Southeast Asia

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

Cambodia

Consolidating rapid growth over the previous 2 years, the economy expanded strongly in 2006, reflecting robust clothing exports, tourism receipts, and construction activity. Forecast growth averaging over 9% in the next 2 years will be more dependent on strengthened domestic economic activity, itself underpinned by improved rural incomes, larger inflows of foreign direct investment (FDI), and greater government capital spending. The main challenge is to diversify sources of growth away from the current narrow base.

Economic performance

GDP growth in 2006 is estimated at 10.4%, consolidating double-digit growth of the 2 previous years. The outturn was buttressed by stronger industrial production and robust expansion in services and construction activity.

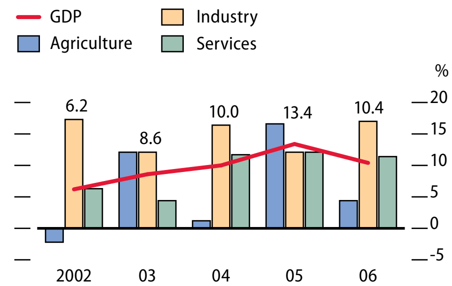
In industry, clothing exports grew by an estimated 32% in volume terms as manufacturers took advantage of temporary safeguard measures imposed against clothing exports from the People's Republic of China (PRC) by the United States (US) and the European Union (EU). Construction activity remained relatively strong due to a boom in residential and commercial buildings in Phnom Penh and Siem Reap. Growth in services was bolstered by solid increases in tourist arrivals. Agricultural production expanded by a stronger than expected 4.4% from the record levels achieved in 2005 (Figure 2.21.1). This was mainly the result of an increase in land under irrigation.

On the demand side, growth was supported by a rise in private investment reflecting growing investor confidence in future economic prospects, and in the Government's ability to maintain economic and political stability. Growth was also helped by a switch to a contribution from net exports (Figure 2.21.2) because of a narrower external deficit.

Budgetary performance continued to improve in 2006 with the overall fiscal deficit estimated at 2.4% of GDP, narrowing sharply from the recent trend deficit. The deficit is 1.5% of GDP if proceeds from the International Monetary Fund (IMF) Multilateral Debt Relief Initiative are included (Figure 2.21.3). Government revenues grew strongly to 11.6% of GDP from 10.4% in 2005, mainly because of an increase in tax collections. The rise in tax receipts compensated for lower capital revenues induced by a lack of privatization activity.

Expenditures are estimated to have risen less rapidly than receipts to 13.1% of GDP, reflecting growth in current spending related to higher outlays on social sectors, defense, and civil-service salaries. Locally financed capital expenditures, however, came in below expectations. Higher than expected revenues and expenditure restraint enabled the Government to reduce its stock of outstanding payment orders to domestic suppliers by about $32 million, or one third. As in the past, the overall deficit was financed by concessional loans and grants.

2.21.1 GDP growth by sector



Sources: Asian Development Outlook database; staff estimates.

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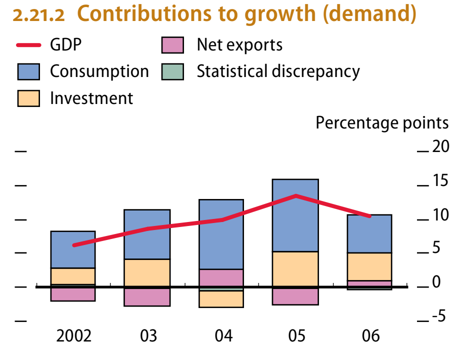
2.21.2 Contributions to growth (demand)



Sources: Asian Development Outlook database; staff estimates.

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In a sign of growing confidence in Cambodia's nascent financial system, broad money (M2) growth accelerated by 38% in 2006, largely on the back of a 54% surge in credit to the private sector and a 32% jump in net foreign assets of the banking system.

The private credit surge was fueled essentially by greater demand for loans for construction, real estate, and wholesale and retail trade, though an increased number of small and medium enterprises also borrowed for business expansion. The increase in net foreign assets of the banking sector reflected a more favorable external balance, and receipts from IMF's Multilateral Debt Relief Initiative.

In line with the stronger fiscal performance, the Government did not need to tap domestic banks to finance the budget deficit. The central bank continued to intervene in the foreign exchange market to stabilize the riel, which appreciated by 1.3% in 2006 to 4,061/$1 by year-end.

Inflation slowed by about 1 percentage point to average 4.7% in 2006. Its fall was mainly a consequence of more moderate rises in food prices, as rice production increased and world market prices for rice stabilized. An easing of international oil prices in the last quarter of 2006 also helped. Year-end inflation at 2.8% showed a downward trend moving into 2007 (Figure 2.21.4).

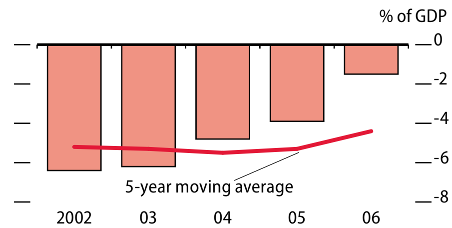
During 2006 merchandise exports expanded by an estimated 26.9%. Clothing shipments, which accounted for 72% of total exports, rose by 20.7% in value terms, despite stronger volume growth, reflecting lower unit prices as a result of stiffer global competition with the end of the Multifibre Arrangement. Exports of natural rubber rose sharply, but from a low base. Imports increased at a lower rate than exports (by 20.3%). The trade deficit, little changed from 2005 levels (Figure 2.21.5), was offset to some extent by significant growth in receipts from tourism, and the current account deficit (excluding official transfers) narrowed to 7.7% of GDP.

As in the past, the 2006 deficit was more than covered by concessional aid and inflows of FDI, leading to a larger overall balance-of-payments surplus. Gross international reserves of $1.1 billion at end-2006 provided about 2.8 months of import cover. External public debt was estimated at $3.3 billion or 46% of GDP, nearly 60% of which is owed to the Russian Federation and the US. Debt from those countries is not being serviced while it is being renegotiated. Most other debt is on highly concessional terms. The debt service ratio relative to exports of goods and services at end-2006 was low at 0.6% on a cash basis.

In policy developments, the Government continued to adopt laws and regulations, both to enhance private-sector activity and to fulfill its World Trade Organization (WTO) commitments. A new law on commercial arbitration provides for a mechanism for alternative dispute resolution and efforts are under way to set up a national arbitration center. The Government also adopted a licensing review plan that would pave the way to remove duplicate and unnecessary licenses affecting businesses.

Progress was also made on financial sector reforms. With a view to reducing the cost of borrowing and improving financial intermediation, a credit information system was introduced, providing commercial banks with credit-related information on prospective borrowers.

2.21.3 Budget balance



Sources: Asian Development Outlook database; staff estimates.

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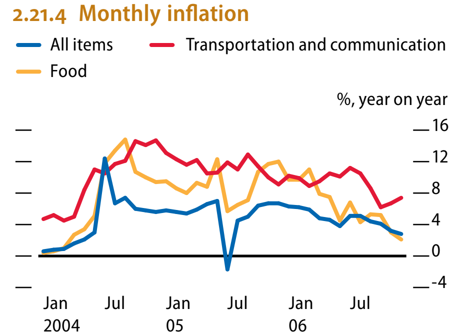
2.21.4 Monthly inflation



Source: National Institute of Statistics, available: http://www.nis.gov.kh, downloaded 28 February 2007.

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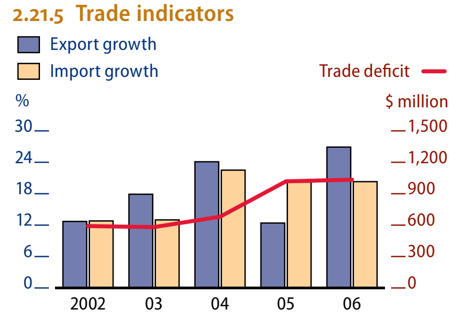
2.21.5 Trade indicators



Sources: Asian Development Outlook database; staff estimates.

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Legislation relating to negotiable instruments and payment transactions, which encompasses all noncash payment methods, was passed, and an online secured transaction filing system will be ready for launch some time this year. With a greater number of commercial laws being passed, arrangements are under way to adopt commercial law training material into the curriculum of universities for training lawyers, judges, and legal clerks.

The Government's public financial management reform program, launched in December 2004, also started to yield results, with an increasing proportion of customs and tax revenues being collected through the banking system, and a growing share of treasury payments to suppliers made by check instead of cash. The procurement process was streamlined and tightened, and the Government established internal audit departments in several ministries.

Economic prospects

The following forecasts are predicated on the Government continuing to implement its National Strategic Development Plan 2006–2010, which aims to achieve interim targets of the Cambodia Millennium Development Goals. Toward this end it is assumed that the Government will maintain fiscal discipline and will continue reforming the management of public finances to strengthen revenue collection and increase outlays on social sectors and rural infrastructure, in line with plan priorities. It is also assumed that the monetary authorities will continue to closely supervise the banking sector to ensure that rapid increases in domestic credit do not give rise to balance sheet problems in the banking sector that could undermine the financial system.

In structural reforms, the forecast presupposes that the Government will continue to implement both policies that follow from the country's membership of WTO, and reforms to increase agricultural productivity. The outlook assumes normal weather conditions over the next 2 years, and that Cambodia will not be subject to an economically disruptive outbreak of avian flu.

Based on these assumptions, GDP growth is projected at 9.5% in 2007 and 9.0% in 2008 (Figure 2.21.6). Agriculture is expected to expand gradually because of productivity gains, reflecting an increase in the area under irrigation, the use of improved agricultural inputs, and greater commercialization in farming. With the maintenance of safeguard measures by the EU and US against PRC clothing exports during this period, Cambodia's clothing industry is likely to grow, but at slower pace than in recent years. This deceleration will be attributable to competition from lower-cost producers, including Viet Nam, which joined WTO in January 2007, and slower growth in world trade and in industrial country growth, particularly the US (Cambodia's largest market).

