermore, the pig disease might not be brought under control as quickly as the forecast assumes. Finally, the increases in the consumer charges from changes

3.2.10 Monthly yuan-dollar exchange rate



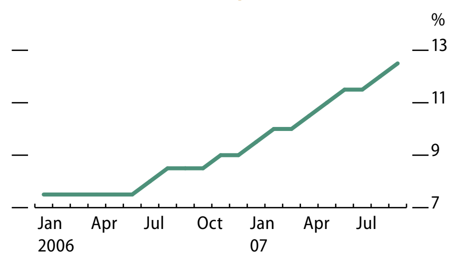
Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.11 Base lending rate



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.2.12 Bank reserve-requirement ratio



Source: People's Bank of China, available: http://www.pbc.gov.cn/english/, downloaded 31 August 2007.

3.2.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	10.0	11.2	9.8	10.8
Inflation	1.8	4.2	2.2	3.8
Current acct. bal. (share of GDP)	8.8	10.9	8.9	10.5

Source: Staff estimates.

to utilities' tariffs could turn out to be larger than currently expected, although these effects would likely be temporary and price liberalization would bring lasting benefits to the economy.

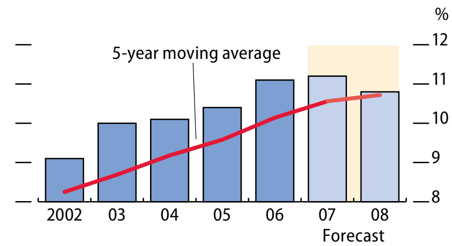
Another risk comes from the booming stock market. A major downturn in stock prices would likely damage bank balance sheets if borrowers faced major losses in stocks and could not service their bank loans. No official data are available on exposure, but it seems that some bank loans to households and enterprises have been used to speculate in stocks. Banks faced with rising nonperforming loan ratios would likely tighten lending, with impacts on the broader economy. A drop in stock prices that reduced household wealth would crimp private consumption, at least in urban areas, given the wider spread of stock ownership in recent years (more than 30 million new stock-trading accounts were opened in January–July 2007 alone).

The authorities face the important challenge of making progress with the plan to rebalance the economy, by reducing its reliance on exports and on investment for growth in favor of private consumption. Such a switch could lessen vulnerability to external shocks and ease environmental strains caused by the emphasis on export- and investment-led heavy industry. Yet policy measures taken over the past few years in this direction have so far achieved only modest rebalancing. Indeed, growth in the trade surplus and in investment outpaced growth in retail sales in the first half of 2007.

From a structural perspective, it seems that any substantial change in the current growth pattern is unlikely as long as the savings rate remains so high. Further, several studies of the country's flow-of-funds tables show that the increase in the national savings rate between 1992 and 2003 came mainly from rising government and enterprise saving; household saving, in contrast, fell by 3% as a share of total disposable income in those years. This drop occurred mainly because the household share of national disposable income declined during the same period, from 69% to 63%, while the government and enterprise shares rose, respectively, from 19% to 22% and from 12% to 15%. Available data since 2003 suggest that this trend has continued. Household incomes have grown in the past decade, but not as fast as enterprise profits and government revenues.

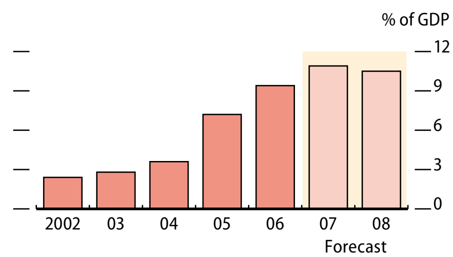
Therefore, lifting the share of total income going to households appears to be needed to achieve the economic rebalancing. Options to stimulate incomes include strengthening the implementation of minimum wages, further improvements to the social safety net, increasing public spending in education and health, and developing the capital market and the banking system to provide more avenues for consumer finance.

3.2.13 GDP growth



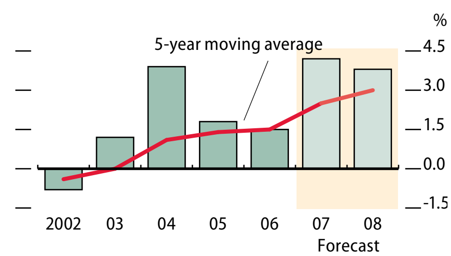
Sources: National Bureau of Statistics; staff estimates.

3.2.14 Current account balance



Sources: National Bureau of Statistics; staff estimates.

3.2.15 Inflation



Sources: National Bureau of Statistics; staff estimates.

India

Asian Development Outlook 2007 (ADO 2007), published in March this year, noted concerns about the economy's overheating, but forecast a soft landing piloted by higher interest rates, exchange rate appreciation, agricultural expansion, and measures to tame the real estate boom. Since then, the rupee has appreciated substantially, interest rates have risen further, the spring harvest was healthy, and the property boom is approaching maturation. So—has a soft landing been achieved?

This *Update* concludes that the economy is on a proper glide path. However, a firm hand on the joystick is needed and this was seen in the tightening of monetary policy at end-July. While overall inflation has moderated, food price inflation remains high, monetary expansion is well above the policy target, and overall demand momentum is staying strong. Still, with continued policy vigilance, the *Update* projects growth tempering to 8.5%, inflation being kept in check, and the current account deficit remaining easily manageable.

Updated assessment

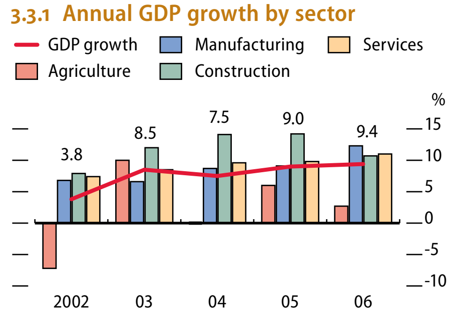
For 4 successive years, GDP has expanded rapidly, placing India among the world's fastest-growing and most vibrant economies. Revised estimates indicate that GDP expanded by 9.4% in FY2006 (ended March 2007)—the highest rate in the last 18 years (Figure 3.3.1). During the fiscal year, manufacturing, up by 12.3%, came into prominence as a source of growth, exceeding the 11% rise in services, the traditional mainstay. GDP from agriculture, which is volatile year to year according to the monsoon, grew by 2.7%.

The economy continued its momentum in the first quarter of FY2007 (April–June 2007) with GDP rising by 9.3%, only slightly lower than the 9.6% quarterly expansion a year earlier (Figure 3.3.2). Sector-wise, the pattern of growth also showed little change: agricultural growth picked up to 3.8%, while expansion in services moderated slightly. The authorities expect growth to ease further to the range of 8.5–9.0% for FY2007 as a result of monetary policies to prevent overheating and to keep inflation in check.

The economy is essentially driven by domestic demand and, unlike many other Asian countries, net exports generally have a small negative impact on growth. Buoyed by a combination of rising corporate profitability, robust credit from banks, and growing business confidence, fixed investment has expanded much faster than consumption in recent years, helping move the economy to its new high-growth path. Notably, the fixed investment-to-GDP ratio has climbed by nearly 6 percentage points over the last 4 years to 29.5% in FY2006, and accounted for over 40% of growth that year. In the first 3 months of FY2007, fixed investment continued to strengthen, to 31.3% of GDP.

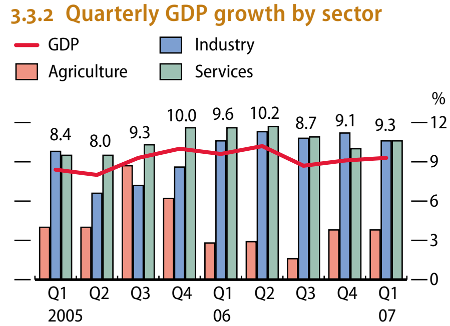
The rapid transformation of the economy was especially evident in

3.3.1 Annual GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 3 September 2007.

3.3.2 Quarterly GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 3 September 2007.

FY2006. Domestic companies, traditionally "home biased ," quadrupled their direct investment abroad to $11 billion as they sought new markets and technology. At the same time, (inward) foreign direct investment (FDI) expanded by 150% to $19.4 billion as global companies worked to establish or expand their presence in the country. Corporate profitability has grown by 30% annually in the 4 years through March 2007, while the Bombay Stock Exchange Index (SENSEX) has posted average gains of 44%. Nevertheless, a large section of the population has experienced little direct benefit from this high-growth era and a major challenge for policy makers is to find ways to further expand on the market-oriented reforms that have created this dynamism, while maintaining broad-based public support.

Above-trend growth has led to demand management pressures as the near elimination of excess capacity in manufacturing added to pressures on prices caused both by escalating and volatile international oil and food prices, and by wide variations in agricultural production. The Reserve Bank of India (RBI) has adapted its monetary policy to new developments aimed at maintaining price stability, while ensuring a credit and interest rate environment supportive of exports and investment demand.

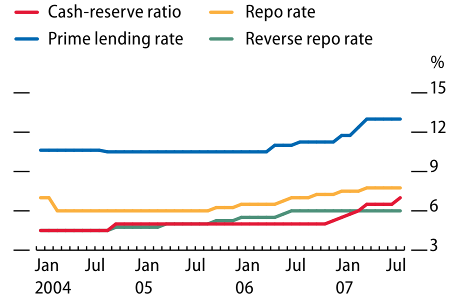
Figure 3.3.3 shows the series of tightening moves in policy rates that RBI has made in recent years to contain excessive demand pressures. In FY2006, it raised its repo rate (the rate at which banks borrow reserves from RBI) by 125 basis points to 7.75% and pushed up banks' cash-reserve ratio by 100 basis points to 6.0%. In response, banks' minimum prime lending rate increased by about 200 basis points over the year to 12.25%. Yet expansion in the money supply during the year still exceeded its target.

Monetary movements in the first 4 months of FY2007 show money supply growth remaining unabated at around 22% at end-July, well above RBI's target range of 17–17.5%, which was set for containing inflation below 5% (Figure 3.3.4). Moreover, growth in reserve money accelerated to 28.8%, driven by RBI foreign exchange purchases. These stemmed from a surge in capital account inflows that began in FY2006, and from a temporary drawdown in government net deposits. Marked excess bank liquidity resulted (i.e., reserve holding above requirements), causing the interbank money market rate to plummet to only 0.7% in July. (This situation of such excess bank liquidity, if sustained, would stoke excessive monetary expansion and high inflation.)

In response to these developments, RBI raised banks' cash-reserve ratio to 7.0% (on 4 August), adjusted regulations to damp borrowing from abroad by Indian companies (which had been feeding the marked rise in capital inflows), and ended a policy (adopted in March 2007) that limited the amount of its liquidity-absorbing reverse-repo transactions in its open-market operations. These actions appear to have brought call money market rates in August back into RBI's policy rate channel—a prerequisite for putting money supply growth on the intended track (Figure 3.3.5).

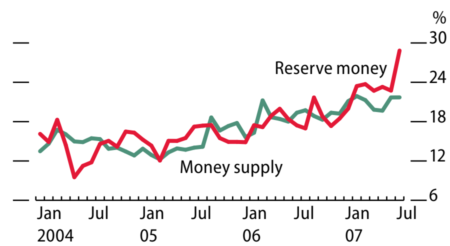
As measured by the wholesale price index, year-on-year inflation increased steadily from 4.1% at end-March 2006 to 6.7% in January 2007; remained stubbornly high through March; then moderated to 4.4% by July (Figure 3.3.6). The decline is attributed to three main elements: some easing of food prices on better supplies (though at nearly 10% food inflation remains high); an unusual negative impact on inflation by the

3.3.3 Policy and prime lending rates



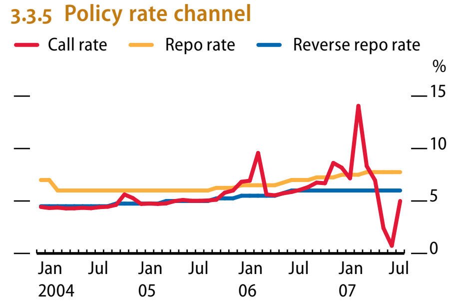
Source: Reserve Bank of India, *Annual Report*, various years, available: http://www.rbi.org.in, downloaded 3 September 2007.

3.3.4 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 28 August 2007.

3.3.5 Policy rate channel



Source: Reserve Bank of India, *Annual Report*, various years, available: http://www.rbi.org.in, downloaded 3 September 2007.

fuel component as a result of reductions in the controlled retail prices of gasoline and diesel in February and March 2007 (crude costs had declined through January) that has now, in a base effect, put retail prices below year-earlier levels; and a reduction in manufactured goods inflation (to 4.9% in July), which carries a 64% weight in the index.

This last factor is a direct outcome of tightened monetary policy. The outlook for commodity prices reinforces the need for reining in those demand pressures that are most susceptible to tighter credit policies, namely consumer and real estate credit. Also, RBI has tightened risk weights and provisioning requirements as part of prudential policies to avoid excessive growth in consumer and real estate credit. Higher interest rates appear to have had little impact on business investment: a very buoyant longer-term outlook has apparently overridden a cyclical rise in borrowing costs.

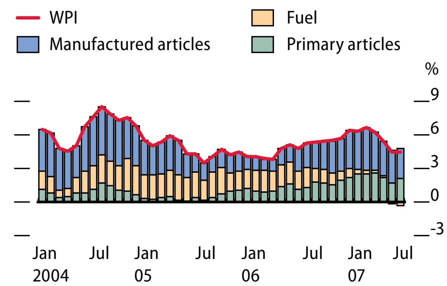
Volatility in international oil prices is a major concern. The average cost of the Indian crude basket, which reached a recent low of $52.62 per barrel in January 2007, rose to $72.70 per barrel in July 2007, resulting once more in a growing discrepancy between domestic and international price levels (Figure 3.3.7). Total "underrecoveries" (caused by the difference between the domestic selling prices and their ex-refinery costs) of the state-owned oil-marketing companies was Rs129 billion (about $1.6 billion or 1.2% of GDP) in the first quarter of FY2007 when crude costs averaged $66.50 per barrel. In FY2006, the Government issued bonds amounting to Rs241 billion related to losses of these companies. Growing financing costs, as a result of a higher crude oil bill, are likely to raise pressure on the Government to make some revision in domestic prices of gasoline, diesel, and cooking gas.

Balance-of-payments data for FY2006 show growth in exports of 20.9% and imports of 22.3%, and the trade deficit widening to $64.9 billion (Figure 3.3.8). This deficit was significantly offset by robust inflows from invisibles, which included earnings from services such as sales of software, call centers and other business services, and private transfers from Indians working abroad. The current account deficit rose marginally from a year earlier to $9.6 billion, staying at only 1.1% of GDP.

However, the capital account surplus, which has been on a rising trend (Figure 3.3.9), nearly doubled from a year earlier to $44.9 billion, driven largely by a surge (to $16.1 billion from only $2.7 billion) in commercial borrowing by Indian companies. With this jump in capital inflows, the overall balance-of-payments surplus escalated to $36.6 billion from $15.0 billion (including a relatively small errors and omissions item). This made managing monetary aggregates difficult. Much of the increase took place in the latter part of the fiscal year. The $19.4 billion in FDI inflows was counterbalanced by increased Indian investment abroad, yet net direct investment flows as a whole almost doubled to $8.4 billion. Net portfolio investment fell to $7.1 billion from $12.5 billion.

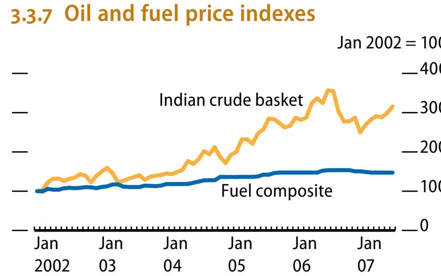
Customs data recorded robust growth in exports and imports during the first 4 months of FY2007 (April–July 2007). Exports increased by 18.2% year on year while imports (c.i.f.) posted a sharp rise of 30.7%, widening the trade deficit to $25.6 billion, or $9.8 billion higher than a year earlier. Although FY2007 balance-of-payments data are unavailable,

3.3.6 Contributions to wholesale price inflation



Source: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 3 September 2007.

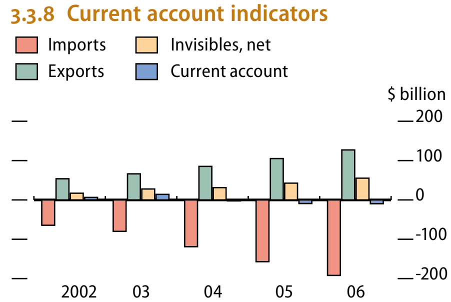
3.3.7 Oil and fuel price indexes



Notes: The Indian crude basket has been converted to rupees prior to indexing. The fuel composite is the weighted average of the wholesale price inflation for petrol, high speed diesel oil, LPG, and kerosene.

Sources: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/; CEIC Data Company Ltd.; Indian Oil Corporation, available: http://www.iocl.com, all downloaded 28 August 2007.

3.3.8 Current account indicators



Source: CEIC Data Company Ltd., downloaded 3 September 2007.

developments in the trade balance and foreign exchange reserves indicate that capital inflows have remained high (Figure 3.3.10).

The exchange rate of the rupee against the US dollar showed two main movements in FY2006: an initial trend to depreciation through July, then appreciation to end-March 2007 at which time the rate was Rs43.60/$1, for a moderate strengthening of 2.3% over the year. The real effective exchange rate was essentially unchanged (Figure 3.3.11). In the first quarter of FY2007, reflecting continuing pressures from capital inflows and limited RBI intervention to fully offset market trends, the rupee-dollar rate appreciated quickly by about 7% to reach Rs40.8/$1 at end-June 2007, and held steady through August, while the real effective exchange rate appreciated by about 9% over the same period.

This abrupt change raised the alarm among a slew of important foreign exchange earners, from textiles and clothing companies, which operate on thin margins and confront stiff competition in international markets, to the information technology industry, which receives payment mainly in dollars and, in addition, faces rapidly escalating (rupee-denominated) wages for its staff.

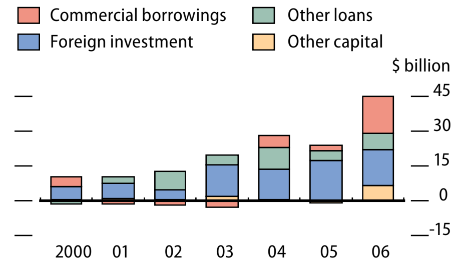
The present policy issues of sound monetary management and appreciation of the rupee illustrate the problems associated with the *impossible trinity*—the incompatibility of an open capital market, a fixed exchange rate, and an independent monetary policy. While India's capital account is not fully open—a longer-term goal to maximize economic efficiency recommended to the Government by an official study—it has been liberalized in recent years both with respect to inflows and outflows.

Even with a growing current account deficit, RBI has had to intervene to avoid sustained upward pressure on the exchange rate, which could have retarded development of the country's relatively small export base. RBI sterilized its foreign exchange intervention—i.e., offset expansion in reserve money and monetary expansion—by selling from its holding of government securities. By 2004, its holding had fallen significantly and had to be augmented by special issues of such securities solely for intervention under the Market Stabilization Scheme. The authorities also used increases in the cash-reserve ratio to neutralize growth in reserve money. Both efforts, however, pushed up domestic interest rates and encouraged further capital inflows.

The surge in commercial borrowing from abroad in FY2007, as well as the weight of growing interest costs for stabilization, induced the authorities to let the rate strengthen in the market. The revised limits on commercial borrowing from abroad (effective August 2007) will likely take the immediate pressure off the exchange rate and help RBI put monetary policy on a better footing. Underlying economic fundamentals, however, determine the real exchange rate, and market-oriented reforms of recent years have sparked productivity gains that will likely continue. This will make for further tension in managing monetary and exchange rate policies. The authorities will have to continue making fine judgments on policy, since capital flows are fickle and businesses tend to be wary of developments that force them into a tighter operating environment.

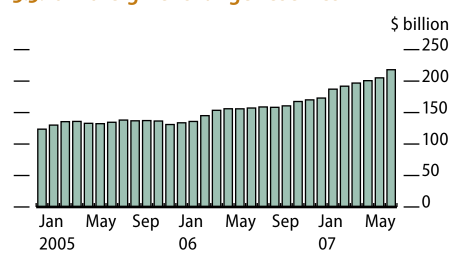
The stock market continues to please those who have invested, as indicated in Figure 3.3.12. The market quickly recovered from a correction in February–March 2007 associated with a bout of global jitters over risk

3.3.9 Capital account



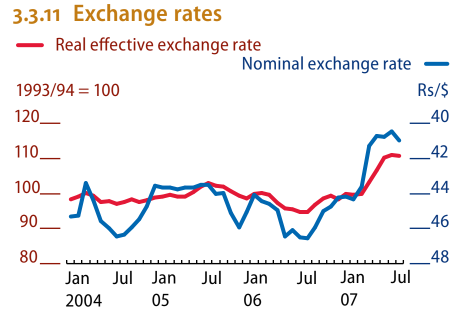
Source: CEIC Data Company Ltd., downloaded 28 August 2007.

3.3.10 Foreign exchange reserves



Source: CEIC Data Company Ltd., downloaded 3 September 2007.

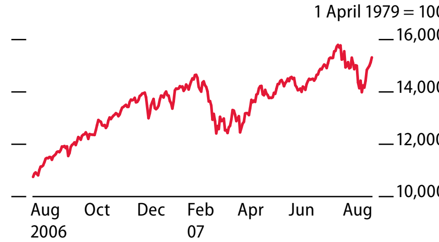
3.3.11 Exchange rates



Sources: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 21 August 2007; staff estimates.

(which affected markets in most industrial and developing countries) and then advanced markedly through mid-July, at which point turmoil in global credit markets sparked another slide. Since mid-August, most of the lost ground has been retraced, with the SENSEX posting a 30.9% advance for the year through end-August. (Foreign institutional investors are limited to an aggregate investment of $5 billion annually.)

3.3.12 Sensex movements



Source: Reserve Bank of India Database on Indian Economy, available: https://reservebank.org.in/cdbmsi/servlet/login/, downloaded 31 August 2007.

Prospects

The *ADO 2007* forecasts for FY2007 and FY2008 were based on five assumptions. This *Update* keeps four of the five: continued fiscal discipline, further tightening of monetary conditions, still-moderate agricultural growth, and a modest appreciation of the real effective exchange rate. However, the assumption of no revision in prices of gasoline, diesel, kerosene, and cooking gas looks less tenable because of increased crude oil prices. The timing of any price revisions of petroleum products, however, will depend to a large extent on the stability of food prices.

ADO 2007 expected that restraints on demand growth from homebuyers, manufacturing investors, and consumers would moderate the growth rate to 8.0% in FY2007. Developments to date suggest an upward revision to the growth forecast for the year, and a marginal upward revision for FY2008. Widespread capacity constraints, robust corporate profits, and the ongoing expansion of capital goods production imply that hardening interest rates are unlikely to dent investment, which will continue as a main driver of growth. Interest rate rises, however, will encourage consumers to put off spending, leading to a reduction in demand for consumer durables, and will damp the pace of construction activities as well.

3.3.1 Selected economic indicators (%)

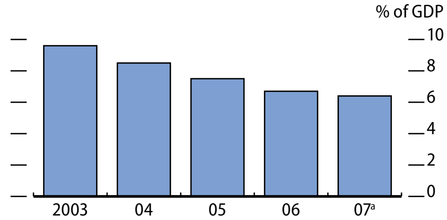
	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	8.0	8.5	8.3	8.5
Inflation[a]	5.0	5.0	5.0	5.0
Current acct. bal. (share of GDP)	-2.2	-1.6	-2.2	-1.9

[a] Wholesale price basis.
Source: Staff estimates.

Industrial production in July grew by only 7.1% from a year earlier, due to stagnation in durable goods manufacturing (though other sectors remained strong). For the first 4 months of FY2007 (April–July) it averaged 9.6%, and is now, riding on robust investment and capital goods production, expected to accelerate to around 10.5% in FY2007, pushing up GDP growth by a half percentage point to 8.5% (Table 3.3.1). The forecast for FY2008 is revised marginally upward to 8.5%.

The general government deficit has been on a declining trend in recent years (Figure 3.3.13). Fiscal responsibility legislation adopted by the federal Government in mid-2004, and subsequently by most state governments, calls for an improvement in the overall deficit to at least 3% of GDP by FY2008. The federal government budget for FY2007 plans for the overall deficit to fall (by 0.4% of GDP) to 3.3% of GDP. Buoyant tax revenues in the first quarter of the fiscal year suggest that the deficit target should be met, as key fiscal indications showed improvement relative to prior-year levels (though the pay recommendations, due in 2008, of the Sixth Pay Commission for government employees could affect the ability of the federal and state governments to maintain the pace of fiscal consolidation).

3.3.13 Consolidated fiscal deficit



[a] Revised government estimate.
Source: Reserve Bank of India, *Annual Report 2006–07*, available: http://www.rbi.org.in, downloaded 3 September 2007.

Rising food prices were one of the causes of recent inflation. Conditions for agriculture are conducive for good growth in FY2007. Rainfall is predicted to be near normal. To enhance the supply of pulses,

the federal Government has decided to import 1.5 million tonnes of them. Domestic wheat procurement by government agencies during April–May 2007 was higher than the same period 12 months earlier. The Government has also decided to import 0.5 million tonnes of wheat to augment its buffer stock. With a positive outlook for domestic food supplies and tightened monetary policies, the inflation forecast (wholesale price index) is unchanged from *ADO 2007* at 5.0% for FY2007 and FY2008 (despite some upward adjustment in domestic fuel prices). Inflation risks persist though, and any shock to food prices, and any larger revision in domestic prices of petroleum products (which is needed), are causes for special concern.

The current account deficit was substantially lower in FY2006 than was expected when *ADO 2007* was prepared. This is primarily attributed to much lower growth in imports (22.3%) as against 26% assumed in *ADO 2007*. It is expected that imports will grow faster than forecast in *ADO 2007* due to hardening international oil prices, but from a lower base. Accordingly, the current account forecast for FY2007 reflects a smaller deficit of $18.2 billion in FY2007, or 1.6% of GDP, down from *ADO 2007's* 2.2% deficit. Similarly, a current account deficit of $24.5 billion, or 1.9% of GDP, is now forecast for FY2008 (with both ratios taking account of the higher nominal GDP).

The key risks to the above outlook emerge from shocks that would undermine fiscal or monetary discipline or radically affect food or fuel prices. Marked further appreciation of the rupee would likely have an adverse impact on exports and corporate profitability in export-oriented sectors. Finally, the recent disturbances in global financial markets might snowball into a global credit crunch, with obvious adverse macroeconomic implications for India.

Indonesia

First-half private consumption and investment showed greater strength than expected in *Asian Development Outlook 2007* (*ADO 2007*), and this is likely to be maintained in the second half, leading to an upward revision in the full-year GDP growth forecast to 6.2%. Net exports are also contributing to aggregate growth. The inflation forecast for 2007 is nudged up to 6.3%. In 2008, GDP growth is projected to edge higher, driven mainly by domestic demand. The Government has addressed several impediments to investment, but further reforms, and implementation of those already approved, are necessary.

Updated assessment

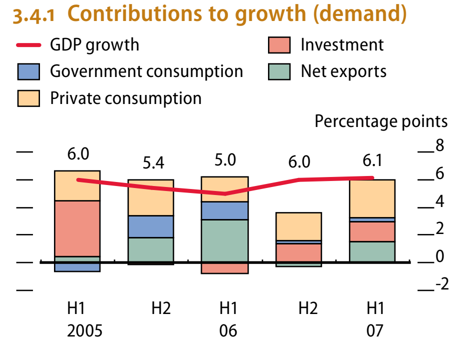
GDP growth accelerated to 6.3% in the second quarter of 2007 from 6.0% in the first, putting first-half expansion at 6.1%. The main drivers of growth were private consumption (Figure 3.4.1), a recovery in private investment, and a solid expansion of net exports. Growth in fixed capital investment increased to 7.3% in the January–June period, the strongest rate in this key indicator for 2 years (Figure 3.4.2). In 2006, investment sentiment had been hurt by high inflation that resulted from a sharp lift in administered fuel prices in late 2005, and a subsequent hike in interest rates. According to data from the state investment agency, actual foreign direct investment (FDI) nearly doubled to $7.3 billion during the first 7 months of 2007 relative to the year-earlier period (the data exclude FDI in oil, natural gas, and banking). Indicators for construction-related investment, such as demand for cement and steel, suggest a recovery in this area, too. A pickup in investment credit also is evident.

Lower inflation and interest rates have helped push up consumer spending, with private consumption increasing by 4.7% in the first half, up by 1.3 percentage points from the second half of 2006. Consumption indicators such as retail sales have picked up during 2007. On the supply side, services again made the biggest contribution to aggregate GDP growth. Industry also expanded, but agricultural output was little changed.

Overall, private consumption and investment are stronger than was anticipated in *ADO 2007*, and the full-year GDP growth forecast is revised up to 6.2% from 6.0%.