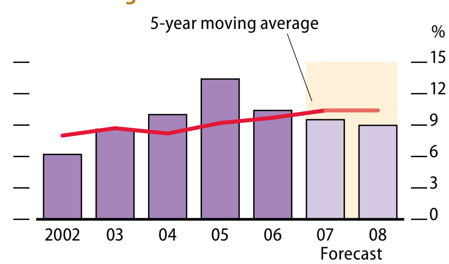
Construction activity is likely to keep expanding with planned construction of a new town, bridges across the Tonlé Sap and Mekong rivers, and a number of special economic zones. These zones will be on Cambodia's borders with Thailand and Viet Nam, where they can take advantage of lower-cost electricity from those countries and transport costs also will be lower.

2.21.1 Selected economic indicators

	2007	2008
GDP growth	9.5	9.0
Inflation	4.2	3.5
Current account balance (% of GDP)	-8.6	-10.1

Source: Staff estimates.

2.21.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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Tourism growth also is projected to continue: tourist arrivals have increased by an average of 25% over the past 5 years (Figure 2.21.7). On the demand side, domestic economic activity looks set to remain upbeat, underpinned by rising rural incomes, by increased inflows of FDI as the economy becomes more commercially oriented and as oil exploration attracts investment (oil and gas were discovered offshore in 2005; Box 2.21.1), and by higher government capital spending on the back of an improved revenue performance.

Inflation is projected to moderate to 4.2% in 2007 and to 3.5% in 2008 (Figure 2.21.8), provided that farm output expands as expected and the world market price for rice and oil are fairly stable. Year-end inflation is likely to decelerate to 3.5% and to 3.0%, respectively. The expected maintenance of a prudent fiscal policy, with no recourse to domestic bank financing, and a broadly stable exchange rate would assist in damping price pressures.

Export demand will moderate as a result of the expected slowing in growth of clothing shipments. Agricultural exports, particularly non-rice crops and fisheries, are projected to expand owing to efforts to promote processing of food products and increased commercialization of the sector. However, due to a low base, such export growth is unlikely to have a significant near-term impact on export values. Exports of tree crops such as rubber are also likely to expand, in part due to robust demand for raw materials from the PRC. Here as well, though, the production base is low, resulting from years of neglect of the sector.

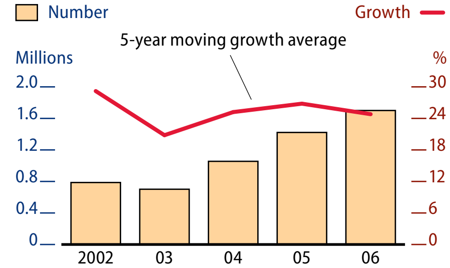
The import intensity of investment projects is likely to mean that import growth exceeds export growth, widening the trade gap and pushing the current account deficit out to 8.6% in 2007 and 10.1% in 2008 (Figure 2.21.9). Continued inflows of concessional loans and grants will partially offset the gap. They will be reinforced by expected higher inflows of FDI for investments related both to nonextractive industries, and to the search for oil, gas, and mineral resources such as bauxite, copper, and gold. Gross international reserves are forecast to be around 3 months of imports in 2007 and 2008.

Development challenges

Robust growth over the past decade and structural reforms have led to a steady decline in the overall incidence of poverty from an estimated 47% in 1994 to a still-high 35% in 2004. The gains have been widespread but not uniform, with the incidence of rural poverty remaining stubbornly high at around 39% and income disparities increasing between rural and urban areas.

An important contributory factor is that economic growth has been narrowly based on clothing and tourism, both of which are urban focused with limited linkages to the rural economy. Moreover, prospects for Cambodia's clothing industry are uncertain. Its manufacturers will face sharper competition for global clothing markets as a result of the accession of Viet Nam to WTO and the scheduled removal in 2009 of safeguard measures against PRC clothing exports to the US. Viet Nam's clothing exports to the US previously came under quota restrictions; the value of items subject to quotas overlapped with 88% of the value

2.21.7 Tourist arrivals



Source: Ministry of Tourism, available: http://www.mot.gov.kh, downloaded 28 February 2007.

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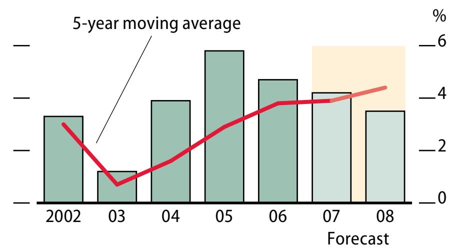
2.21.8 Annual inflation



Sources: National Institute of Statistics, available: http://www.nis.gov.kh, downloaded 28 February 2007; staff estimates.

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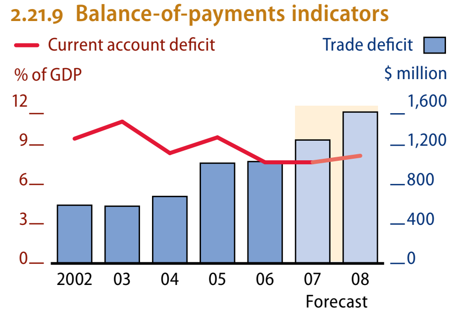
2.21.9 Balance-of-payments indicators



Sources: Asian Development Outlook database; staff estimates.

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of Cambodia's total clothing exports to the US. Moreover, the value of existing safeguard measures against PRC clothing exports to the US overlaps with 70% of the value of Cambodia's garment exports to the US.

Supported by development agencies, the Government has been addressing these challenges through institutional and policy reforms. The unfinished agenda, however, remains large.

In agriculture, the state has pursued a policy of increasing irrigation and land titling to lift productivity. These policies are beginning to yield results, but various deficiencies are threatening to undermine progress. In the area of land management—identified in the National Strategic Development Plan as fundamental for development and poverty reduction—regulations to implement crucial elements of the Land Law passed in 2001 have still not been approved, while some regulations that have been approved are not being implemented as planned. This has resulted in land conflicts, lost livelihoods, a further concentration of wealth, and worsening rural poverty and income inequality.

For the private sector, changes have been made in recent years to reduce the cost of doing business and to improve the business climate through trade facilitation measures and reductions in the cost and time associated with business registration. But little progress has been made to approve the Law on Concessions, which has been before the National Assembly since 2005 and is intended to improve transparency in the management of state assets and to promote private participation in infrastructure.

Progress has also been slow in legal and judicial reform, hindering the effective implementation of laws and forcing the private sector to operate according to uncertain market rules.

2.21.1 Oil and gas discovery

The discovery of oil and gas holds out hope for a substantial injection of revenue into the government budget. Exploration is at an early stage, but some estimates suggest that one of six offshore exploration areas could contain as much as 700 million barrels of oil. That could produce a revenue flow for the Government from this block alone of an estimated \$750 million–\$1 billion a year at full production, or roughly of the same order of magnitude as total revenues collected in 2006.

If significant amounts of oil or gas are brought into production, funding for poverty reduction and for development of social and economic infrastructure would be boosted in the medium term.

However, international experience also shows there is a need to guard against the phenomenon of a natural resource curse, where oil wealth leads, paradoxically, to economic stagnation and political instability. This can happen because hydrocarbons production rarely generates much employment, benefits mainly urban areas, can spur inflation and currency overvaluation, and can create more opportunities for corruption.

Such developments could erode the competitiveness of domestic agriculture and manufacturing, sectors that employ many Cambodians. Consequently, diversification of sources of growth, especially in rural areas, becomes a high near-term priority to ensure broad-based development and to avoid the possible damaging economic effects of natural resource wealth.

Effective legal and institutional safeguards are also needed, to ensure that the state collects and spends such wealth for the benefit of all.

Indonesia

Moderate economic growth last year was based on private consumption and exports, while fixed investment growth dwindled. Inflation eased from high levels as the year progressed, enabling a reduction in interest rates. The economy is expected to pick up in 2007 and 2008, supported by greater development spending and some improvement in the investment climate. There is a window of opportunity to accelerate reforms, which would pave the way for a significant lift in investment, in turn making headway on job creation and poverty reduction.

Economic performance

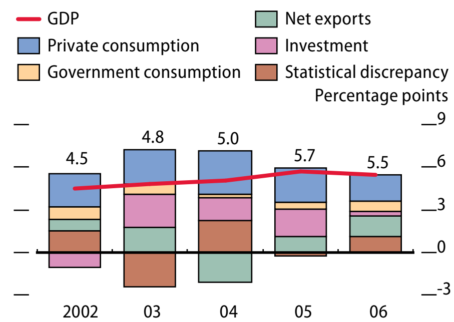
The economy grew by a modest 5.5% in 2006, slightly faster than average expansion over the previous 3 years. In line with recent trends, private consumption made the major contribution to overall GDP growth (Figure 2.22.1), even though spending slowed after the October 2005 reduction in fuel subsidies, which pushed up inflation and interest rates until well into 2006. Sales of motorcycles, a good barometer of confidence, fell by 12% in 2006, and auto sales collapsed by 40%. For all of 2006, growth in private consumption decelerated to 3.2%, from 4.0% a year earlier.

Net exports also made a significant contribution to overall growth. Exports surged by 9.2%, supported by buoyant world trade and high global prices for Indonesia's commodities such as crude oil, natural gas, minerals, and palm oil. Import growth slowed sharply to 7.6%, in part a result of weak investment for most of the year. Fixed investment grew by just 2.9% in 2006, far below rates achieved in 2004 and 2005, although it perked up in the fourth quarter when inflation and interest rates eased. As a result, investment made a relatively small contribution to GDP growth.