Inflation slowed to average 6.2% in the first 6 months of 2007, within this year's 5–7% target range set by Bank Indonesia, the central bank. Year-on-year inflation stepped down from 6.6% at end-2006 to 5.8% in June 2007, then quickened to 6.5% in August (Figure 3.4.3). The initial drop was mainly a result of moderating food prices, reflecting both a government decision to resume rice imports in response to drought in early 2007, and the start of a delayed rice harvest. The recent increase was attributed to a combination of pressures: higher food prices when the harvest ended, other seasonal factors, and a depreciating rupiah. The stronger domestic demand and higher food prices have led to a marginal upward revision in the 2007 inflation forecast to 6.3% from 6.2% in *ADO 2007*.

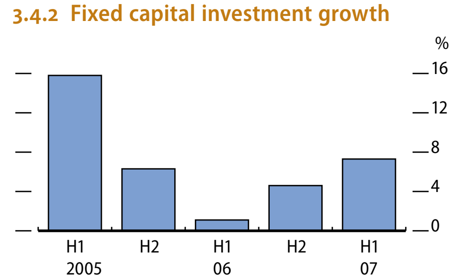
3.4.1 Contributions to growth (demand)



Note: Excluding statistical discrepancy.

Source: CEIC Data Company Ltd., downloaded 16 August 2007.

3.4.2 Fixed capital investment growth



Source: CEIC Data Company Ltd., downloaded 16 August 2007.

Fiscal policy in 2007 has focused on accelerating development spending, while reducing public debt. Cuts in fuel subsidies 2 years ago and increased revenues from more effective tax administration have permitted higher development outlays. Government forecasts for the budget deficit put it at 1.6% of GDP in 2007, compared with an original target of 1.1%. This variance is due to greater than expected spending (particularly on disaster management, infrastructure, electricity subsidies, and fiscal transfers to regions) and lower revenues (following a shortfall in oil and gas income caused by lower production, and lower privatization receipts relative to budgeted levels).

Higher volumes of concessional borrowings from development banks will provide most of the additional financing for the deficit. The wider fiscal gap is still consistent with a further reduction in the ratio of total central government debt to GDP to around 36% at end-2007, from 39% at end-2006.

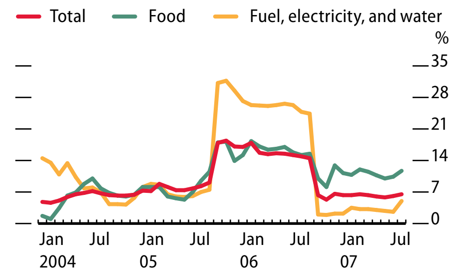
Preliminary trade data for the first 6 months of 2007 show that merchandise exports increased by 14.5% to $53.7 billion (Figure 3.4.4). Exports of manufactures and minerals rose by 18.9% and 35.4%, respectively, although sales of oil and gas to overseas markets fell by 7.0% due to lower production. Imports increased 1.7 percentage points faster than exports, by 16.2% to $33.6 billion, on strong growth in demand for imported consumption goods, raw materials, and (to a lesser extent) intermediate goods, refined oil products, and capital goods. Despite this faster import growth, the trade surplus rose to $20.0 billion from $18.0 billion a year earlier, as a consequence of a higher export base.

Even though a surplus on the transfers account was bolstered by growing remittances from migrant workers, the trade surplus was offset to some extent by widening deficits in the services and income accounts. This reflected primarily a rise in imports of construction and financial services, and the repatriation of profits and dividends by foreign companies operating in Indonesia. The upshot is that the current account surplus is estimated to have moderated during the first 6 months of 2007 from the corresponding period of 2006. However, due to continued strong inflows of both foreign portfolio capital and FDI, the overall balance of payments for the first half is estimated at a surplus of $3.7 billion. This helped lift international reserves to $51.9 billion at end-July 2007, from $42.6 billion at end-2006 (Figure 3.4.5).

These broad patterns are expected to continue for the rest of the year, and the surplus in the current account is now projected to decline to 1.4% of GDP in 2007 from 2.7% in 2006. This still represents an increase over the *ADO 2007* forecast (of 1.0%), due to the higher than expected growth in exports. External reserves, fueled by a likely increase in FDI in the second half of 2007, are seen increasing further to about $55 billion at the end of the year, providing 7.7 months of import cover. Total external debt is projected to decline to about 31% of GDP at end-2007 from 37% the previous year, reflecting net repayments of loans by banks and companies.

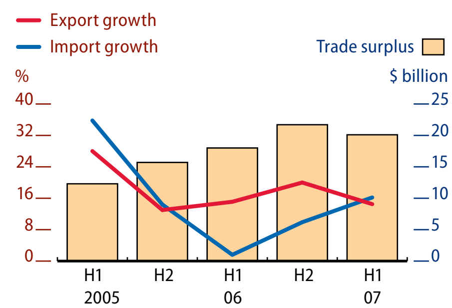
Slowing inflation enabled Bank Indonesia to lower its policy interest rate by 450 basis points to 8.25% between early May 2006 and late July 2007. The flow-on to lower commercial bank lending rates contributed to a recovery in credit, which rose by 20.4% in June 2007 from a year earlier. Credit to business is now growing at a faster rate than credit to

3.4.3 Monthly inflation



Source: CEIC Data Company Ltd., downloaded 7 September 2007.

3.4.4 Trade indicators



Sources: Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd.; both downloaded 7 September 2007.

3.4.5 Gross international reserves

Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

consumers, reversing a trend seen in recent years (Figure 3.4.6). Slightly faster growth in credit than deposits raised the loan-to-deposit ratio to 65.8% in April 2007, the highest level in 6 years. With commercial banks' loan rates declining at a more gradual pace than deposit rates, their profitability has improved.

A range of factors, including improved macroeconomic fundamentals, relatively high interest rates on debt securities and deposits, and expectation of currency appreciation attracted significant foreign portfolio inflows and helped propel the Jakarta Composite Index of share prices up by 30% in the first 7 months of this year (Figure 3.4.7). The portfolio inflows, in turn, helped support the rupiah. However, the reassessment in financial markets of global risks early in the second half prompted a weakening of the rupiah, and by end-August the currency had depreciated by 4.1% from the start of 2007 (Figure 3.4.8). The stock market index fell from its July peak, but at end-August was still up by 21.5% from the beginning of the year.

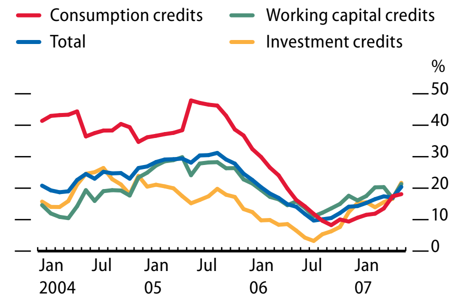
Recent data suggest that the pickup in economic growth has helped lower the poverty incidence to around 16.7% in March this year from 17.8% in March 2006. These levels of poverty, however, translate to almost 40 million poor people and remain far from the Millennium Development Goal target of 7.6% by 2015, and the Government's own target of 8.2% by 2009. Deeper structural reforms and pushing through with already-approved changes are necessary to make significant inroads into poverty and unemployment.

Indeed, some progress has been made over the past 2 years in reallocating fiscal expenditures toward programs that favor the poor and away from inefficient fuel subsidies. But Indonesia is still underspending in key sectors, including infrastructure, where the level of spending has fallen from a high of around 6% of GDP before the Asian financial crisis in 1997–98 to 2–3% of GDP recently. (Spending on infrastructure in Viet Nam, for example, in 2006 exceeded 9% of GDP.)

In surveys, businesses continue to identify this lack of investment in infrastructure—along with a weak legal system, labor-market rigidities, excessive bureaucracy, and corruption—as major impediments to business activity and investment. But reforms are slowly being made. Parliament finally passed a new investment law in March 2007, having earlier prevaricated. Among other changes, the law provides for equal treatment of local and foreign investors and for the resolution of contract disputes between the Government and investors (a major source of disputes in the past) through international arbitration. As part of the implementing regulations of the new law, the authorities have clarified which business sectors are open to foreign investors.

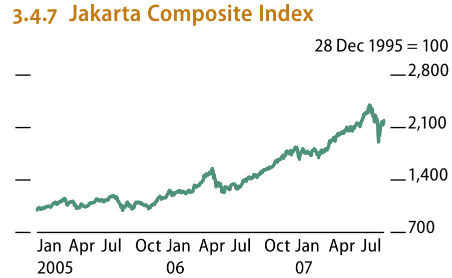
Steps in the appropriate direction include an investment climate policy package (adopted in February 2006), which includes proposals to reduce the time required to set up a company, and measures to boost smaller enterprises (adopted June 2007), which aim to improve access to finance. But against these potentially useful measures, labor unions have blocked amendments to the Labor Law intended to increase flexibility of labor regulations. Businesses criticize the current law for, among other things, mandating layoff payments that are much higher than in comparable countries, and limiting the ability of employers to outsource work.

3.4.6 Growth of commercial banks' loans



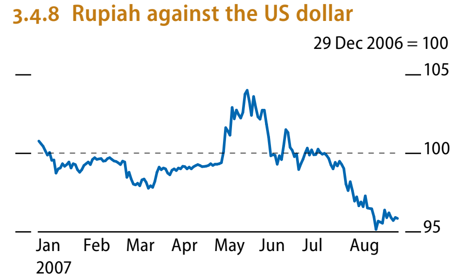
Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

3.4.7 Jakarta Composite Index



Source: CEIC Data Company Ltd., downloaded 7 September 2007.

3.4.8 Rupiah against the US dollar



Note: An index below 100 signifies a depreciation of the rupiah.

Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

Companies see these requirements as stifling employment generation, particularly in labor-intensive sectors such as textiles and footwear.

Prospects

Growth in 2008 is likely to be driven by domestic demand. The reductions in domestic interest rates since May 2006 and an improving investment climate are set to push investment growth next year, while a recovery in consumer confidence will lead to an acceleration in private consumption expenditure. GDP growth will be supported by higher rates of credit expansion to the private sector as bank and corporate balance sheets strengthen. Moreover, government infrastructure outlays are expected to increase.

These positive developments are likely to be partly offset by a smaller surplus in net exports as imports rise in response to stronger investment and consumption demand, and as exports moderate in line with a projected decline in global nonfuel commodity prices. Overall, GDP growth in 2008 is forecast to edge up to 6.4% (Figure 3.4.9), a marginal upward revision from that in *ADO 2007*.

The 2008 budget predicts a wider deficit of 1.7% of GDP, reflecting a near 50% increase in capital spending from the revised 2007 budget; a 16.2% reduction in state spending on consumption; and increased allocations for education and health, and for transfers to the regions. The authorities aim to meet the additional financing needs through the issuance of government securities, the recovery of state bank assets as part of banks' restructuring efforts, increased privatization receipts, and external loans. But even with these higher budget financing requirements, the central Government's total debt-to-GDP ratio is projected to decline further to around 33% in 2008 from 36% this year.

On the external side, the current account surplus is projected to fall to 0.7% of GDP in 2008 (the same as forecast in *ADO 2007*; Figure 3.4.10), as export growth eases while stronger domestic investment and consumption demand lifts imports. In addition to a smaller trade surplus, wider deficits are likely in the services and income accounts. However, the overall external balance will remain in surplus owing to growth in FDI and portfolio investment flows, which will contribute to the further accumulation of foreign exchange reserves. Total international reserves should be about $62 billion at the end of next year, or 7.4 months of import cover.

Food prices are expected to be more stable than this year (assuming normal weather and food production) paving the way for inflation to ease to an average 6.0% in 2008, against 6.1% forecast in *ADO 2007*.

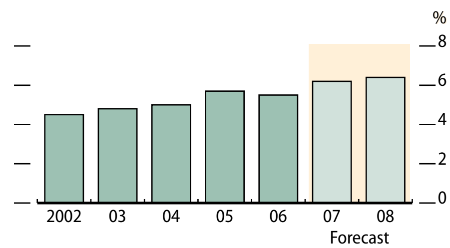
Domestic risks to this outlook are headed by inadequate effective action on structural reforms, insufficient investment in infrastructure (which could lead to supply bottlenecks), and regional governments' inability to implement projects. Despite budgeted increases in national public infrastructure expenditure in 2008, actual disbursement might come in below target. In the regions, too, despite their now larger role in spending, earlier this year they were holding an estimated 2.5% of GDP in cash deposits, reflecting their weak capacity to carry out projects (thereby hindering GDP growth).

3.4.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	6.0	6.2	6.3	6.4
Inflation	6.2	6.3	6.1	6.0
Current acct. bal. (share of GDP)	1.0	1.4	0.7	0.7

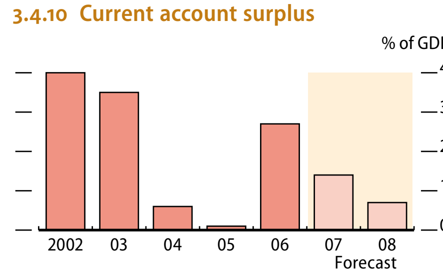
Source: Staff estimates.

3.4.9 GDP growth



Sources: CEIC Data Company Ltd., downloaded 16 August 2007; staff estimates.

3.4.10 Current account surplus



Sources: CEIC Data Company Ltd., downloaded 16 August 2007; staff estimates.

Malaysia

Consumption spending, bolstered by rising incomes, led economic expansion in the first half of 2007, with fixed investment making a robust contribution. Public investment under the Ninth Malaysia Plan is supporting growth, but weaker global demand for electrical and electronic products hurt exports. The projection for GDP growth this year is revised up slightly to 5.6% and kept at near this level for 2008. Inflation has slowed and is projected to stay low.

Updated assessment

Led by domestic demand, the economy expanded by 5.6% in the first half of 2007. Private consumption accelerated at its fastest pace (10.8%) for several years (Figure 3.5.1), accounting for nearly all the expansion in GDP (Figure 3.5.2). Supporting consumption were increases in incomes, stronger prices received for agricultural commodities, a healthy labor market, and stable interest rates. Government consumption also stepped up in the first half.

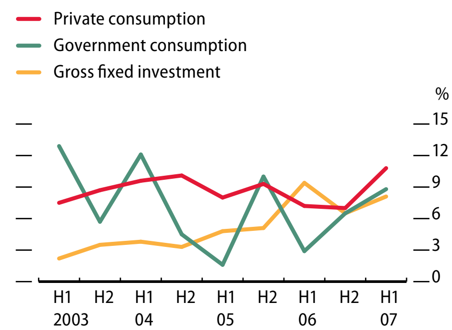
Fixed investment expansion was a robust 8.1%, close to the increased rate posted in 2006, the first year of the Ninth Malaysia Plan (2006–2010), which boosts investment on public infrastructure. Private sector fixed investment showed signs of picking up, with strong sales growth in construction-related materials and in loans to business. Net foreign direct investment (FDI) rose by 54.1% to $1.6 billion in the first 3 months of the year. Total fixed investment added 1.9 percentage points to GDP growth (though this was more than offset by a decline in inventories).

Real exports and imports grew by about 2.5% in the first half, much slower than in recent years, partly a reflection of weaker global demand for electrical goods (including electronic products), one of Malaysia's biggest export industries. Net exports added just 0.4 percentage points to GDP growth.

On the supply side, expansion in the services sector accelerated to nearly 10%, and contributed 4.5 percentage points to total growth in the first half of 2007 (Figure 3.5.3) This sector has grown much faster than industry over recent years as the economic structure has evolved toward a greater emphasis on services. Double-digit growth rates were recorded in three major subsectors: real estate and business services, finance and insurance, and wholesale and retail trade. Services benefited from strong consumption spending and an increase in tourism.

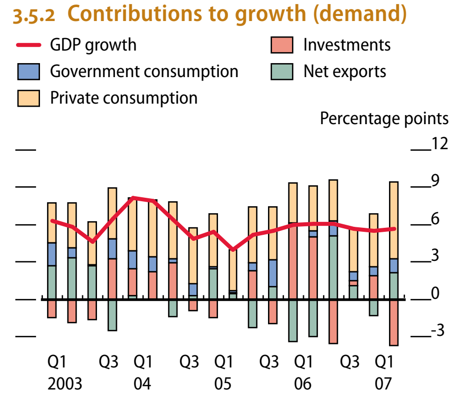
Industrial production, in contrast, grew at a slower rate in the first half (2.4%) than the year-earlier period, and contributed only 1.1 percentage points to GDP growth. Manufacturing slumped and barely stayed in positive territory, at 0.5%, reflecting weaker global demand for electrical products, where output contracted by 5.6% in the first half. Construction, in particular civil engineering, benefited from infrastructure spending under the Ninth Plan and development of oil and

3.5.1 Consumption and gross fixed investment growth



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

3.5.2 Contributions to growth (demand)



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC Data Company Ltd.; both downloaded 30 August 2007.

natural gas projects. It grew by 4.4%, after shrinking for 3 years in a row. Mining production also switched to a positive outturn, and was up by 3.5%, as oil and gas output picked up. Agriculture grew by just 0.6% in the first half as unfavorable weather reduced palm oil yields.

In the second half of 2007, private consumption will get further support from significant pay increases for about 1 million public sector employees. These came into effect in July, at an annual cost to the Government of more than $2 billion. Investment for the full year will remain underpinned by public infrastructure development. However, net exports will be a drag on aggregate growth. Taking these factors into account, the projection for full-year GDP growth in 2007 is revised up to 5.6% from 5.4% in *ADO 2007*.

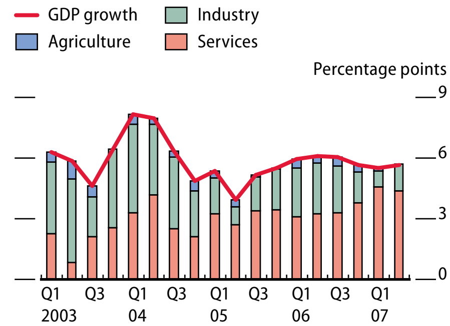
Total government expenditure increased by 25.4% in the first half of 2007 year on year (Figure 3.5.4), with development spending up by more than double this rate as spending picked up under the Ninth Plan. Public spending is projected to accelerate in the second half of the year, when government outlays usually accelerate. The Government is aiming for a full-year fiscal deficit of 3.2% of GDP, narrower marginally from 3.3% in 2006. Based on an expected rise in petroleum-related revenue, the fiscal target could well be met. Over the longer term, though, reliance on such revenue (oil and gas receipts, including dividends from the national oil company, account for about 35% of total revenues) makes the fiscal position more susceptible to a decline in energy production or prices.

Inflation, at 2.0% on average in the first 7 months of 2007, decelerated from 3.8% in the year-earlier period (Figure 3.5.5). The impact of an 18–24% increase in retail fuel prices in March 2006 subsided, an appreciation of the ringgit helped curb imported price pressures, and the Government maintained price controls on food staples. Although inflation trended down, Bank Negara Malaysia, the central bank, kept its overnight policy interest rate at 3.5%, given buoyant domestic demand and a robust labor market.

Based on lower than expected inflation and the steady stance of monetary policy, the inflation projection for the full year is revised down to 2.5% from 2.7% in *ADO 2007*. Money supply (M2) expanded by 13.3% in January–July year on year, reflecting increases in net foreign assets held by the banking sector and a steady rise in international reserves. The ringgit, after appreciating by 7.0% against the US dollar in 2006, firmed by a further 2.2% by end-July, although it subsequently gave back much of 2007's appreciation, to be 0.8% firmer by end-August, after the global reassessment of risk caused a softening in many currencies. Foreign exchange administration policies were liberalized from April in a move aimed at facilitating development of the financial market and investment in ringgit assets. The changes included greater flexibility in ringgit overdraft facilities for nonresidents and higher limits for residents to invest in foreign currency assets.

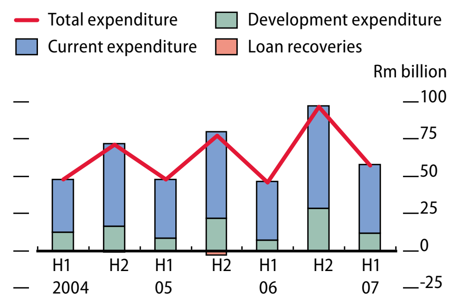
The weakness in global demand for electrical goods, which make up about half of Malaysia's total merchandise exports, induced a sharp pullback in growth of total merchandise exports to 7.7% in the first half (on a US dollar customs basis) from 13.8% in the year-earlier period. The value of these products shipped from Malaysia was virtually flat in US dollar terms in this period. In contrast, exports of agricultural

3.5.3 Contributions to growth (supply)



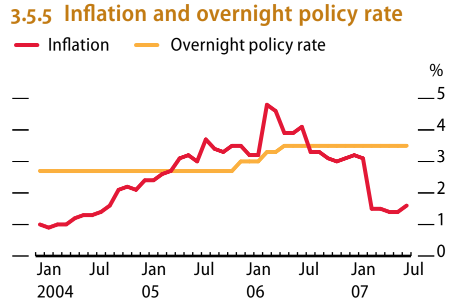
Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC Data Company Ltd.; both downloaded 30 August 2007.

3.5.4 Government finance



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

3.5.5 Inflation and overnight policy rate



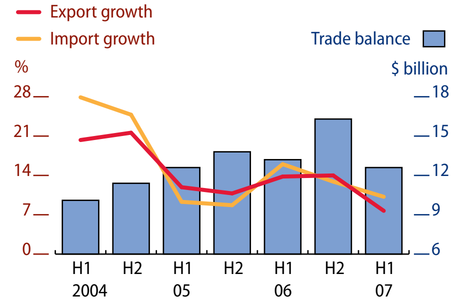
Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

products surged, led by palm oil. Prices of this commodity climbed on strong global demand, reinforced by a rise in soybean oil prices as some US producers switched to planting corn for biofuel, and by the fact that India, a major buyer of edible oils, reduced its tariff on palm oil imports.

Merchandise imports rose by 10.2% in the first half in US dollar terms, also slowing from the first half of 2006. Imports of some consumption goods such as food, consumer durables, and medicines rose at a rapid rate, as did imports of intermediate goods. But imports of capital goods rose by just 3.4%. Faster growth in total imports than exports in the first 6 months lowered the trade surplus slightly to $12.6 billion (Figure 3.5.6). Data available for the first quarter show the current account surplus at $5.8 billion, down $2.0 billion from end-2006. For the full year, the current account surplus is projected to decline to a still-substantial 11.9% of GDP (changed from 10.7% in *ADO 2007* because of revisions to 2006 data). International reserves in the first 7 months of 2007 rose to $98.5 billion, equivalent to 8.9 months of retained imports and 8.7 times short-term external debt.

Employment rose by 305,000 in the first quarter from a year earlier, with services generating many of the jobs. This increase was well above that of the labor force (270,000). Consequently, the unemployment rate fell to 3.4% from 3.8% a year earlier, and is expected to decline further by year-end.

3.5.6 Trade indicators



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007.

Prospects

Robust domestic demand and a projected improvement in exports of electrical goods are expected to sustain the economy's momentum into 2008. Consumer spending will again be the main driver of growth, supported by increases in incomes. Public investment will remain strong as projects are rolled out under the Ninth Plan. These include the Iskandar Development Region, a large logistics and tourism project in southern peninsular Malaysia, and the Northern Corridor Economic Region, involving four states in the north of the peninsula.

Private sector investment is likely to be encouraged by planned cuts in the company income tax rate to 26% in 2008 and 25% in 2009 (the rate was lowered this year to 27% from 28%), by plans to exempt dividend income from tax, and by solid consumer demand expected next year. Regional development projects, such as Iskandar, will involve substantial private sector participation, too. To stimulate real estate development, the Government recently announced tax breaks for property owners and liberalized foreign ownership guidelines, which should have some impact next year.

Net exports are again likely to be a drag on performance. GDP growth in 2008 is projected at 5.7%, about the average rate recorded over the previous 5 years (Figure 3.5.7) and unchanged from *ADO 2007*.

The Government budget announced in September 2007 puts expansion at 6.0–6.5% in 2008, compared with an official projection of 6.0% in 2007. The budget projects that growth will accelerate from 2007 levels in agriculture, construction, manufacturing, and oil and gas; and slow only slightly in services from this year's fast pace.

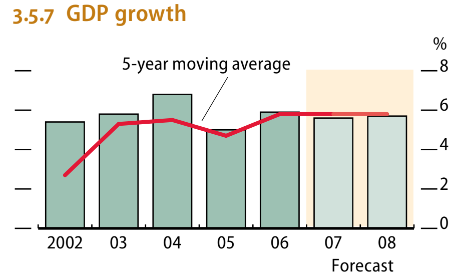
From the production side, manufacturing will gain from the projected

3.5.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	5.4	5.6	5.7	5.7
Inflation	2.7	2.5	2.7	2.5
Current acct. bal. (share of GDP)	10.7	11.9	10.2	11.6

Source: Staff estimates.

3.5.7 GDP growth



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

increase in external demand for electrical products. Construction will continue to benefit from public sector development spending and the incentives for private-sector property development. In agriculture, production is projected to rise for food, natural rubber, and palm oil, encouraged by high prices. Oil and gas will be boosted by completion of maintenance work on oil fields and expansion of capacity.

To maintain development of services, the Government is targeting the financial subsector and tourism for growth. It is providing incentives for further expansion of Islamic financial services, including tax exemptions. Tourism also has strengthened rapidly and is receiving government investment and incentives. Tourist arrivals rose by nearly 25% to 10.7 million in the first half of 2007, spurred by promotion of events celebrating Malaysia's 50th anniversary of independence. Gross earnings from tourism will account for about 7% of GDP this year. The official goal is for 20.1 million tourist arrivals in 2007, rising to 21.5 million next year.

Exports should perform better in 2008 than this year, especially for electrical products, but the US economy, Malaysia's biggest export market, could still be hurt more than anticipated by the housing and financial market problems there. Palm oil and liquefied natural gas exports are seen expanding. Although growth in imports is likely again to outpace that of exports, the higher base of exports is projected to result in a larger merchandise trade surplus. Increased tourism earnings will be offset in the services account by higher payments for transportation and business services.

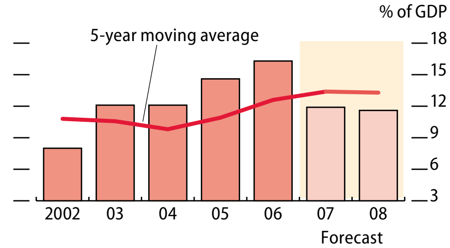
Taking these projections into account, plus likely net outflows in the income and transfers accounts, the current account surplus is forecast to decline as a share of GDP to 11.6% (Figure 3.5.8), revised from 10.2% in *ADO 2007*.

On the fiscal side, the Government is expected to maintain a generally expansionary policy, while gradually reining in the deficit (which has narrowed from 5.5% of GDP in 2000). Despite the impact on revenue of tax breaks announced this year, the authorities aim to limit the budget deficit to 3.1% in 2008.

Inflation next year is forecast to stay at around 2.5% (Figure 3.5.9), trimmed from the *ADO 2007*. This prediction would need to be raised if the Government further phased down fuel subsidies or implemented a goods and services tax (scheduled to start in January this year to replace the sales and services tax, but postponed).

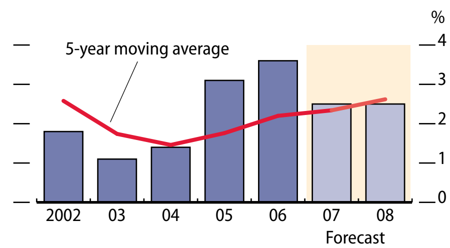
The main risk to the above outlook is a significant slowdown of the US economy, which would hurt exports. The external account surplus would be smaller and GDP growth would be weaker in this scenario. Given that consumption is expected to be a driver, an acceleration in inflation could erode consumer spending and therefore GDP growth. The Ninth Plan targets 6% average annual GDP growth for 2006–2010, to be achieved in part by moving the economy up the value-added chain in manufacturing and services. The outcome could fall short of target if further gains are not made in building workforce skills and in enhancing the investment climate.

3.5.8 Current account balance



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

3.5.9 Inflation



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 30 August 2007; staff estimates.

Pakistan

Robust and broad-based growth marked FY2007 (ended June 2007). Vigorous domestic demand was the catalyst, but it also induced inflation pressures. Monetary policy was tightened but fiscal policy remained expansionary, and a key challenge will be to align the two policies more closely. Encouraging revenue performance helped keep the fiscal deficit unchanged relative to GDP, although the trade and current account deficits widened, financed by strong external inflows. A concern is that these inflows could slow or reverse. The present momentum is expected to continue in FY2008, moderated by the impact of tight monetary policy conditions, high international oil prices, and slow export growth.

Updated assessment

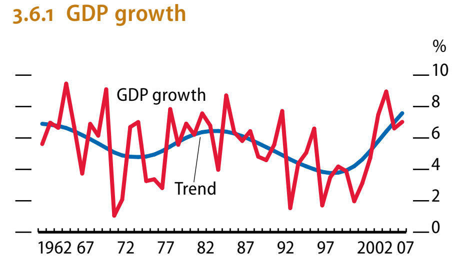
Underpinned by continued healthy domestic demand, the economy maintained its robust performance in FY2007, to achieve 7% growth (Figure 3.6.1). This outcome was broad based and supported by a solid recovery in agriculture (better availability of irrigation water), continued momentum in large-scale manufacturing, and sustained expansion of services. In recent years, growth from the demand side has been led by increased private consumption on rising per capita incomes, higher workers' remittances from abroad, and easier consumer credit (which, however, slowed sharply in FY2007 due to tighter monetary conditions).