The weakness in investment stemmed not only from higher borrowing costs but also continuing deficiencies in the business environment. Planned reforms on tax, investment, and labor laws were bogged down in the parliament. Both realized foreign direct investment and domestic investment fell by a third in 2006, to $6.0 billion and $2.2 billion, respectively. Investment approvals, on the other hand, rose, which indicated that investment could turn up soon. As a share of GDP, gross fixed capital formation in Indonesia last year was 24%, up slightly from 2005 (Figure 2.22.2).

By sector, services continued to grow faster than agriculture and industry, and contributed 3.0 percentage points of the total 5.5% GDP growth (Figure 2.22.3). Transport, telecommunications, and domestic trade services performed strongly. Construction, part of the industry sector, grew by 9%, supported by a property market boom in many cities. Industry's contribution to GDP growth was 2.1 percentage points. Growth in manufacturing was moderate but mining growth was low, despite the country's wealth of mineral resources and high world prices for these

2.22.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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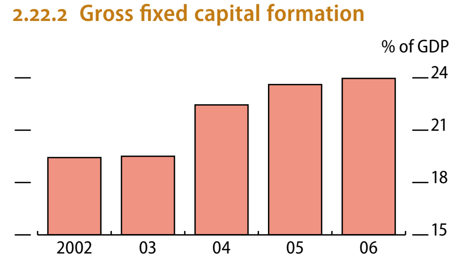
2.22.2 Gross fixed capital formation



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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commodities. A manifestation of weakness in the natural resources sector is Indonesia's continuing status as a net oil importer: crude oil production fell by 8% to 860,000 barrels a day by end-2006, and is down nearly 31% from 2001. Agriculture was hurt by drought in many parts of the country, although it continued to expand and contributed nearly a half percentage point to GDP growth.

Inflation eased from the rapid pace of above 17% in January, to around 7% late in the year as the impact of the 2005 raising of fuel prices faded (Figure 2.22.4). Bank Indonesia, the central bank, lifted its policy interest rate in 2005 to counter the upward pressure on prices. By May 2006, it was able to start reducing the policy rate, and by year-end had cut it by 3.0 percentage points to 9.75%. High interest rates and low levels of investor confidence led to a slowing in credit growth to 12.5% in 2006 from 29% a year earlier. While the central bank lowered its policy rate from May, commercial banks did not cut their lending rate to the same extent owing to perceptions of risk. Indicative of this, gross nonperforming loans increased from 8.3% of total loans at end-2005 to 8.6% in November 2006.

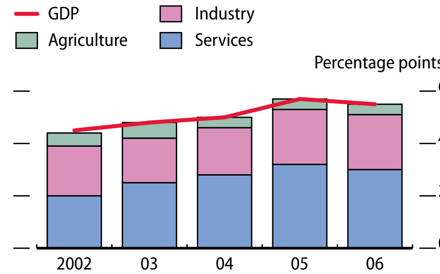
Much of the increase in nonperforming loans since 2004 has been due to operational and governance problems at state-owned banks. Consequently, the adoption in October 2006 of a regulation allowing state banks to restructure and dispose of such loans helped bring down the ratio to 7.0% by year-end. In early 2007, Bank Indonesia cut its policy rate in February and again in March, to 9.0%.

Citing improvements in the country's fiscal management and the Government's efforts to deal with corruption, international rating agencies Moody's and Fitch uprated Indonesia's outlook in early 2007 to positive from stable, though the sovereign rating remains below investment grade. Foreign portfolio investment inflows picked up last year. The Government issued $2.0 billion in international bonds in 2006 and $1.5 billion in February 2007. Stock prices soared, with the market index up by 55.3% in 2006, and market capitalization rose to the equivalent of about 40% of GDP from around 30% in 2005.

On the external front, the strength in merchandise exports (up 18.1% in nominal US dollars) and moderate rise in imports (up 5.1%) propelled the trade surplus 69.5% higher to $29.7 billion. Trade in services remained in deficit, to the extent of $11.2 billion, largely the result of rising imports of construction and financial services. The current account surplus rose to $9.6 billion (Figure 2.22.5), or 2.6% of GDP. Foreign reserves reached $42.6 billion, equivalent to about 7 months of import cover. These developments supported the rupiah, which appreciated by 9% over 2006 to end the year at Rp9,150/$1.

Overall, the economy's vulnerability to external shocks has been decreasing, reflecting sound debt management. The ratio of total external debt to GDP fell from 46.1% in 2005 to just under 34.0% in 2006. The debt service ratio rose to above 20% from 15.5%, primarily because of the early repayment of $7.8 billion owed to the International Monetary Fund and the end of a postponement on debt servicing that had been granted by the Paris Club to help the country handle its December 2004 earthquake and tsunami disaster. Public debt was reduced to 42.4% to GDP in 2006 (Figure 2.22.6).

2.22.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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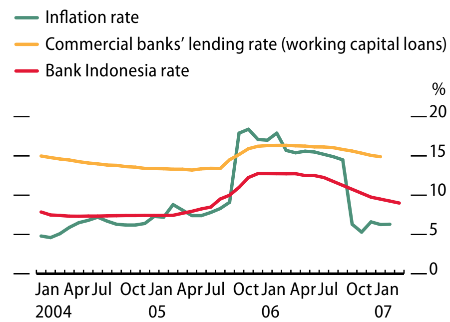
2.22.4 Interest and inflation rates



Sources: International Monetary Fund, *International Financial Statistics* online database, available: http://ifs.apdi.net, downloaded 26 February 2007; Bank Indonesia, available: http://www.bi.go.id, downloaded 14 March 2007.

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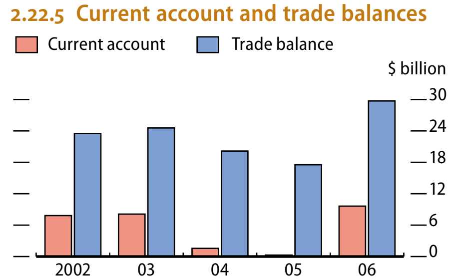
2.22.5 Current account and trade balances



Sources: Asian Development Outlook database; Bank Indonesia.

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The Government pressed ahead with its aim to contain the fiscal deficit and redirect public expenditures to development and social goals. The realized fiscal deficit in 2006 was 1.0% of GDP, against a planned level of 1.3% (Figure 2.22.7). Total national public expenditures—at all levels of government—have risen steadily over the past 8 years, and at an accelerated pace in 2004–2006.

As a proportion of GDP, national public expenditures rose from about 19% in the years 2003–2005 to about 20% in 2006. The cost of subsidies, mainly for fuel and electricity, increased to 4.4% of GDP in 2005, and then declined to 3.2% last year. The October 2005 hikes in fuel prices cut about $10 billion a year from subsidies. Fiscal space generated by these cuts has enabled the Government to increase fiscal transfers to the regions from 5.6% of GDP in 2005 to an estimated 7.4% in 2006. Overall development expenditures are estimated to have risen by 1 percentage point to 7% in 2006.

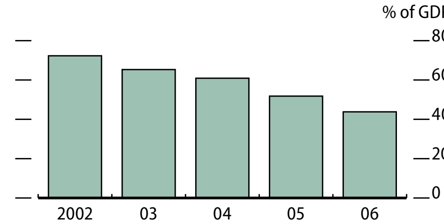
At the central government level, there is a clear effort to redirect spending. Education outlays rose by 34% in real terms last year. They accounted for 17.2% of total government spending and stood at 3.6% of GDP. However, health and infrastructure expenditures remain low, with health less than 1% of GDP in 2006 and new public infrastructure investment below 3%.

Although fiscal transfers to the regions have gone up substantially, the funds often are not spent because of severe capacity limitations. As of November 2006, the regions were estimated to hold the equivalent of almost $10 billion (3.1% of GDP) in cash deposits. The central Government is rolling out a community-designed development program that could become a vehicle for lifting spending by local governments. The program will provide resources to communities to undertake locally executed small-scale public works projects.

While macroeconomic stability has been restored, much remains to be done to combat unemployment and poverty. The moderate pickup in economic growth since 2001 has not been enough to reverse a persistent increase in unemployment from below 9% to an estimated 10.3% over this period (Figure 2.22.8). Underemployment, based on the Government's estimate, was about 21% in 2003. Consequently, about 42% of Indonesians live on $1–2 a day, leaving them particularly vulnerable to adversities such as ill health or natural disasters. National poverty incidence is estimated to have increased from 16% in 2005 to 17.8% in March 2006. The reduction in fuel subsidies certainly hurt many people, although it was cushioned by government cash payments that provided subsistence support for 19.2 million poor and near-poor households.

But what appears to have deepened poverty to a greater extent was a 33% rise in rice prices between early 2005 and early 2006, caused by lower output of the crop and the Government's reluctance to lift a ban on rice imports. After a prolonged debate in 2006 over the benefits to the poor of imports against possible damage to domestic growers, the Government imported rice from Viet Nam in the fourth quarter to shore up its buffer stock and stabilize prices. Late seasonal rains and drought in several parts of the country delayed rice planting and pushed up prices by a further 8% in December. The Government therefore imported more rice early this year.

2.22.6 Total government debt



Sources: Bank Indonesia, available: http://www.bi.go.id; Ministry of Finance, available: http://www.dmo.or.id, both downloaded 28 February 2007.

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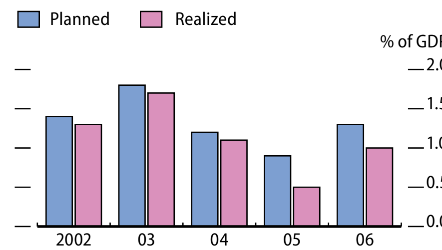
2.22.7 Fiscal deficit



Sources: Asian Development Outlook database; Ministry of Finance, available: http://www.fiskal.depkeu.go.id, downloaded 28 February 2007.