In FY2007, private and government consumption contributed 45.4% of total output growth. For the first time in 4 years, total investment overtook private consumption as the largest contributor. This was the result of a strong expansion in real fixed investment of 20.6%, up from 17.6% in FY2006. As a share of GDP, total investment (including stocks) edged up from 21.8% to 23.0%. Several sectors, including manufacturing, construction, transport and communications, finance, and trade, witnessed high double-digit growth rates in private investment during the year.

On the production side, agriculture picked up in FY2007 (from stagnation in the previous year), posting 5.0% expansion. Large-scale manufacturing continued to grow briskly at 8.8%. However, as a result of unchanged raw cotton production and weakening export demand, the textile sector's performance was lackluster. Growth decelerated in the automobile sector too, as demand faltered, in part on the higher cost of consumer credit following a tightening of monetary policy. Rebuilding work in the regions that had been devastated by the October 2005 earthquake continued to boost a notable expansion in construction, just as greater private and foreign direct investment (FDI) did in the property sector.

Services, a major contributor to growth over the past 5 years, rose by 8.0%. Its momentum was spearheaded by the financial and telecommunications subsectors, both recipients of substantial amounts of

3.6.1 GDP growth



Note: Trend growth rates are calculated using a Hodrick-Prescott filter.

Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 21 August 2007.

FDI. Investment inflows resulting from the issuance of global depository receipts (securities listed and traded in a foreign stock exchange), as well as a series of mergers and acquisitions, further supported financial sector momentum.

Inflation, after averaging 8.6% in the previous 2 years, declined only marginally in FY2007 to 7.8% from 7.9% (Figure 3.6.2). Despite heightened global oil prices toward the end of the fiscal year, the Government did not raise domestic oil prices in response (having made some downward price adjustments in gasoline and diesel, in March 2007).

A tighter monetary policy brought down nonfood inflation markedly to 6.0% (from 8.6% in FY2006), which led to a moderation in overall core inflation (nonfood, nonenergy) to 5.5%, from 7.1%. But food prices, which make up 40% of the consumer price index, rose sharply by 10.3%, reflecting a combination of global trends and domestic factors: dependency on imports of edible oil, whose price increased; and a shortfall in local production of chilies, pulses, and fresh vegetables.

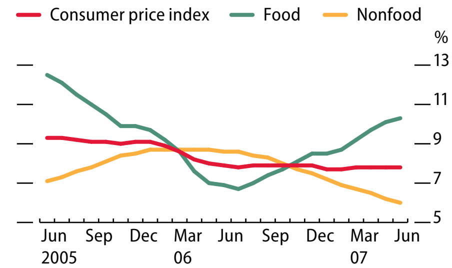
The State Bank of Pakistan (SBP), the central bank, tightened monetary policy for FY2007 to manage aggregate demand and so contain inflation pressures. In August 2006, it raised its discount rate (the main policy rate) from 9.0% to 9.5%; increased the statutory liquidity ratio from 15% to 18%; and raised the cash-reserve ratio for demand liabilities from 5% to 7%. However, the effectiveness of a tighter policy was confounded by unexpectedly large net capital account inflows which, despite a wider current account deficit, produced a very large overall balance-of-payments surplus.

Reflecting this higher surplus, net foreign assets of the banking system registered a sharp increase to PRs286 billion in FY2007. This boosted broad money supply (M2) growth to 19.3%, which overshot its 13.5% growth target. The sharp rise in SBP net foreign assets, plus much larger use of its special refinance facilities (for industry and exports) resulted in exceptionally high growth of 20.9% in reserve money, keeping liquidity conditions easy at banks.

With the high levels of net foreign exchange inflows, the central bank stepped up its purchases in the interbank market to maintain the currency steady against the US dollar at slightly above PRs60/$1 during the year. While it succeeded in avoiding nominal appreciation against the dollar, it incurred the cost of an increase in M2 and reserve money which, in turn, will most likely have a continuing inflation impact. (The decline in the US dollar against other currencies largely offset inflation differentials and the real effective exchange rate appreciated by marginally less than 1% in FY2007.) Open-market operations by SBP were sufficient to avoid a drop in bank lending rates, which changed little over the year. Private sector credit growth slowed to 16.9%, its lowest level in 3 years (Figure 3.6.3).

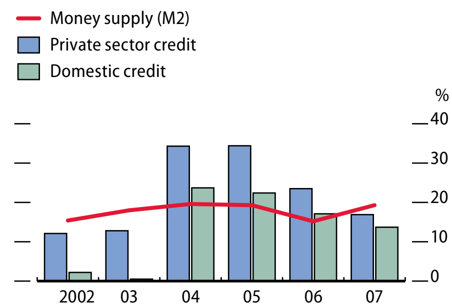
Fiscal policy remained expansionary. Actual total public expenditure in FY2007 at PRs1,675 billion was higher than planned and 19.5% greater than the previous year, while actual development spending rose to PRs433.7 billion (Figure 3.6.4). Borrowing from SBP was high for most of FY2007. An offshore $750 million bond issue in May 2007, however, helped the Government make a large repayment of its outstanding credit from the central bank at the end of the fiscal year. This masked SBP's

3.6.2 Inflation, 12-month moving average



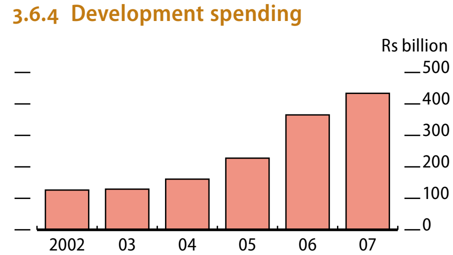
Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 31 August 2007.

3.6.3 Growth of money and credit



Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 8 September 2007.

3.6.4 Development spending



Source: Ministry of Finance, *Economic Survey 2006-07*, available: http://www.finance.gov.pk, downloaded 31 August 2007.

intrayear problems in controlling reserve money to achieve its policy targets, and highlights the need for closer alignment between monetary and fiscal policies to manage aggregate demand more effectively.

Nonbank borrowings through the national savings schemes and long-term Pakistan investment bonds picked up sharply in FY2007. Greater reliance on these sources, rather than domestic bank borrowing or the issue of foreign bonds, would limit the adverse macroeconomic consequences of an expansionary budget policy that seeks to rapidly advance development spending.

Tax receipts remained buoyant, exceeding the target. On the back of improved revenue collection and administration reforms, direct taxes in particular registered impressive growth of 48%. Accordingly, the share of direct taxes in total tax collected by the Central Board of Revenue rose to 39.4% from 31.6% a year earlier. This performance kept the budget deficit to 4.3% of GDP (Figure 3.6.5).

Export growth decelerated to a disappointing 3.3%, from 14.9% in FY2006. One reason was slower growth in textile exports (which account for around 60% of total exports), which appears to stem from greater international competition in the postquota era. Another important factor was marked weakness in the performance of the other exports category. The ultimate causes of poor exports are grounded in long-term and deep structural issues relating to the lack of diversification of export industries, poor compliance with quality standards, and concentration of exports in a small number of markets.

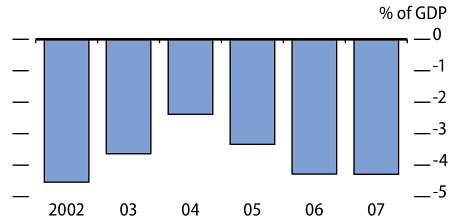
The growth of imports, too, in FY2007 saw a sharp deceleration, to 7.9%, from an average of 30% in the 3 previous fiscal years, reflecting the notable slowing in domestic consumption during the year: consumer and intermediate goods were virtually stagnant, (with large reductions in important items such as automobiles); oil imports moderated; but capital goods remained buoyant. Growth in oil imports also moderated. The trade deficit widened significantly in absolute levels but as a share of GDP was essentially static at 6.9%.

With a deterioration in the income account, the current account deficit (excluding official transfers) slumped to $7.5 billion (Figure 3.6.6). This represented a significant widening in dollar terms for the third year in a row, reaching 5.2% of GDP. Yet the deficit would have been even greater if workers' remittances had not increased by almost 20%, to $5.5 billion.

The financing of the current account deficit was again managed without difficulty, given that the financial account surplus amounted to an estimated $10.2 billion—a very large $4.3 billion advance relative to the previous year. However, the continuity of these flows is not ensured and thus raises questions about the deficit's sustainability. Nearly all the rise in the surplus came from non-debt-creating inflows that have financed the bulk of the large increases in the current account deficit of the past 3 years.

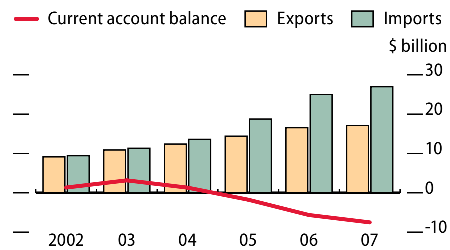
Total foreign private investment inflows nearly doubled to a record $8.4 billion from $4.5 billion a year earlier, including $5.1 billion in FDI (up from $3.5 billion; Box 3.6.1) and the balance of $3.3 billion in portfolio investment (up from $1.0 billion), mainly in equities. With a large $3.5 billion overall surplus, SBP foreign exchange reserves in FY2007

3.6.5 Budget balance



Source: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 21 August 2007.

3.6.6 Current account indicators



Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 31 August 2007.

3.6.7 Foreign exchange reserves

Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 31 August 2007.

3.6.1 Trends in foreign direct investment

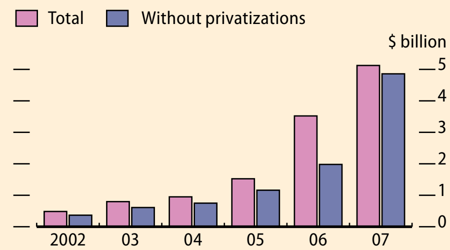
Foreign direct investment (FDI) has grown rapidly in recent years (Box figure). In FY2007, it reached an estimated $5.1 billion, for a year-on-year increase of 45.6%, and accounted for one half of the financial account surplus.

FDI flows have, however, been highly concentrated in four sectors: telecommunications, financial services, oil and gas, and tobacco and cigarettes. Together, these sectors accounted for three fourths of total FDI in the first 11 months of FY2007, with telecommunications on its own amounting to almost a third of total FDI. The largest investment in the telecoms sector in FY2007 came from the PRC, which amounted to about 16% of total FDI.

The financial sector was the second largest sector. Between July 2006 and May 2007, FDI amounted to $897 million, largely due to the consolidation in banking, which resulted in several large mergers and acquisitions. Investment in oil and gas exploration also rose significantly, by 77% compared with FY2006, and reached $480 million by May 2007. The tobacco and cigarette industry also registered a steep increase to $389 million in FY2007 from only $2.3 million in FY2006. This was mainly the result of an investment of $382 million by Philip Morris International to take over Lakson Tobacco.

Even with a record amount of FDI, efforts need to be made to lessen the level of concentration. Success will not only increase total FDI flows but will also result in reduced volatility attached to these flows. Unlike some other countries in the region, Pakistan attracts little FDI into manufacturing. This feature needs to be remedied to stimulate economic and employment growth, by bringing in improved technologies, business practices, and innovation so as to raise the level of manufacturing competitiveness and to accelerate structural change. In Part 2 of this *Update*, the role of FDI and wider supply-side considerations in promoting export performance is analyzed. Part 3 of *Asian Development Outlook 2007* discusses the role that diversification within manufacturing play in promoting broader growth.

Inflow of foreign direct investment



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 21 August 2007.

climbed steeply to $13.3 billion (Figure 3.6.7). External debt as a share of GDP continued declining, to 26.9%.

Prospects

On the basis of strong demand, bolstered by increased private and public investment, the economy is seen keeping most of its momentum and achieving 6.5% growth in FY2008. The slight deceleration reflects several factors: the tightening of the monetary policy stance to contain consumer demand; the impact of high international oil prices; continued slow growth in exports, due mainly to greater international competition in the textile sector; and expected slow growth in the US economy (Pakistan's largest trading partner) in July–December 2007.

On 1 August 2007, SBP raised its discount rate from 9.5% to 10.0% and has recommended that the Government adopt quarterly ceilings for budgetary borrowings from itself. The central bank also took measures to limit refinancing from its special credit facilities. The tighter monetary policy is expected to continue to hold down nonfood inflation. The agricultural pickup in FY2007 should help ease the supply-side constraints that triggered food inflation, and good harvests in wheat, pulses, and sugar are likely to help stabilize their prices.

Overall, inflation in FY2008 is expected to subside to 6.5%. However, if the Government borrows more from the banking system to finance higher than budgeted expenditures resulting in a wider than planned

3.6.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	6.8	7.0	6.5	6.5
Inflation	7.0	7.8	6.5	6.5
Current acct. bal. (share of GDP)	-4.5	-5.2	-3.9	-5.5

Source: Staff estimates.

deficit, or if external inflows are unexpectedly strong, SBP will likely find it difficult to offset the impact on the money supply and ultimately inflation.

The Government is to continue its expansionary fiscal policy in FY2008 as announced in the June budget, with an increase in salaries and pensions of government employees, larger subsidies, and a 20% hike in development spending. Expenditure on earthquake areas will continue, and relief and rehabilitation of districts in Sindh and Balochistan, badly affected by the recent rains and floods, will add to public spending. Servicing the domestic debt will also remain at high levels. The Central Board of Revenue expects receipts to stay robust, and the Government has set a 21% improvement target in revenue collection for FY2008. Taking these factors into account, the *Update* forecasts the fiscal deficit to be 4.2% of GDP in FY2008, slightly above the government budget plan of 4.0%.

On the external side, relatively slow growth in exports is projected because of continuing weakness in textiles, while import growth is expected to be elevated, reflecting a larger oil bill and continued robust expansion in investment. Accordingly, the trade deficit is likely to remain heavy at $11.4 billion or 7.1% of GDP. While the net services and income deficits will continue to widen, workers' remittances, targeted to reach $6.2 billion, should hold the current account deficit to $8.8 billion, or 5.5% of GDP, in FY2008. This level is well beyond the *ADO 2007* estimate of 3.9% of GDP.

Overall, Pakistan's growth over the 4-year period FY2003–2007 has averaged an impressive 7.5%, and this rate could be sustained in the medium term if two conditions are met: macroeconomic fundamentals remain strong, and policy commitment to governance and economic reform continues. Also, despite recent improvements, the still-low investment and savings rates represent a constraint to achieving and maintaining high growth, and that has to be addressed.