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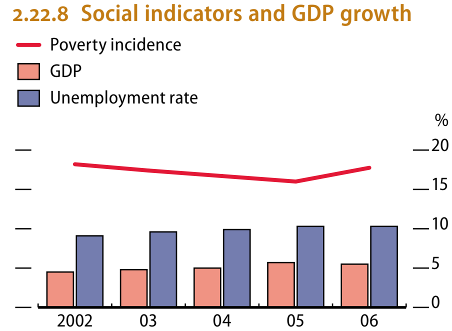
2.22.8 Social indicators and GDP growth



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd., downloaded 26 February 2007.

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Some progress was achieved on policy matters in 2006, but several important issues were not resolved. Government financial management was strengthened with a focus on improving tax and customs administration and on treasury reforms. The parliament enacted amendments to the Law on Customs, enabling customs procedures to be simplified and imposing stiffer penalties on smuggling. This law, and one on warehouse receipts that enables their use as collateral for financial intermediation, were the only noteworthy economic laws approved by the parliament.

Legislators did not resolve their differences over the more important laws on investment, tax, and labor market issues. The proposed investment law would clarify which sectors are open for foreign investment and simplify investment procedures. Proposed amendments to the income tax system would, among other changes, establish a single corporate income tax rate, phase down the maximum income tax rate for individuals, and cut the tax on dividends. The law also would (once on the statue books) provide tax incentives to investment in mining, oil, gas, and geothermal energy and to small and medium enterprises.

Proposed changes to labor legislation also stalled, as discussion continued to resolve the three main weaknesses of the 2003 Labor Law: there is no role for negotiated wage settlements, instead allowing for ad hoc increases in minimum wages by regional administrations leading to unpredictable increases in labor costs; it mandates severance, or layoff, payments that are much larger than in comparable economies; and it limits the ability of employers to outsource tasks, even tasks that cannot be done locally.

The Government fell short of its 2006 privatization target, raising Rp2.5 trillion ($277.2 million), including Rp2.1 trillion through a 5.1% divestment in the state gas utility Perusahaan Gas Negara, against a budget target of Rp3.0 trillion. For 2007, the budget targets privatization receipts of Rp2.0 trillion.

Economic prospects

The Government is at the midpoint of its elected term, and the opportunity to implement reforms that could accelerate economic growth may be fairly brief because electioneering and positioning for 2009 parliamentary and presidential elections will probably start from about mid-2008. The following forecasts assume the administration will push harder in the next year or so to implement the policy measures already in place. They also assume that the Government will improve the legal and regulatory environment, and that regional governments will do a better job in spending transfers from Jakarta.

On this basis, economic expansion is projected to accelerate to 6.0% this year and 6.3% the next, rates of growth not seen since the mid-1990s (Figure 2.22.9). A gradual decline in interest rates will likely feed a recovery in bank lending to fuel growth in consumption and investment. The latter should also benefit from the recent strong export performance, as well as an anticipated pickup of manufacturing. A long list of planned infrastructure projects involving public-private partnerships was prepared by the Government in early 2005, but only a handful have been started.

2.22.1 Selected economic indicators

	2007	2008
GDP growth	6.0	6.3
Inflation	6.2	6.1
Current account balance (% of GDP)	1.0	0.7

Source: Staff estimates.

The focus now is on a shorter list of projects; some power, transport, and water supply projects are expected to get under way in 2007 or 2008. Gross fixed investment is forecast to climb to 25–27% of GDP over the forecast period. Spurred by investment growing at above 9% and consumption at 4.5%, GDP growth will likely be ratcheted up in 2008 by election-related spending.

In the external accounts, exports are forecast to decelerate to around 10% in nominal terms this year because of softer growth in major export markets. Imports, in contrast, will accelerate to meet the higher investment needs. The current account surplus is expected to decline to 1.0% of GDP in 2007 and 0.7% in 2008 (Figure 2.22.10).

Central government public expenditures are forecast to rise by 1.4 percentage points of GDP to 22.5% in 2007. In particular, development expenditures in nominal terms are budgeted to increase by 25%, or from 3.2% of GDP in 2006 to 3.6% in 2007. Spending looks likely to exceed budget projections for various reasons: January 2007 floods in Jakarta that killed over 80 people and caused extensive property damage; a hot mudflow from an East Java gas exploration site, which requires an estimated $833 million to clean; repairing earthquake damage in West Sumatra; and buying rice for buffer stocks. With these elements, the overall 2007 deficit is expected to be wider than the 1.1% of GDP forecast in the budget. Still, Government debt is projected to decline because of repayments and may yet reach the targeted 30–32% by 2009.

Inflation is projected to average just over 6% this year and next (Figure 2.22.11). However, these forecasts would need to be raised if the Government decided to reduce subsidies on electricity. A phased increase in power tariffs and a restructuring of the tariffs, so that each market segment paid the true cost of providing electricity, would be desirable, as it would free budget resources for more productive purposes. It would also encourage investment in power generation—the Government provided nearly $4 billion (1.4% of GDP) in subsidies to the state power generation utility in 2005 and an estimated $2.6 billion last year.

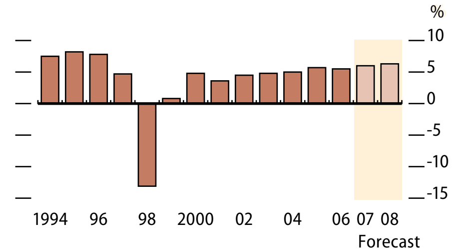
Two key domestic downside risks lurk: agricultural output and avian flu. Drought persists in parts of the country, while other areas have been flooded; and the El Niño weather phenomenon may return, which would cause drier than usual weather. Avian flu has already claimed more than 60 human lives in Indonesia, the largest death toll in the world, and agriculture has suffered from selective culling of poultry in many parts of the country and from bans on backyard poultry-keeping in urban areas.

An optimistic scenario for the next 5 years is that pending laws and regulations are enacted, encouraging private sector development and accelerating GDP growth to 7–8%. A gloomier scenario has the country faltering on implementation of policies and failing to unblock funding constraints at the regional level. In such an event, Indonesia would be locked into sub-6% growth.

Development challenges

The foremost challenge is to accelerate growth to a level that can create enough jobs to hold back the tide of unemployment and underemployment and reduce the vulnerability of the poor.

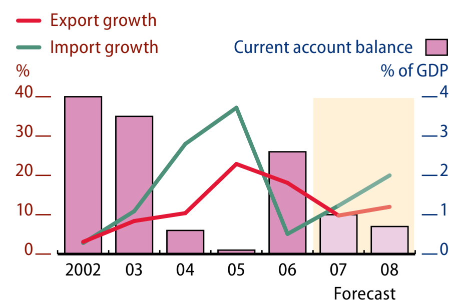
2.22.9 GDP growth



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd., downloaded 26 February 2007.

Click here for figure data

2.22.10 External indicators



Sources: Bank Indonesia; staff estimates.

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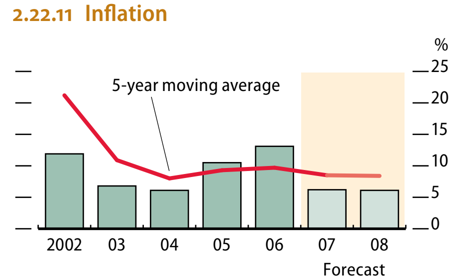
2.22.11 Inflation



Sources: CEIC Data Company Ltd., downloaded 26 February 2007; staff estimates.

Click here for figure data

Macroeconomic stability and sustained modest growth rates have been achieved in recent years through generally sound policy management, but little in the way of major structural improvements. Portfolio investment has been strong, partly a result of the surge in global liquidity, but direct, long-term investment is tepid.

Rankings of national competitiveness (Table 2.22.2) put Indonesia below many comparable economies in factors such as government efficiency, the business environment, and infrastructure quality. The Government has done much to prepare its reform agenda over the period 2003–2006. Effective implementation, though, has lagged. Attention to some vital issues would boost the outlook.

Finalizing and adopting the proposed investment and tax reform packages is vital. While the investment climate-related laws still pending in the parliament are likely to be enacted this year, a long delay and a continuing lack of clarity on institutional arrangements for investment coordination within the Government have undermined credibility. On the labor front, the authorities need to bring labor and business to the negotiating table to achieve consensus on ways to make the labor market more flexible, particularly with regard to outsourcing and payment for layoffs. In this regard, a proposed insurance-based system to fund such payments holds promise.

A significant increase in private investment also requires greater legal and regulatory certainty. The executive branch of the Government can play a key role in two ways. First, it can improve credibility by speaking with one voice, and adopting a concerted approach to resolving contract disputes. Several disputes between the Government and private investors have been protracted, damaging Indonesia's credibility. Second, greater coordination between executive, parliamentary, and judicial institutions, and between central and regional authorities, would be most useful. The judiciary should be adequately resourced and be able to look at the costs imposed by its rulings on the investment climate. Private investment would be encouraged if small and medium enterprises had better access to funding.

The plan to improve physical infrastructure needs a solid push. High-quality projects have to be prepared, and then bid out in a transparent manner. An effort now under way to prepare model projects requires support by all the ministries concerned. Civil service reforms are also needed (Box 2.22.1.).

Given Indonesia's vulnerability to natural disasters, another challenge is to enhance disaster management capabilities and risk mitigation. Better coordination and planning can help to reduce the impact on the population and the economy of calamities such as floods and earthquakes. Regional governments in particular need to use their increasing resources to build better roads and flood protection systems and to plan for the perhaps inevitable disasters.

2.22.2 World competitiveness rankings

Country	2001	2003	2006
China, People's Rep. of	26	29	19
India	42	50	29
Malaysia	28	21	23
Philippines	39	49	49
Indonesia	46	57	60
Number of countries/ regions ranked	49	59	61

Source: World Competitiveness Yearbook, 2006, published by IMD, Switzerland.

2.22.1 Civil service reforms

Attracting capable people to the civil service will take better incentives, merit-based entry, and a more performance-oriented culture.

Public agencies sometimes perform similar functions with unclear mandates. For instance, there are numerous agencies with different responsibilities on civil service management.

In the audit area, the supreme audit institution has the legal mandate, but inadequate human resources, while an internal government agency with no clear mandate on audits has hundreds of well-qualified auditors. Local governments that are entrusted with severe public resources have huge capacity constraints.

Some ministries, such as finance, are moving to strengthen their organizational structure and improve capacity. This needs to be replicated across the whole government bureaucracy.

Civil service reforms would help the Government sustain its anticorruption efforts.

Lao People's Democratic Republic

Foreign investment in hydropower and mining, together with rising exports of minerals in 2006, continued to drive double-digit growth in industry, the major contributor to GDP growth. Inflation slowed to levels not seen since 1994. However, progress was slow on reforming fiscal management and on improving the climate for private investment. Economic growth is projected to decelerate moderately this year.

Economic performance

Growth accelerated to 7.3% in 2006, to average 6.5% over the past 5 years. Robust growth over the period is largely attributable to industry, particularly the development of hydropower projects and gold and copper mining. Industry registered double-digit growth over the period (13% last year), expanding to account for 31% of the economy (up 10 percentage points in a decade). It was the largest contributor to total GDP growth in 2006 (Figure 2.23.1). Services grew by 5.5% and agriculture by 3.3%. Actual gross foreign direct investment (FDI) increased by 30% to $650 million, driven by large investments in the Nam Theun 2, Nam Ngum 2, and Xe Kaman 3 hydropower projects and in mining.

While growth picked up, average inflation eased to 6.8% in 2006, the lowest rate in 12 years (Figure 2.23.2). Rice output recovered after being hit by floods—and this helped slow inflation.

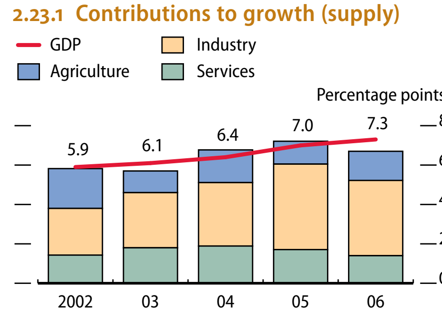
The kip appreciated against the US dollar by 5.2% using average exchange rates for 2005 and 2006, but the currency weakened slightly against the Thai baht (Figure 2.23.3). The Bank of the Lao People's Democratic Republic (Lao PDR) could be expected to take steps if needed to prevent any sharp decline against the baht, owing to the importance of Thailand as a supplier to the country.

Merchandise exports in nominal terms soared by an estimated 51% in 2006 as a result of both higher prices and export volumes of minerals. Over the past 5 years, exports have averaged 23% growth. Imports have been boosted by foreign inputs for hydropower and mining projects. In 2006, imports grew by 13.5% and are expected to accelerate further this year. The current account deficit widened to 14.0% of GDP. External reserves, at about $300 million, were buoyed by higher mining exports and FDI. Reserves equal 3.3 months of imports of goods and services.

The overall fiscal deficit (excluding grants) narrowed to about 5.7% of GDP in FY2006 (ended 30 September 2006) from 6.0% in FY2005 (Figure 2.23.4). Revenue collection (chronically a weak link in the budget) increased partly because tax collection functions were moved back to the central Government from the provinces. Also, a new tax law that came into effect in 2005 widened the tax base and increased receipts from large projects and tourism.

However, revenues are still hampered by tax exemptions and by lackluster collection of nontax items. Overall, the fiscal position remains

2.23.1 Contributions to growth (supply)



Sources: National Statistics Centre, available: www.nsc.gov.la, downloaded 21 February 2007; staff estimates.

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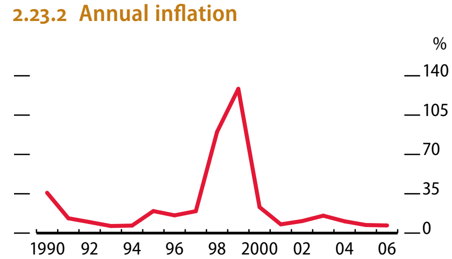
2.23.2 Annual inflation



Source: National Statistics Centre, available: www.nsc.gov.la, downloaded 21 February 2007.

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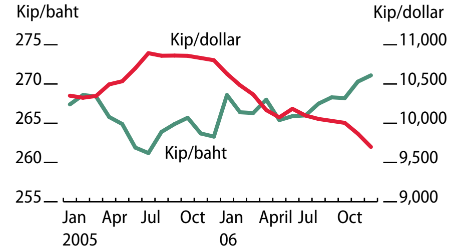
fragile. Expenditures were generally below allocations in FY2006, especially on the capital side. Overambitious revenue projections compelled the Ministry of Finance to maintain strict cash management of actual budget allocations. This approach has enabled the Government to rein in the overall budget deficit to levels required to maintain macroeconomic stability, but it may well delay planned expenditure. External public debt was estimated at $1.6 billion (46% of GDP) at end-2006. Much of the debt is owed to multilateral development banks and the Russian Federation on concessional terms.

Efforts were maintained to improve the performance of state-owned enterprises (SOEs). Restructuring of large SOEs continued in 2006 with draft external audits done on four of them. Restructuring plans were prepared on another five. The aim is to promote their commercial viability so as to reduce the funding burden on the budget and on state-owned banks. While SOEs are now less important in terms of their contribution to the economy and employment than a decade ago, they still generate a large share of nonperforming loans (NPLs), which risks the stability of the banking system.

On the fiscal reform front, the National Assembly passed several tax enhancements and a value-added tax is scheduled to come into effect in late 2007. More needs to be done, though, to implement these measures and to more broadly lift efforts to raise revenues (now equivalent to 12.5% of GDP) and reform state-owned banks.

The Government approved the Sixth Socioeconomic Development Plan 2006–2010 in July 2006. It aims to achieve annual average GDP growth of 7.5–8% over the 5 years with agriculture and forestry increasing by 3–3.4%, industry by 13–14% and services by 7.5–8%. GDP per capita is targeted to increase to $700–750. Inflation is envisaged to average 6–6.5% a year.

2.23.3 Exchange rates



Sources: International Monetary Fund, *International Financial Statistics* online database; Bloomberg; both downloaded 7 February 2007; staff estimates.

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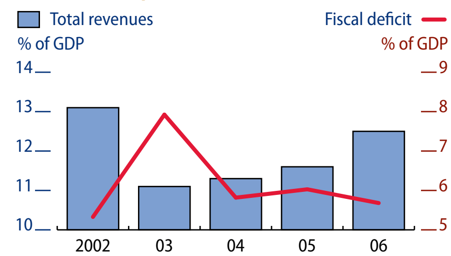
2.23.4 Fiscal performance



Sources: International Monetary Fund, *Lao People's Democratic Republic: Selected Issues and Statistical Appendix*, November 2006; staff estimates.

Click here for figure data

Economic prospects

Projections for 2007 and 2008 assume that the Government will accelerate structural reforms and meet targets of the Development Plan. As it pursues membership of the World Trade Organization, the Government is expected to improve the climate for investment and trade. The outlook also assumes further economic integration into the subregion—driven by the ASEAN Free Trade Area (AFTA) and other regional initiatives—which should lead to improved transportation links, facilitate trade and investment, and promote tourism with neighboring countries. FDI inflows are projected to remain buoyant, with new investment in rubber plantations, contract farming, and in tourism.

On the downside, global prices of gold and copper are likely to stabilize after sharp gains over recent years. Economic growth is projected to slow in most of the Lao PDR's export markets, including the People's Republic of China, European Union, Thailand, and the United States. Taking into account these influences, GDP growth is projected to slow by a half percentage point to 6.8% this year. Projected lower year-average global prices of fuel and food will bring down inflation to about 5%.

Exports of clothing to the US are increasing, but this industry is constrained by Lao PDR's high transportation costs and need to import much of its raw materials for clothing. While total exports will

2.23.1 Selected economic indicators

	2007	2008
GDP growth	6.8	6.5
Inflation	5.0	5.2
Current account balance (% of GDP)	-15.3	-13.1

Source: Staff estimates.

remain strong, the merchandise trade deficit is projected to widen as a consequence of increased imports required for mining and hydropower projects. Imports of consumer items are also expected to increase as a result of reductions in tariffs required by AFTA commitments. In services, tourist arrivals rose by 15% to an estimated 1.3 million in 2006 and are projected to reach 1.6 million in 2008 (Figure 2.23.5).

The current account deficit will remain substantial in the forecast period. Inflows of grants and FDI should cover the external financing requirement.

Domestic risks to the projections include a possible resurgence of avian flu, which could undermine growth in tourism and agriculture, and put an additional strain on the budget. The slow pace of reforms also puts the economy at risk. Unless improvements continue in the trade and investment climate, the growth outlook will weaken. The main risk on the fiscal side is that revenues from natural resources may be seen as a substitute for undertaking difficult reforms to mobilize nonresource revenues, limiting the improvement in the overall revenue effort and making fiscal consolidation more difficult.

Development challenges

Solid rates of economic growth have reduced income poverty, though more attention is needed to ensure that growth generates the Development Plan's target of reducing the number of poor households to below 15%, and creating 652,000 additional productive jobs during 2006–2010. Exploiting hydropower (Box 2.23.1), minerals, and forestry resources can maintain GDP growth, but these activities have limited capacity to generate employment.

The population is relatively young and is expected to grow at about 2% annually. Thus, development of commercial agriculture and labor-intensive services should be a high priority if new entrants are to be absorbed into the labor force. Agriculture, which employs about 80% of the population, remains vital to development that lifts more people out of poverty. An improved climate for small and medium enterprises would diversify income sources, add value to agriculture production, and provide steady employment.