The lack of industrial and export diversification has to be rectified, to bring down persistent growth in the current account deficits to levels consistent with sustainable financing. As a matter of some urgency, ongoing power shortages, which could become a bottleneck to growth, need to be resolved. Yet the fundamental issue is a resolution of the current political uncertainties. The forthcoming presidential and parliamentary elections must be seen by the population as fair, and need to ensure the continuity and coherence of economic policy, so as to sustain economic and governance reforms.

Philippines

GDP grew much faster than expected in the first half of 2007, led by net exports, private consumption, and government spending. For the full year, the aggregate growth forecast is revised to 6.6% from 5.4% in *Asian Development Outlook 2007* (*ADO 2007*), and the prediction for 2008 is edged up to 6.0%. Inflation forecasts are revised down for both years. Fiscal revenue collection fell behind target in the first half of this year, raising concerns about efforts to rein in the deficit and increase spending on development.

Updated assessment

GDP growth accelerated to 7.3% in the first half of 2007 from 5.6% in the first half of 2006 (Figure 3.7.1). The sharp rise was due to robust growth of net exports and private consumption, and higher government expenditure. Private consumption, accounting for more than three quarters of GDP, grew by 6.0% in the period, underpinned by an 18.1% rise (to $7.0 billion) in remittances from overseas workers. Government consumption rose by a sharp 11.8% and public sector construction investment surged by 33.8%. Both were boosted by some nonrecurring factors: recovery expenditures for typhoon-damaged areas and accelerated spending ahead of legislative and local government elections in May 2007.

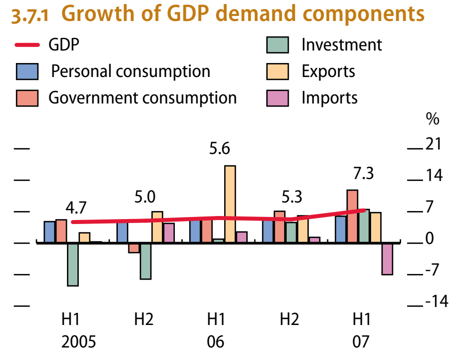
In a positive sign for future productive capacity, investment in durable equipment grew by 2.0%, after 2 years of contraction. Total investment contributed positively to aggregate growth in the first half.

On the supply side, services recorded particularly strong growth of 8.6%. Retail trade, a major subsector, expanded by 10.5% on the robust private consumption. Industry grew by 7.2%: construction and mining performed well, manufacturing less so (Figure 3.7.2). Construction was strongly supported by the jump in public sector investment. Private sector construction also grew, by 8.5%, a turnaround from a decline in the year-earlier period. Mining output (up by 24.3% in the first half) benefited from high global prices for minerals and startups of new projects. Production of coal, natural gas, and nickel increased, although from low bases. Quarrying surged with the higher levels of construction activity.

Manufacturing grew by just 3.9% in the first half, the lowest rate of expansion in several years, in part because of weakness in global demand for electronic products, a major export category. Agriculture, which was hit by typhoon damage late in 2006, recovered to grow by 4.0% in the first half of 2007.

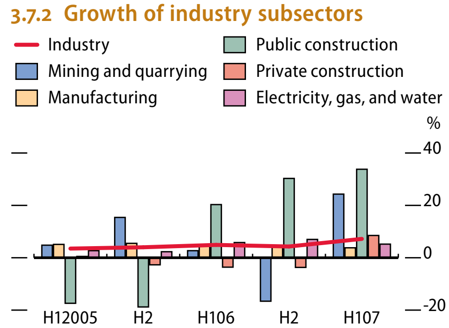
The outlook for the full year has improved with the stronger than expected first-half performance and lower than projected inflation. Private consumption spending will continue to be boosted by remittances. On the other hand, with elections out of the way, government spending is unlikely to be as strong in the second half. The contribution of net exports is projected to decline, too, because imports were unusually weak in the first half. Moreover, a prolonged dry spell, mainly in the largest

3.7.1 Growth of GDP demand components



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 30 August 2007.

3.7.2 Growth of industry subsectors



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 30 August 2007.

island of Luzon, could hurt agricultural output. Consequently, GDP growth in the second half is not projected to match the first-half result. Still, taking into account the higher than expected private consumption and government-led investment, the GDP forecast for this year is revised up to 6.6% from 5.4% in *ADO 2007*.

Merchandise exports (on a customs basis and in US dollars) rose by 6.6% in the first half, well below the 18.2% pace in the year-earlier period. One reason for the slowdown was relatively torpid growth in exports of electronic products (6.3% against 14.7% a year ago) because of weaker global demand. Electronic products account for 60% of total merchandise exports. Garment exports fell by 11.3%, hurt by an appreciating peso. In contrast, shipments of minerals shot up by 53% owing to strong demand from markets including the People's Republic of China.

Merchandise imports on the same basis rose by only 2.3% in the first half, in part reflecting weakness in the electronic and garment industries. Furthermore, imports of fuel and of industrial equipment were flat, and imports of cereals fell sharply as domestic harvests improved early in the year. Thus, the trade deficit for the first half narrowed to $776.1 million from $1.7 billion a year earlier. This narrower gap and the rise in remittances helped bolster the current account surplus, which rose to $1.8 billion, equivalent to 5.8% of GDP, in the first quarter of this year. For the full year, the current account surplus is now expected to come in at 5.4% of GDP, revised up from 3.2% in *ADO 2007*.

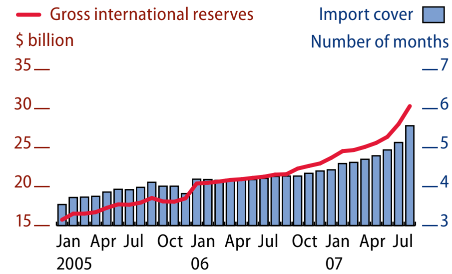
Gross international reserves increased to $30.3 billion as at end-August 2007, equivalent to 5.6 months of imports (Figure 3.7.3). Strong demand for pesos for current and capital account transactions led to a 5.2% appreciation against the US dollar in the 8 months to August (Figure 3.7.4). The real effective exchange rate appreciated by 5.1% in that period.

Despite the lift in domestic demand, inflation decelerated faster than anticipated, to average 2.6% in the January–August period. (Figure 3.7.5). The impact of a 2 percentage point rise in value-added tax early in 2006 subsided, and the peso's appreciation helped offset higher import prices. Prices of food staples were stable in the first half (although the dry weather could put upward pressure on food in the second). Lower than expected inflation in the first 8 months has prompted a downward revision in the full-year forecast to 2.9% from 4.8% in *ADO 2007*.

Broad money (M3) growth rose by about 20% on average in the first 6 months of 2007, double the rate of a year earlier, driven mainly by foreign exchange inflows and, to a lesser extent, by the growth of credit to the public and private sectors. Reflecting ample liquidity in the banking system, interest rates on domestic treasury bills eased: the nominal yield on 91-day bills declined below comparable US treasuries in November 2006, for the first time in 25 years, and this relationship has been maintained this year (Figure 3.7.6).

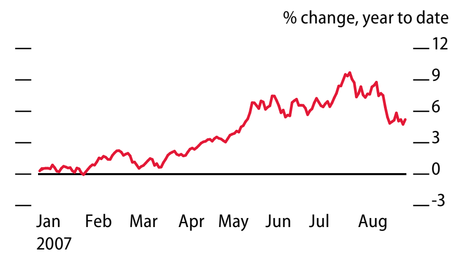
Concerned that the strong growth in money supply posed risks to future inflation, the Bangko Sentral ng Pilipinas, the central bank, in May moved to drain surplus liquidity. It encouraged government-controlled corporations to deposit funds with the central bank and made available a special deposit account facility to a wider range of financial institutions. In July, the monetary authorities ended a tiering system on rates paid to

3.7.3 Reserves



Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 7 September 2007.

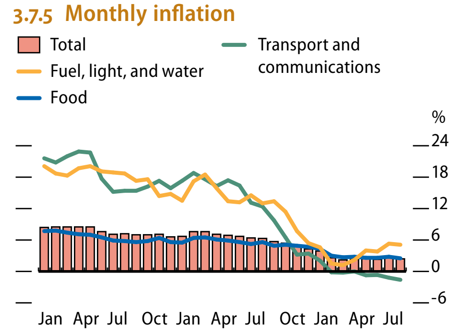
3.7.4 Peso against US dollar



Note: A point above zero indicates an appreciation of the peso.

Source: CEIC Data Company Ltd., downloaded 3 September 2007.

3.7.5 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd.; both downloaded 5 September 2007.

banks on overnight deposits, an arrangement that had been introduced late in 2006 to encourage banks to lend. Simultaneously, the central bank cut key policy rates. It has described the overall impact on monetary policy of these July changes as neutral.

The Government has made significant progress in narrowing the wide fiscal gap over recent years, reining in the fiscal deficit to 1.1% of GDP in 2006, the narrowest in 9 years, through, among other measures, broadening the tax base and raising the value-added tax. This year's deficit target was set at P63.0 billion, or 0.9% of GDP. However, revenues collected in the first half of 2007 fell short of programmed levels, so that the deficit was P9.7 billion wider than target (Figure 3.7.7).

Proceeds from privatization are expected to be used to cover shortfalls in revenues. The Government raised P43 billion from the sales of stakes in various corporations, as well as some property, in the first 7 months of 2007. More asset sales are planned.

Outstanding government debt declined by 5.4% in the first half from a year earlier, to P3.78 trillion ($81.6 billion). However, the still-high debt (about 60% of GDP, excluding contingent liabilities of debt guarantees to state-controlled companies; Figure 3.7.8) and the large share of interest payments in the budget (they consumed 25.4% of total revenues in the first half) expose the economy to swings in sentiment in financial markets.

The labor market strengthened somewhat with faster economic growth. In April, the unemployment rate was 7.4% on a preliminary basis, down from 8.2% a year earlier, and the underemployment rate declined to 18.9% from 25.4%. Business process outsourcing has been an encouraging field for job creation. It boosted employment from 2,400 to 237,400 between 2000 and 2006 and has potential to grow more. That would require diversification into higher value-added segments, such as medical transcription, back-office processing, and digital content, which in turn needs skills training. Job creation is a major challenge for the country, given that 43 million people live on less than $2 a day and the labor force is increasing by 2% a year.

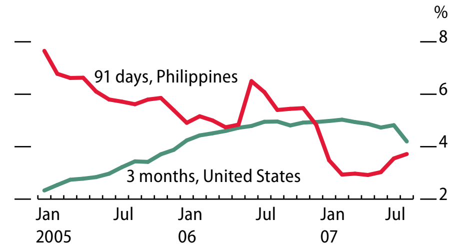
Prospects

Robust growth is expected to be sustained in 2008, though not at the pace of this year. Services will continue to be the main driver, supported by growth in remittances and therefore in consumption. Retail trade and transport, residential real estate, and communications services are expected to expand strongly. Services as a whole is projected to grow by 7.4% next year (Figure 3.7.9).

In industry, export-oriented manufacturing will do better if global demand for electronic products picks up as projected, but mining and quarrying are likely to decelerate from the rapid expansion seen in 2007. Government expenditures on infrastructure will support growth of construction. Industry as a whole is expected to grow at around 5.0%, and agriculture, assuming normal weather conditions, at 3.9%.

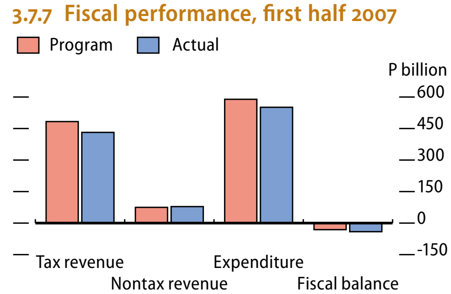
Improvements in the business climate brought about by lower inflation and reductions in the fiscal gap will likely mean slightly higher growth in total investment next year. There are signs that foreign direct investment is starting to pick up: major commitments have been made

3.7.6 Treasury bill rates



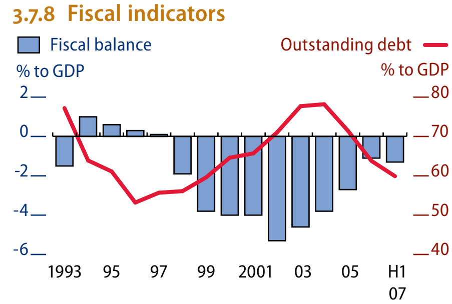
Sources: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph; Board of Governors of the Federal Reserve System, available: http://www.federalreserve.gov; both downloaded 7 September 2007.

3.7.7 Fiscal performance, first half 2007



Source: Department of Finance, available: http://www.dof.gov.ph, downloaded 31 August 2007.

3.7.8 Fiscal indicators



Sources: National Statistical Coordination Board, available: http://www.nscb.gov.ph; CEIC Data Company, Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, all downloaded 30 August 2007.

by a Korean ship-building company, a PRC glass manufacturer, and a US semiconductor company. Net foreign direct investment rose by 16% in the first half of 2007, to a still-modest total of $1.2 billion. Certainly a lift in investment would be welcome: the ratio of gross domestic investment to GDP declined from 21.2% to 14.3% between 2000 and 2006, curtailing economic growth and employment generation. Increased government investment in infrastructure should further enhance the business climate. (The budget proposed for 2008 includes a 20% increase in development expenditures.) Taking into account the various influences, the forecast for GDP growth in 2008 is revised up to 6.0% from 5.7% in *ADO 2007*. Given the moderation in inflationary pressures, the inflation forecast for 2008 is revised down to 3.5%.

Merchandise export growth is projected to be supported by some strengthening of global demand for electronic products next year. If the rest of Asia grows as projected, this will benefit the Philippines: its share of total exports going to East Asia (excluding Japan) and ASEAN has increased from 25.5% in 1997 to 41.9% in 2006 (Figure 3.7.10). However, some of these exports are used in the other Asian countries to make products ultimately shipped to the US, so that an unexpected weakening in that market would also have an impact on Philippine exports to the rest of Asia. Merchandise imports are projected to pick up from this year's weak level because of the growth in consumption and investment, and to provide inputs for the electronics industry. The current account surplus is projected at 5.2% of GDP, close to this year, but revised up from *ADO 2007*.

Planned reforms of the power sector, if achieved, would bring several benefits. The Government aims to privatize power generation and transmission as a way to stimulate investment in the sector and reduce its costs. One goal is to sell 70% of the power generation assets in Luzon and Visayas by end-2008. Having started with sales of relatively small hydropower plants, the Government expects to sell major facilities, including two 600 megawatt coal-fired thermal plants, and to award the concession for transmission assets in 2007 and 2008. Progress would improve the investment climate and the fiscal position (long-term debt of the power sector is a major portion of government contingent liabilities).