The country looks likely to meet its Millennium Development Goals in income poverty reduction. However, some nonincome targets related to basic education, maternal health, child nutrition, and access to clean drinking water may be beyond reach. Although coverage of basic services is improving, service quality and affordability are problems, and several regions are underserved.

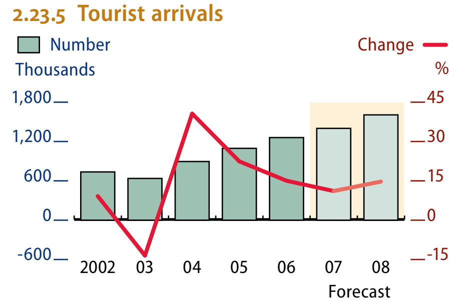
Fiscally, financial management and reporting systems require further strengthening. Government efforts to mobilize revenues have yet to reach expectations and tax administration requires strengthening. Development of much-needed private sector activity requires greater legal enforcement, more efficient business license requirements, and clarity on property rights. Much work remains to be done on restructuring SOEs and state-owned commercial banks.

2.23.1 Power and growth

Growth will continue to be supported by construction of the big 1,070-megawatt (MW) Nam Theun 2 hydroelectric project—which began in 2005 and is expected to be completed in 2009—and further expansion of gold and copper production. An energy cooperation agreement signed with Cambodia in 2006 looks likely to lead to a purchase agreement.

Thailand, the main consumer of Lao PDR–generated electricity, is preparing to sign new purchase agreements for power. Additional purchase agreements are expected because the 250 MW Xe Kaman 3, the 70 MW Xe Set 2, and the Nam Ngum 2 hydropower projects are scheduled to start production during 2009–2012. New mines are also due to get under way in the medium term.

2.23.5 Tourist arrivals



Source: Lao National Tourism Administration, *Statistical Report on Tourism in Laos*, 2004, 2005.

Click here for figure data

Malaysia

Consumption spending produced a pickup in growth in 2006. Private and public investment also strengthened with support from the Ninth Malaysia Plan. Growth is projected to slow by about a half percentage point in 2007 as export markets soften and both household spending and private investment decelerate. Higher government investment is expected over the Ninth Plan period as the Government encourages firms to climb the value chain, but constraints such as gaps in skills will need to be overcome for private investment to follow.

Economic performance

The economy grew by 5.9% in 2006, largely because of robust consumer spending (Figure 2.24.1). Private consumption continued to be a driver, rising by 7.0% and accounting for 3.5 percentage points of total growth. Last year was the fourth in a row that private consumption rose faster than GDP. Low, though rising, interest rates and favorable terms of trade for agricultural exports such as natural rubber (raising rural incomes), supported household spending.

Strong consumer spending encouraged business investment, which helped push growth in private fixed capital investment to 11.1% in 2006. Higher business confidence also stemmed from several years of robust exports and expectations of higher government spending following publication of the Ninth Malaysia Plan (2006–2010), which commits the Government to large development programs over the 5 years (Box 2.24.1 below). In the first year, public investment rose by 5.4% after much weaker spending in previous years. Total investment (including changes in inventories) contributed 1.7 percentage points of GDP growth.

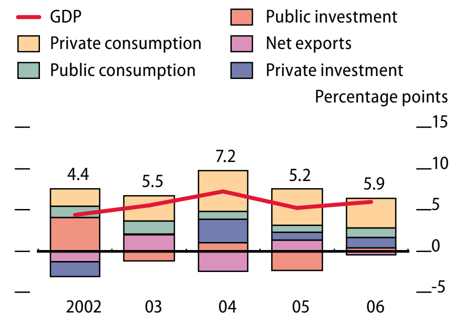
On the production side, agriculture represents less than 10% of GDP, but is important for rural incomes and for exports, and as a basis for large and growing agroindustry subsectors. Growth in 2006 of 6.4% (Figure 2.24.2) represented a longer-term supply response to high international prices for crops, such as rubber and palm oil, and better weather than seen in 2005.

Industrial output rose by 5.3% in 2006, but this masks a combination of strong manufacturing growth (up 7.0%) with continued weaknesses in mining (down 0.2%) and construction (down 0.5%). Mining, at 6–7% of GDP, consists mainly of oil and natural gas production. Output of hydrocarbons in 2006 was hindered by shutdowns of production facilities for scheduled maintenance.

Construction contracted for a third year in a row, although it appeared to be stabilizing during 2006, perhaps in response to the startup of Ninth Plan projects. Manufacturing makes up a third of the economy and has been growing rapidly, supported by export-oriented sectors including electrical and electronic products.

Services account for more than half the economy and grew by 6.6% in

2.24.1 Contributions to growth (demand)



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

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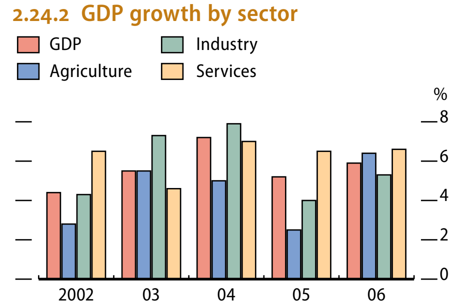
2.24.2 GDP growth by sector



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.

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2006, paced by finance- and trade-related businesses. Total employment rose by 2.5% in 2006 and the unemployment rate steadied at 3.4%.

Pushed by higher international energy prices, consumer prices rose by 3.6% in 2006 after 3.0% in 2005. Inflation peaked in the first half of the year after hikes of 18–24% in administered retail fuel prices in February 2006. (Malaysia is a net exporter of oil and gas and the Government subsidizes retail energy.) Before the sharp price rises in February, retail diesel and gasoline prices were little different from the equivalent costs of crude oil, with production and distribution costs subsidized. After the price rises, the remaining subsidies were estimated to be equivalent to 28% of average retail prices and totaled roughly RM19 billion, or about 14% of federal government spending. Cost pressures, while slower in the second half of 2006, were still apparent later in the year, as, for instance, electricity prices were hoisted in June by an average of 12%, depending on the category of user.

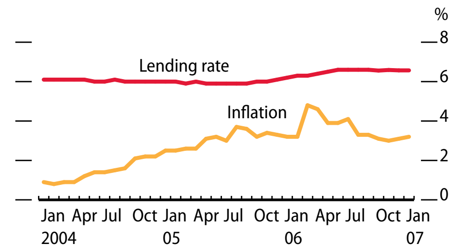
The inflationary pressures prompted increases in interest rates, although monetary policy remains broadly accommodating to growth. Bank Negara Malaysia, the central bank, raised its overnight policy rate from 2.7% to 3.5% in three separate actions between November 2005 and April 2006, and has kept it unchanged since. Lending interest rates have been above comparable inflation rates (Figure 2.24.3). The rise in the overnight policy rate lifted most short-term deposit rates so they were narrowly positive in real terms as inflation moderated. In 2006, broad money (M2) rose by 16.6%, little different from 2005 (Figure 2.24.4).

Malaysia's decision in mid-2005 to move off the fixed peg for the ringgit allowed some flexibility in monetary policy in 2006. The ringgit appreciated by 7.0% from the start of 2006 to year-end against the US dollar. This was somewhat more than the movement of the yuan, but it was less than for other Southeast Asian currencies. The smooth shift to a managed float from a US dollar peg and the steady appreciation relative to the US dollar have enhanced the credibility of the monetary authorities and reduced market concerns of sudden currency revaluations.

Fiscal policy has balanced meeting a longer-term goal of cutting government borrowing with a more immediate concern of encouraging growth. The fiscal deficit has been lowered from above 5% of GDP in the early part of this decade to 2.6% in 2006. As a net hydrocarbons exporter, high international energy prices provide a cushion for government spending. In 2006, a $1 per barrel rise in the price of crude oil corresponded to RM228 million ($62 million) higher oil-related revenues. Such revenues represented 37% of central government income; however, remaining retail fuel subsidies could absorb up to one quarter of these receipts.

The external sector lowered GDP growth by 0.4 percentage points in 2006 because growth of imports (in dollar terms) at 24.5% outpaced that of exports of 16.9% (Figure 2.24.5). Total exports still exceeded imports, supported by strong growth in electronic and electrical goods (constituting about half of merchandise exports) and rising prices for oil, gas, and some agriculture products. Imports are linked closely to exports, with intermediate imports making up about 70% of the total. These imports grew apace with exports, while imports for consumer goods grew faster, responding to strong household demand.

2.24.3 Lending rate and inflation



Note: Lending rate is the average for commercial banks.
Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.
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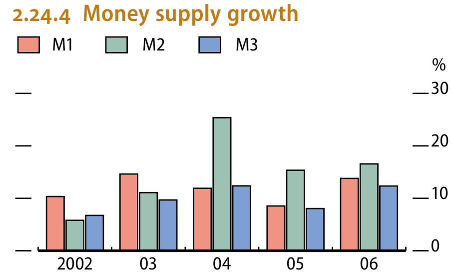
2.24.4 Money supply growth



Source: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007.
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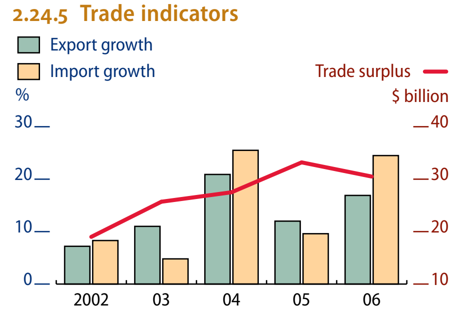
2.24.5 Trade indicators



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.
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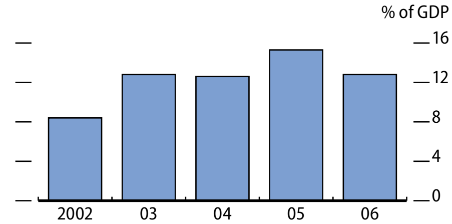
Owing to the smaller merchandise trade surplus, the current account surplus fell slightly to $19.6 billion or 12.8% of GDP (Figure 2.24.6). The deficit on net services exports widened a little. International reserves climbed to $82.2 billion, equivalent to seven times external debt falling due within 12 months.