The main domestic risk to this outlook is related to fiscal reform. Improvement in the fiscal performance in 2006 raised optimism about the country's economic prospects, as illustrated by an increase in net portfolio investment in the first 7 months of 2007 to $3.6 billion, four times as large as a year earlier. However, the shortfall in (mainly tax) revenues in the first half of 2007 has raised concerns about the fiscal consolidation program. If the Government's efforts stall, sovereign borrowing costs could rise. Privatization proceeds are not recurrent, so cannot always be relied on to fill the budget gap. A balanced budget is targeted for 2008, but that still requires privatization proceeds to cover planned expenditure.

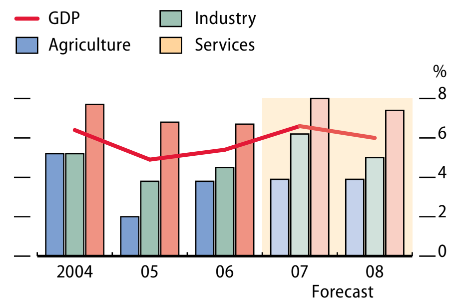
Higher tax revenues are all the more important as the Government's stance on fiscal expenditures has shifted from austerity (seen in a decline of government expenditures from 19.9% of GDP in 2002 to 17.3% in 2006) to an expansion of development spending. If revenues do not rise commensurately, the public investment program may need to be trimmed, or the fiscal deficit allowed to widen.

3.7.1 Selected economic indicators (%)

	2007		2007	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	5.4	6.6	5.7	6.0
Inflation	4.8	2.9	5.0	3.5
Current acct. bal. (share of GDP)	3.2	5.4	2.9	5.2

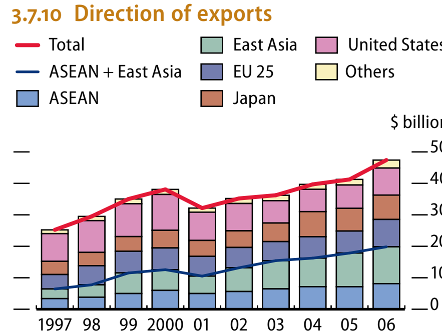
Source: Staff estimates.

3.7.9 GDP growth



Sources: Asian Development Outlook database; staff estimates.

3.7.10 Direction of exports



Source: CEIC Data Company Ltd., downloaded 2 August 2007.

Thailand

Better than expected net export performance is helping offset sluggishness of consumption and investment caused by political uncertainties, thus keeping the GDP growth projection for 2007 at 4.0%. The soft domestic activity has, though, prompted a downward revision in the inflation forecast. Domestic demand is expected to pick up in 2008, if consumer and business confidence returns after elections for a new government. The GDP growth projection for next year remains at 5.0%.

Updated assessment

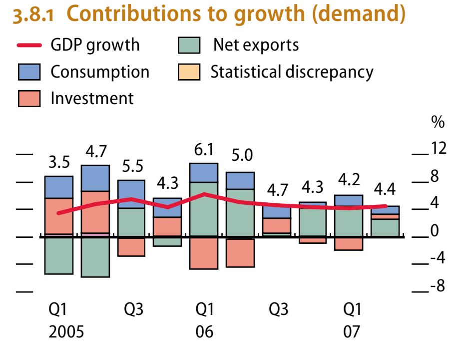
The economy grew by 4.3% in the first half of 2007. Net exports were the driving force (Figure 3.8.1), as domestic demand weakened due to disruptions in the political environment and a lack of clarity about economic policy direction. (An interim Government was installed after a military coup in September 2006, and national elections are planned for December this year.) Private consumption, hurt by weakness in consumer confidence (Figure 3.8.2), expanded modestly by 1.1% in the first half. Unsettled politics also hurt gross fixed investment, which fell by 0.6%, with private fixed investment down by 1.5% (Figure 3.8.3).

The interim Government accelerated its spending to buttress domestic demand: almost 70% of annual state-owned enterprise investment was disbursed in the first 6 months of FY2007 (ending 30 September 2007). Domestic demand is expected to remain weak for the rest of 2007. Private consumption is seen growing by 2%, around the same range as projected in *Asian Development Outlook 2007* (*ADO 2007*) earlier this year, but forecast growth in total fixed investment is revised down to 2% from 5%. Taking into account stronger than expected net exports, the projection for full-year GDP growth is maintained at 4.0%, the lowest rate in 6 years.

On the production side, agriculture grew by 6.2% in the first half, accelerating from a year earlier, on an increase in sugarcane and cassava production. But growth in industry and services combined slipped to 4.2%, reflecting slowdowns in light industries, high-technology industries, and hotels and restaurants.

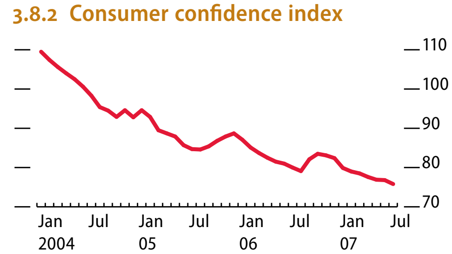
The external side performed better than anticipated, with exports stronger and imports weaker than forecast in *ADO 2007*. Merchandise exports grew by 18.4% in the first half of 2007 (Figure 3.8.4): agriculture's were up by 15.6%, partly a result of higher rice prices, and industry's by 19.1%, led by electrical appliances, automobile parts, and construction materials. Shipments to India and Eastern Europe, relatively small but increasingly important markets for Thailand, recorded particularly strong growth as these economies accelerated. In the second half, export growth is likely to ease, partly because the baht has continued to appreciate, which is damping orders for some exports, and in July, export growth decelerated sharply to 6.2%. A decision by the United States (US) in June to reduce preferential treatment for some imports from Thailand,

3.8.1 Contributions to growth (demand)



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 3 September 2007.

3.8.2 Consumer confidence index



Note: A reading of less than 100 denotes deteriorating confidence.

Source: Center for Economic and Business Forecasting, University of Thai Chamber of Commerce, available: http://www.utcc.ac.th, downloaded 25 August 2007.

including gems and jewelry, should have a fairly limited impact on exports. For all this year, total exports are projected to grow by 12.5%.

Imports in January–June rose at the modest rate of 6.4%, affected by the slack domestic demand. Capital goods imports barely grew (by 0.3%), reflecting weak investment (stemming from shakier business confidence), and fuel imports fell by 3.4%. Imports could pick up modestly in the second half, given depletion of inventories of imported materials and the firmer exchange rate.

The solid first-half export performance, combined with weak imports, generated a merchandise trade surplus of $5.1 billion, a sharp turnaround from a deficit of $1.9 billion a year earlier. Net income from tourism, transportation, and remittances was also strong. Together these moved the current account into surplus, at $6.2 billion, compared with a deficit of $1.6 billion in the first half of 2006. The full-year figures for the trade surplus and net income are projected to be stronger than forecast in *ADO 2007*. Drawing these strands together, the projection for the current account surplus for 2007 is revised up to 3.0% of GDP, from 1.3%.

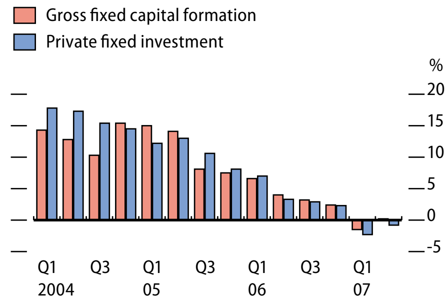
The rising current account surplus and a surge in private capital inflows into the Thai stock market boosted foreign exchange reserves to $72.1 billion in July 2007, equivalent to 3.8 times short-term external debt and to 6 months of imports. The rise in foreign reserves also reflects central bank sales of baht to moderate the currency's appreciation. Even so, the baht appreciated by 4.8% against the US dollar by late August from end-2006. The Stock Exchange of Thailand index of share prices rose by 20% over those 8 months.

Controls introduced in December 2006 to curb capital inflows and to slow currency appreciation were gradually eased, although a 30% non-interest-bearing reserve requirement on unhedged external borrowing and foreign purchases of Thai debt securities remains in place (stock market investments are exempted). In July 2007, the interim Government relaxed rules on Thai residents' foreign investment and foreign currency holdings. The Finance Ministry aims to refinance $3.2 billion in foreign debt held by the Government and state-owned enterprises to help reduce upward pressure on the baht by increasing demand for foreign currency to repay external creditors.

Soft domestic demand has weakened inflation pressures, and average consumer price inflation was only 2.0% in the first 8 months of 2007. In August, year-on-year inflation slowed to 1.1% (Figure 3.8.5), with core inflation (i.e., excluding volatile food and energy), at just 0.7%. Such figures allowed the Bank of Thailand scope to lower its policy interest rate by 175 basis points to 3.25% between January and August. Inflation is likely to remain low over the rest of this year, assisted by currency appreciation (cushioning rising oil prices), and softer than expected domestic demand (limiting firms' ability to raise prices). For all 2007, inflation is forecast at 2.0%, revised down from 2.5% in *ADO 2007*.

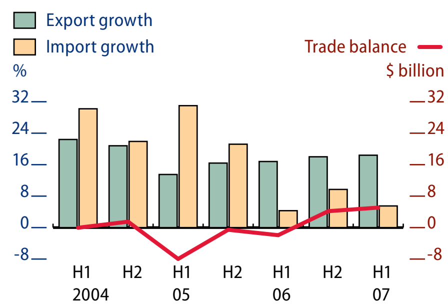
On the fiscal side, the Government targeted a budget deficit equivalent to 1.7% of GDP in FY2007. Government consumption spending looks set to rise by 11%, helping bolster domestic demand. As for the public infrastructure program, which projected investment of as much as $42 billion on a variety of major projects in 2005–2009, the interim Government had aimed to make progress this year on expanding mass

3.8.3 Fixed investment growth



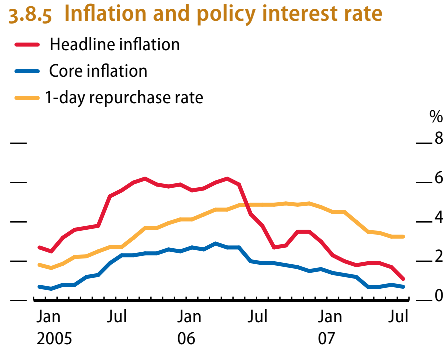
Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 3 September 2007.

3.8.4 Trade indicators



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 31 August 2007.

3.8.5 Inflation and policy interest rate



Note: Core inflation excludes fresh food and energy items.

Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 3 September 2007.

transit rail lines for Bangkok—a significant part of the program—but contract bidding was postponed. Some projects, such as investment in energy, water resources, and low-cost housing, have gone ahead over the past couple of years, but others have faced delays.

Prospects

The outlook for 2008 assumes that national elections are held in December this year as planned and that an elected government pursues a credible economic program. In that case, consumer and business confidence would likely revive. Private investment would pick up, supported by the reduction in interest rates this year and fairly high capacity utilization (75% in July). A new government would likely continue with the public infrastructure program: energy, water, and health projects are already in the FY2008 budget. The question is how quickly it could start building the mass transit lines.

This year's appreciation of the baht is likely to crimp growth of some exports in 2008, especially those with low levels of imported content, as well as agricultural products and clothing. However, export growth is still expected to achieve the level foreseen in *ADO 2007*. Imports will pick up as companies rebuild inventories and domestic demand starts to revive. On this basis, the forecast for GDP growth next year is maintained at 5.0% (Figure 3.8.6). Inflation is projected to edge up to 2.5% on average—an unchanged forecast from *ADO 2007* (Figure 3.8.7)—as firmer domestic demand paves the way for price increases.

Moderating export and strengthening import growth would result in a trade surplus lower next year than this, but still considerably higher than that forecast in *ADO 2007*. The current account is now seen posting a small surplus (0.5% of GDP), as opposed to a deficit (of 0.7%) in *ADO 2007*.

For FY2008, the Government has approved a budget with a deficit of B165 billion, or 1.8% of GDP. The total public-investment budget will increase by 8% relative to FY2007, with additional allocations for the mass transit system, energy, and the petrochemical industry. The aim of this expansionary fiscal policy is to stimulate domestic demand. The incoming government will have the fiscal space to further raise public investment if required, as public debt at end-May 2007 stood at 38.2% of GDP, well within a self-imposed 50% ceiling under the fiscal sustainability framework.

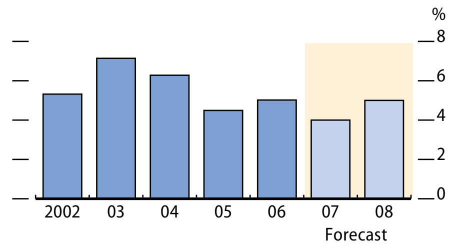
The main risk to this outlook involves a continuation of policy uncertainty into 2008, if the newly elected government cannot quickly implement a sound program for the economy. Further weakness in domestic demand would make the economy susceptible to any unexpected reduction in external demand, the main element underpinning growth so far in 2007.

3.8.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	4.0	4.0	5.0	5.0
Inflation	2.5	2.0	2.5	2.5
Current acct. bal. (share of GDP)	1.3	3.0	-0.7	0.5

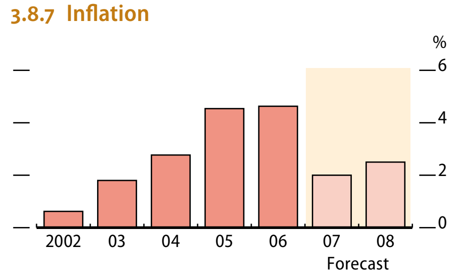
Source: Staff estimates.

3.8.6 GDP growth



Sources: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 3 September 2007; staff estimates.

3.8.7 Inflation



Sources: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th/web4_e/cpi/index.asp, downloaded 31 August 2007; staff estimates.

Viet Nam

Buoyant investment and consumption drove robust economic growth in the first half of 2007. A surge in imports, partly investment-related, widened the trade deficit more than expected in *Asian Development Outlook 2007* (*ADO 2007*). GDP growth forecasts for all 2007 and for 2008 are maintained at rapid rates of 8.3% and 8.5%, respectively. The wider trade gap now points to current account deficits in both years. With stronger than expected inflation (and upward revisions to the forecasts), the Government has taken steps to contain the price pressures.

Updated assessment

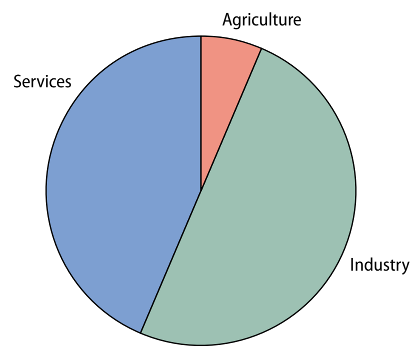
A half percentage point faster than the year-earlier period, the economy accelerated to 7.9% growth in January–June 2007, with nearly all of it coming from industry (3.9 percentage points) and services (3.4 percentage points) on the production side (Figure 3.9.1). Private industry expanded by 20.5%, more than double the pace of state enterprises. Among subsectors, manufacturing grew by a robust 12.3%, but mining (showing minimal growth) suffered from a 7.4% contraction in crude oil production as output at the White Tiger oil field, the biggest in Viet Nam, declined. In services, trade and finance grew by 10.4% and the hotels and restaurants subsector, benefiting from buoyant consumption and increased tourism, rose by 12.7%.