2.24.6 Current account balance



Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

Click here for figure data

Economic prospects

The economy is projected to grow by 5.4% in 2007, a half percentage point slower than in 2006, based on the assumption that the external environment will be less supportive. Likely continued moderate appreciation of the ringgit (similar to the appreciation against the US dollar in 2006) will also diminish gains from exports in dollar-denominated markets. The deceleration in export growth will, however, also lower import demand (for intermediate products), mitigating the larger impact on the domestic economy.

Although prices for export commodities might soften, they will likely still be stronger than expected a few years ago, and current expectations are for commodity prices to stay high enough to merit new investment in oil and gas projects as well as rubber and palm oil (Figure 2.24.7). Overall, real private investment is expected to expand at a more moderate 7.7% pace in 2007 compared with 2006. Investment by the public sector, though, is forecast to pick up, encouraged by the Ninth Plan.

Surveys late in 2006 suggested rising consumer confidence, in line with growing incomes and receding inflation. Consequently, private consumption spending will continue to support growth, but not as strongly as in recent years as trends in expenditure move back in line with the larger pattern of national income growth. This slowing in household spending, an assumed moderate appreciation of the ringgit against the US dollar, and lower global oil prices than in 2006, point to inflation decelerating to about 2.7% in 2007.

The growth of monetary aggregates stepped up in the second half of 2006, so for the monetary authorities it will be important to carefully balance accommodating growth with discouraging any buildup of inflationary expectations. Pressure on the ringgit to appreciate, manifested especially in the buildup of foreign reserves, complicate this balancing act.

By industry, construction is expected to expand as a result of increased investment, especially by the public sector. House construction may soften though, because approvals for housing trended down last year. Mining (largely oil and gas) is set to expand as projects started earlier come on stream. Manufacturing and services will show some slowdown in output growth, especially in segments that rely on overseas trade. Agriculture will benefit from continuing opportunities to supply products such as rubber and palm oil to export markets, but also from structural changes, such as the growing role of supermarket supply chains that can better link higher value-added urban markets to farms.

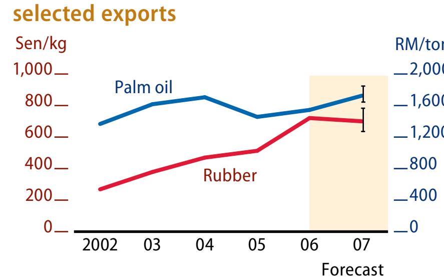
The policy of gradual fiscal consolidation is likely to be maintained, but will be balanced against the interest of ensuring that the Ninth Plan's investment programs are undertaken. Financing the Government's broader development agenda is helped by large surpluses run by

2.24.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.7
Inflation	2.7	2.7
Current account balance (% of GDP)	10.7	10.2

Source: Staff estimates.

2.24.7 Price movements of selected exports



Note: Vertical bars indicate the range of price forecasts for 2007.

Sources: Bank Negara Malaysia, available: www.bnm.gov.my, downloaded 28 February 2007; staff estimates.

Click here for figure data

government-linked companies such as the oil firm Petronas. However, the projects that make up the plan will test the capacity of government administrators both to initiate and implement them expeditiously.

The importance of government investment spending to the forecast highlights the domestic risks to the projections: meeting the Ninth Plan's investment agenda is crucial to ensuring that growing business and household confidence is warranted. Maintaining momentum in economic activity will also be important to reduce the impact of possible negative economic shocks such as could come from avian flu or weather-related problems, as seen in floods that swept the state of Johor in late 2006 and early 2007.

Development challenges

Malaysia is a middle-income country attempting to ensure more rapid, sustained growth and job creation. The Ninth Plan sets an ambitious tone. One focus of the plan—moving up the value-added ladder of manufacturing industries and services—is well articulated, and firms will get encouragement from the Government to enter the fields of biotechnology and of information and communications technology. Some firms have experience in world markets for electronic and electrical goods that should help them expand into these new fields.

It will be a challenge for Malaysia to build the workforce skills that enable it to forge world-class firms in these new areas. The Ninth Plan proposes to revamp the education system. An important role is seen for the private sector, in providing educational services and in linking education curricula with the needs of employers. This will be a long-term endeavor; in the medium term the success of the move into new industries is likely to depend on how well domestic firms partner with foreign firms.

In many respects, the country is well placed to attract business partnerships and investment. It scores better than many others in Southeast Asia in international rankings on the availability of infrastructure services and on the issue of corruption.

But the performance on generating investment has been patchy. During 2000–2006, in real terms private investment accounted for 12.0% of GDP (9.4% in nominal terms), much lower than the 35–36% prior to the 1997/98 Asian financial crisis. One key to encouraging a sustainable increase in investment levels will be improving the performance of government-linked companies, which span a wide range of sectors in the economy, dominating some fields and accounting for more than one third of the domestic stock market capitalization. Efforts have been made to improve management and governance at such companies, but much of the essential market structure of sectors they dominate is unchanged.

More broadly, surveys show that firms say they face a restrictive regulatory environment, especially in the services sectors. Liberalization of the services sector, which is on the agenda of the Association of Southeast Asian Nations (ASEAN), would help ensure that Malaysia meets its target of encouraging growth in high technology industries.

2.24.1 Ninth Malaysia Plan

The Ninth Malaysia Plan, issued in 2006, reiterates an official target to lift the economy to "developed nation" status by 2020. It lists specific poverty targets, such as halving the overall rate and eliminating severe poverty by 2010. It also sets ambitious, but not unrealistic, economic targets. Its 6% average annual GDP growth target for 2006–2010 would mean bettering the record of the past half-decade, but by less than 0.5 percentage points a year.

The plan sets the tone for government policies, including:

- An emphasis on government investment to provide infrastructure, support domestic demand, and encourage private investment. The projects providing for the Iskandar Development Region next to Singapore, for instance, encourage private firms to exploit synergies between the two countries, already one of the most successful examples in ASEAN of production sharing and trade.
- Actions to assist firms compete internationally. Thus the Government is encouraging a consolidation of palm-oil plantations into the world's largest listed palm-oil plantation enterprise controlling 600,000 hectares. This should enhance potential for internal productivity gains.
- Continuing financial sector strengthening. In early 2006, a restructuring of the large banking groups was nearly complete, allowing banks to meet more stringent capital requirements. The banking system's net nonperforming loans fell to 4.8% of all loans, from 5.8% in 2005.
- Support to sectors that might have a comparative advantage. Recent liberalization in finance, for instance, was aimed especially at encouraging issuance of Sharia-consistent instruments to strengthen Islamic finance. Assets of Islamic banking institutions made up 11.8% of all assets in mid-2006, and 47% of all outstanding bonds in September 2006 were Sharia compliant.

Myanmar

High prices for natural gas exports and a good harvest led to a modest pickup in economic activity. But macroeconomic stability remains elusive with monetized fiscal deficits feeding high inflation. The cushion provided by the gas exports makes now an opportune time to embark on structural reforms, including exchange rate unification, fiscal consolidation, and agricultural liberalization, and to redirect public spending to development of social and physical infrastructure.

Economic performance

According to official data, GDP increased by 13.2% in FY2005 (ended 31 March 2006). The expansion was driven by double-digit growth in agriculture, including livestock and fisheries; energy and power; manufacturing; mining; and services. The economy is heavily dependent on agriculture, which constitutes about half the economy. Industry accounts for roughly 15%, with services and trade the rest.

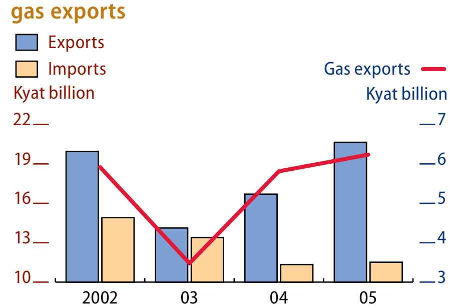
An objective assessment of economic performance and trends is made difficult by fundamental weaknesses in data. Data for variables closely correlated with GDP suggest that economic growth was significantly less than officially estimated. Indicators of inputs, such as energy and fertilizer, imports of capital goods, and expansion of agricultural acreage are consistent with lower than given GDP growth. For example, agricultural acreage grew by 3% in FY2005 when agriculture officially grew by almost 20%, implying a productivity increase not evident in other data. Economic growth in FY2005 nonetheless picked up somewhat, on the back of a stronger export performance (Figure 2.25.1), especially in natural gas; a good agricultural harvest; and growth in construction.

The fiscal deficit, including state enterprises, narrowed to about 4% of GDP. This reflected enhanced tax revenues (Figure 2.25.2) following steps in FY2004 to improve tax administration, reduce evasion, and increase tariff revenues from use of a more depreciated exchange rate than the official rate for valuing imports. Expenditures also declined marginally, but remained high at almost 10% of GDP, reflecting inefficiencies in public expenditure management as well as capital spending associated with a shift of the capital from Yangon to Naypyidaw.

In the absence of a well-developed market for government debt, the deficit is financed through monetization by the Central Bank of Myanmar. Broad money grew by 25% in FY2005 on top of an even higher growth rate the previous year. Inflation consequently accelerated after a pause in FY2004 (Figure 2.25.3), and is in double digits. Fuel price hikes, including an eightfold jump in October 2005, also boosted inflation.

The external balance has been supported by higher export volumes and prices for natural gas. Gross official reserves totaled just over $1 billion in September 2006, equivalent to 6 months of imports. The market-based parallel foreign exchange rate for the kyat appreciated in the second half of 2006, though for the year as a whole it weakened.