Agriculture, hit by drought, avian flu, and livestock diseases, put in a weaker performance in the first half than a year earlier, to contribute only 0.5 percentage points to aggregate expansion. This sector still accounts for about 55% of total employment, however.

On the demand side, strong investment and consumption were the main drivers. Investment grew by 14% in the first half, stimulated by Viet Nam's entry into the World Trade Organization (WTO) in January 2007 and by improvements in the business environment. Much of investment's growth is from the domestic private sector, whose share of overall investment increased to about 35% in the first half of 2007 (up from 23% in 6 years). As part of efforts to maintain improvements in the business climate, a "single window" at the Department of Planning and Investment has been set up in some cities to streamline procedures and reduce the time needed for starting a business.

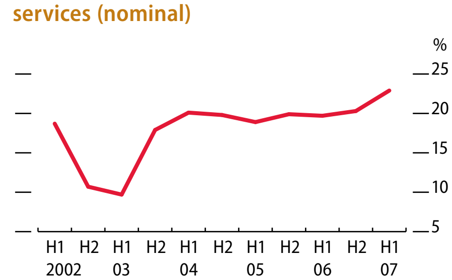
Foreign direct investment (FDI) approvals in the first 7 months of this year rose by about 55% to $6.4 billion and seem headed for a record $13 billion for the full year. An increasing share is going into property (in anticipation of rising demand for offices and commercial buildings) and into tourism. Consumption growth was supported by wage increases, particularly for skilled workers who are in short supply, and remittances from Vietnamese living abroad. Retail sales of goods and services in nominal terms rose by an estimated 23% in the first half of 2007, slightly above the pace of a year earlier (Figure 3.9.2).

3.9.1 Contributions to growth (supply), first half 2007



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.9.2 Growth of retail sales of goods and services (nominal)



Sources: General Statistics Office of Viet Nam, available: http://www.gso.go.vn; CEIC Data Company Ltd.; both downloaded 31 August 2007.

Since GDP usually picks up in the second half of the year, mainly because budget disbursements accelerate, economic growth for all 2007 is forecast to be 8.3%, unchanged from the *ADO 2007* projection.

Buoyant investment led to a steep 30.4% increase in merchandise imports in the first half of 2007, about double the year-earlier rate. Imports of capital goods surged by 46.5%, and imports of raw materials and intermediate goods were also vigorous (Figure 3.9.3). Growth in merchandise exports, in contrast, slowed to 19.4% from 25.7% (Figure 3.9.4). The value of crude oil exports fell by 10%, largely because of the drop in oil production. Seafood exports, one of the biggest export categories, were hurt by concerns in some overseas markets about contamination of shrimp by antibiotics. Other export categories performed robustly, though: coffee exports more than doubled as global coffee prices increased, and textiles and clothing rose by 25.9% after the abolition of quotas following WTO accession. Exports of wooden furniture, which have grown rapidly in the past couple of years, rose by 23%.

As a result of these trends in the first half, the trade deficit widened sharply to $4.8 billion, equivalent to about 16% of GDP, from $2.0 billion in the year-earlier period. Concerns were, though, largely assuaged by the composition of imports: much of their increase reflected capital goods and other inputs for export production (the clothing industry, for example, imports almost 70% of its inputs). Moreover, the external position is supported by rising remittances and tourism receipts. With the deterioration in the trade gap, Viet Nam is now forecast to have a current account deficit equivalent to 5.0% of GDP this year, revised from a small surplus expected in *ADO 2007*.

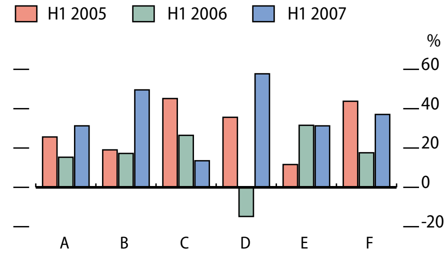
Strong FDI inflows and a rise in portfolio investment contributed to a surplus in the overall balance of payments. The State Bank of Viet Nam, the central bank, accumulated additional foreign exchange reserves of $7 billion in January–July to reduce upward pressure on the currency. The Government in January 2007 widened the dong's daily trading band against the dollar from 0.25% to 0.5%, allowing for more flexibility in monetary policy.

The impact on money supply of FDI and portfolio inflows was only partly offset by central bank sterilization operations, leading to a liquidity buildup. Credit soared by 35% in the first 6 months, above the central bank's full-year target of 25%. High levels of liquidity, plus heavy domestic demand and some food supply issues, pushed inflation up to 8.6% in August, taking the average inflation rate for the first 8 months of this year to 7.4% (Figure 3.9.5). Food prices rose, driven by outbreaks of avian flu and a pig disease that caused meat shortages.

Administered energy prices went up, too. The Government, phasing out energy subsidies, raised prices of electricity (by 7.6%), and coal (20%) early in the year and subsequently abolished a subsidy on gasoline (keeping subsidies for kerosene and diesel). Largely as a result, gasoline prices rose by 7.6% in the first 8 months. The heightened inflation pressures have prompted an increase in the full-year forecast to 7.8% from 6.8% in *ADO 2007*.

The authorities have taken several steps to contain price pressures. The State Bank of Viet Nam increased issuance of bills to drain excess liquidity and in June it raised the reserve-requirement ratio for banks

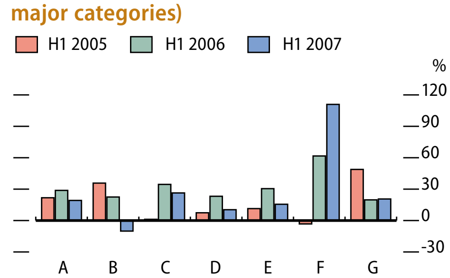
3.9.3 Merchandise import growth (total and major categories)



A = Total imports; B = Machinery and spare parts; C = Petroleum; D = Steel productsr; E = Fabrics; F = Electronic products.

Source: CEIC Data Company Ltd., downloaded 31 August 2007.

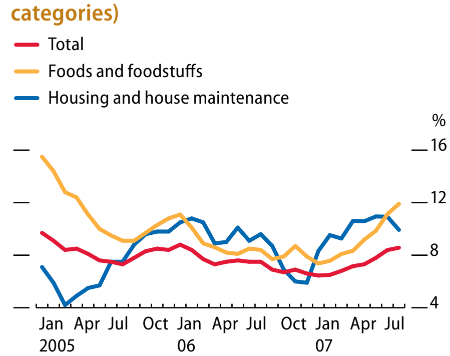
3.9.4 Merchandise export growth (total and major categories)



A = Total exports; B = Crude oil; C = Textiles and clothing; D = Footwear; E = Fisheries products; F = Coffee; G = Computer and electrical components.

Source: CEIC Data Company Ltd., downloaded 31 August 2007.

3.9.5 Inflation (total and high inflation categories)



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

from 5% to 10%. The Ministry of Finance in August lowered import tariffs on 18 groups of commodities to assist in the inflation-fighting effort. Tariff rates on food and construction materials were cut by at least half. As part of this effort, the Government in July had already dropped a plan to increase wages across the public sector.

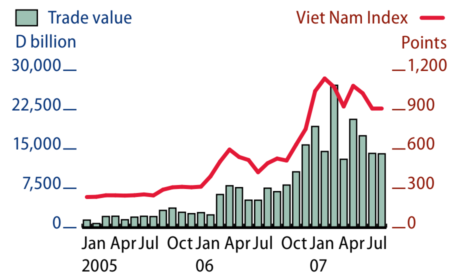
Fiscal policy remains expansionary as the Government invests heavily in infrastructure. This has led to a widening fiscal deficit and an increasing public debt. The overall fiscal deficit is expected to reach 5.0% of GDP in 2007.

In policy developments, Viet Nam lowered its average tariff rate from 17.4% to 14.5% under its WTO commitments, and the average rate is scheduled to come down further over the next few years. The increased competitive pressures from deepening integration with global markets have emphasized the need to reform state-owned enterprises (SOEs). The Government plans to equitize (partly privatize) an additional 1,500 SOEs, out of the remaining 2,100, by 2010. Among moves already made, state-owned Bao Viet Insurance Corporation, the largest insurance company, issued shares through an initial public offering in June 2007, and others are lining up to do this. In addition, the state's holdings in fully and partly owned SOEs are being transferred from ministries and provincial governments to the State Capital Investment Corporation, which is likely to reduce the involvement of ministries in the management of the enterprises.

A WTO commitment to open banking to foreign ownership is underlining the urgency of reforming state-owned commercial banks as well. The Government encouraged this in April by raising the stake that foreign banks and investors can hold in Vietnamese banks, from 10% to, in most cases, 15%. Two state-owned banks—Vietcom Bank and Mekong Housing Bank—plan to make initial share offerings, but volatility in the stock market has caused some slippage of the schedule.

The stock market boomed through 2006, with the Viet Nam Index of share prices climbing by 144%. In the first 10 weeks of 2007, the index rose by a further 50%, but has since dropped by about 20% from the record set in March (Figure 3.9.6). Stock market capitalization of listed companies has increased to the equivalent of about 28% of GDP this year, from just 5% in 2005. The central bank, concerned that banks might be taking on excessive risk exposure to stocks and about the impact on inflation of rapid credit growth, in June called on banks to limit lending for share purchases to a ceiling of 3% of total loans by end-2007.

3.9.6 Ho Chi Minh City stock trading center



Source: CEIC Data Company Ltd., downloaded 31 August 2007.

Prospects

The outlook for next year assumes that WTO accession will further integrate the economy into global business networks, encourage FDI, and help maintain the momentum for domestic reforms, which are generally improving the business environment. Investment is forecast to grow by about 15% in 2008, similar to this year, taking it to 41% of GDP. Robust consumption will be underpinned by rising wages for skilled employees and by remittances.

Led by strong growth of two of its components—manufacturing and construction—industry is expected to grow by 10.6% in 2008. Higher

3.9.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	8.3	8.3	8.5	8.5
Inflation	6.8	7.8	6.3	6.8
Current acct. bal. (share of GDP)	0.2	-5.0	1.3	-4.7

Source: Staff estimates.

value-added products, including computers and electronic goods for export, constitute an increasing share of manufacturing output. In construction, projects under way or planned include major hotels and resorts, as well as high-end office and apartment buildings in Hanoi and Ho Chi Minh City. Public sector construction will emphasize the building of roads, ports, and power generation facilities.

Services, spurred by consumption and tourism, as well as the gradual opening of some subsectors to foreign participation, is projected to grow by 8.6% next year. Subsectors likely to expand fastest are banking and finance, trade, transport and telecommunications, and tourism. Agriculture is projected to pick up to 3.1% in 2008, slightly faster than this year's weaker than usual pace. On these influences, GDP growth for 2008 is projected to edge up to 8.5% (Figure 3.9.7), in line with the *ADO 2007* forecast.

Trade benefits from WTO accession are expected to keep export growth brisk in 2008, at 22%. Clothing exports will build on the gains made from the ending of quotas on Vietnamese garments. In addition, the shrimp industry has improved its quality control, and this should lift exports.

Import growth is seen staying high, reflecting the continued need for capital goods (to support investment spending) and for export-related inputs. The current account deficit is projected at 4.7% of GDP in 2008 (Figure 3.9.8), similar to that in 2007 but marking a revision from a small surplus forecast in *ADO 2007*. Inflows of FDI, portfolio investment, and aid will likely maintain a surplus in the overall balance of payments.

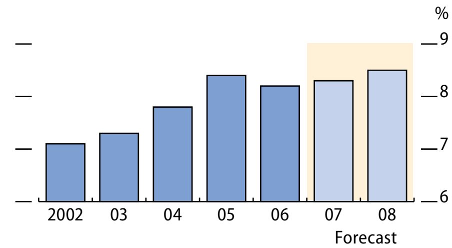
Strong domestic demand and high levels of liquidity related to the balance-of-payments surplus will likely see little dissipation of strong inflation pressures. Average inflation for 2008 is forecast at 6.8%, easing from 2007's rate but revised up from 6.3% in *ADO 2007* (Figure 3.9.9). The fiscal stance is expected to remain expansionary, with an estimated fiscal deficit of 5.0% of GDP.

Pressing challenges involve reining in inflation, addressing bottlenecks in infrastructure (particularly electricity and ports), and tackling skilled-labor shortages. Demand for electricity is growing by 17% annually, overtaxing the system, and leading to power outages. Just over half the power supply comes from hydropower, which is vulnerable to drought. Consequently, six new FDI-funded thermal power plants are planned, at a cost of $8.5 billion. They are currently awaiting government approval.

Given the heavy investment required in infrastructure, and the constraint imposed by a 5% budget deficit, greater private participation in infrastructure would help accelerate the program and reduce the strain on the public debt, which has grown rapidly to about 45% of GDP. The encouragement of private participation in building power facilities in the past 2 years is a welcome step in this direction.

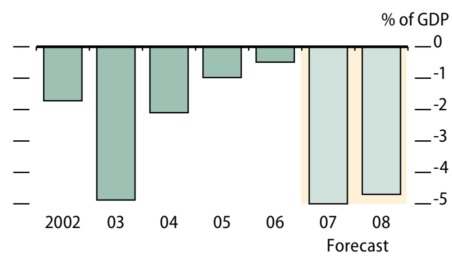
A business forum in May 2007 identified difficulties in finding skilled labor as a key constraint in doing business in the country. Deficiencies in the education system are largely to blame for this bottleneck, and recognizing this, the authorities are taking some steps to change the education system, including encouraging privately operated schools and universities. Removing the 3% limit on the number of foreign employees in an enterprise would also help.

3.9.7 GDP growth



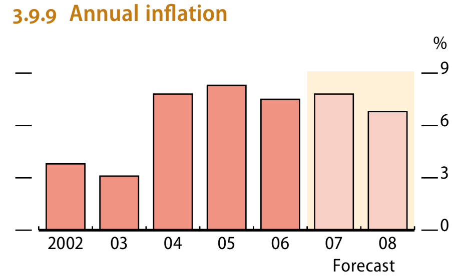
Sources: Asian Development Outlook database; staff estimates.

3.9.8 Current account balance



Sources: Asian Development Outlook database; staff estimates.

3.9.9 Annual inflation



Sources: Asian Development Outlook database; staff estimates.