2.25.1 Total exports and imports, and gas exports



Source: Myanmar Central Statistical Organization, available: http://www.csostat.gov.mm, downloaded 2 March 2007.

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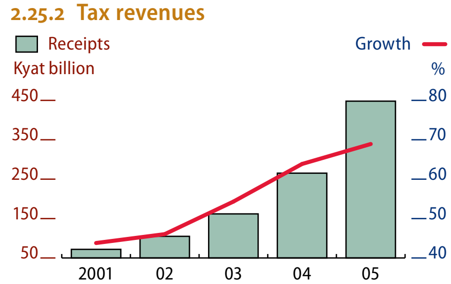
2.25.2 Tax revenues



Source: Myanmar Central Statistical Organization, available: http://www.csostat.gov.mm, downloaded 2 March 2007.

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Economic prospects

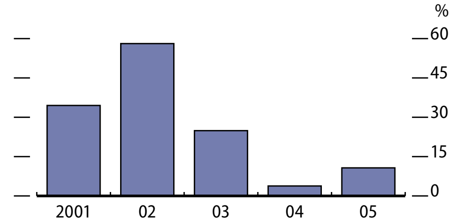
The Government's 5-year plan for 2006–2010 calls for average GDP growth rates of 10%, to be achieved through higher agricultural production, new gas fields, and increases in hydropower generation. The economy would be fortunate to achieve even half that over the medium term. In addition to the trade and investment sanctions by the United States and some others, the investment climate, outside the energy sector, remains poor for policy and infrastructure reasons. One of the few bright spots is the expanding trade relationship with fast-growing neighbors the People's Republic of China and India.

Growth and investment could be constrained as well by inflationary expectations. The economy runs chronic fiscal deficits, financed by monetary expansion. Inflationary pressures will also be influenced by a sharp rise in public sector wages in March 2006. Inflation could move back up from low double-digits to the 30–40% range. This would have a disproportionate impact on the large, poor, majority of the population. It could also prompt further currency depreciation.

The current account was in surplus in FY2005 due to the rising value of gas exports as well as a decline in imports. High gas prices will continue to buffer the external accounts, and exploration for more gas and oil is under way.

Continuing macroeconomic fragility will keep the economy vulnerable to sharp downturns in gas prices, as will shocks such as political strife, poor harvests, or instability in the banking system.

2.25.3 Inflation



Source: Myanmar Central Statistical Organization, available: http://www.csostat.gov.mm, downloaded 13 March 2007.

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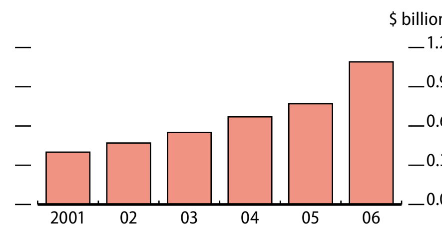
2.25.4 International reserves



Notes: International reserves exclude gold. Data for 2006 are up to September.
Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 2 March 2007.

Click here for figure data

Development challenges

Given the rise in international reserves to relatively comfortable levels (Figure 2.25.4) and the likelihood that gas prices will remain high for some time, now would be an opportune moment to move toward a unified exchange rate. The current system lacks transparency, creates incentives for corruption, and induces distortions in the economy. Although exchange rate reform may adversely affect inflation and the finances of state-owned enterprises that can import at the official exchange rate, gradually introducing measures would help mitigate any adverse impact.

Some steps have been implemented to expand tax revenues, but public finances require further consolidation, in particular through reforms in state enterprises (they often require subsidies). Fiscal consolidation should be accompanied by steps to improve the debt market and to allow greater autonomy for the central bank. Strengthened public finances would enable greater policy flexibility for measures to assist the poor, such as improved social and physical infrastructure, and would lift growth.

Promotion of private sector development requires, among other reforms, improvements in the investment climate (with greater transparency and predictability in regulations). In view of the importance of agriculture and its impact on poverty, strengthening the sector should be a key goal. In this regard, it would be helpful to move away from administrative measures in the form of price controls and periodic export bans toward greater reliance on market-based mechanisms.

Philippines

Achievements in 2006 included moderate economic growth, a downtrend in inflation, and stronger fiscal and external positions. This year, still-high levels of remittances and low real interest rates, as well as greater fiscal expenditures, should keep expansion at around the same level. However, it has not been strong enough to lift employment sufficiently, mainly because of a declining investment-to-GDP ratio. Improvements in the investment climate are needed, to spur economic expansion, increase employment generation, and provide public resources for social programs.

Economic performance

GDP rose by 5.4% in 2006, maintaining its slight upward trend of the past 5 years (Figure 2.26.1). With a strong rise in remittances from overseas workers to $12.8 billion (11.0% of GDP), gross national product growth accelerated to 6.2%, from 5.6% in 2005. Personal consumption expenditures and net exports were the main contributors in 2006. The substantial remittances and low interest rates supported private consumption. However, gross fixed capital formation continued to decline as a share of GDP to the lowest level in 20 years (Figure 2.26.2), reflecting a deficient investment environment and restraints on the public capital spending required to buttress the Government's fiscal position.

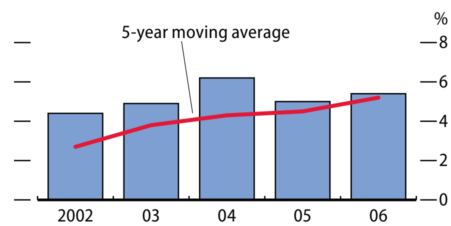
On the supply side, the pace of growth in agriculture more than doubled from 2005 to 4.1% in 2006 with more favorable weather conditions early in the year and a larger harvested area. Production of rice and corn in particular rebounded from a slump the previous year, and fisheries maintained a solid advance.

Industry's growth rate remained just below 5%. Transport and communications, finance, and private services, including business process outsourcing and other information technology-enabled services, led the way in the services sector, which grew by 6.3% and accounted for 3 percentage points of total GDP growth (Figure 2.26.3).

However, growth has not been strong enough to raise the employment level to significantly dent the unemployment rate. In the 3 years 2004 to 2006, employment edged up by 2.5% on average each year, or about half the level envisaged in the Medium-Term Philippine Development Plan 2004–2010. Services, primarily wholesale and retail trade, accounted for two thirds of the employment gain, and agriculture a quarter.

Unemployment remained close to 8% in 2006. Slightly more than half of the unemployed were high-school graduates (32.3%) and college graduates (18.4%), indicating that, in addition to raising the overall level of employment, there may be a mismatch in skills (see *Education and structural change in four Asian countries* in Part 3). In a worrisome trend, the number of underemployed rose to 23% of total employment in 2006 from 18% in 2004.

2.26.1 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007.

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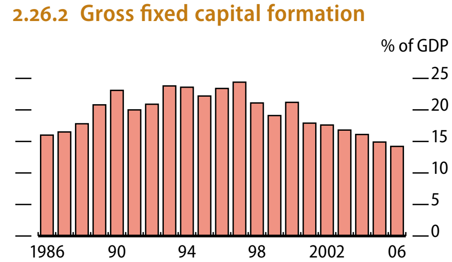
2.26.2 Gross fixed capital formation



Source: CEIC Data Company Ltd., downloaded 12 February 2007.

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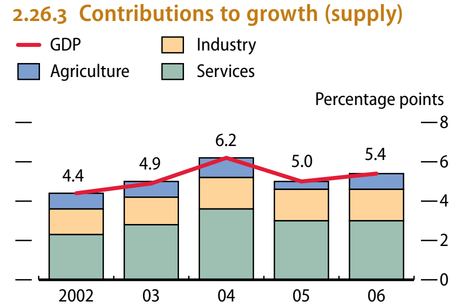
2.26.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007.

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The Government's efforts to buttress its fiscal position by raising revenues and restraining growth of current expenditures have contributed to a gradual rise in the gross domestic savings rate to 19.8% of GDP in 2006 from 17.1% in 2001. With both public and private investment weak, the savings-investment gap widened. As a result, the current account balance went from a deficit of 2.4% of GDP to an estimated surplus of 4.0% of GDP over the same period.

Merchandise exports rebounded in 2006 across all major product categories, a result of robust demand in external markets. Exports performed well in spite of a 22% appreciation between 2004 and 2006 of the real effective peso exchange rate. Almost half the export expansion was attributable to semiconductors, which account for 47% of total merchandise exports (Figure 2.26.4). Resource-based exports, especially gold and copper, also surged on high international commodity prices, and contributed close to a third of total export growth.

The import intensity of key exports, such as electronics and garments, led to strong growth of imports as well. The rate of increase was slower than that of exports however, reflecting a more moderate rise in world oil prices and higher domestic production in agriculture, which tempered the growth of food imports. The deficit in the services account narrowed, too, because of higher receipts from communications and business services, as well as tourism. Remittances (Figure 2.26.5) continued to provide important support to the current account.

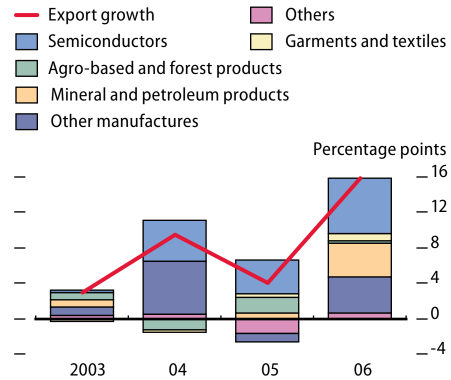
The overall balance of payments posted a hefty surplus of $2.6 billion in the first 3 quarters of 2006, similar to a year earlier. Although inflows of net portfolio investment slowed from 2005, net foreign direct investment (FDI) during the 3 quarters rose to $1.6 billion (1.4% of 2006 GDP). However, 43% of the FDI was in the form of intercompany loans rather than new equity; and FDI (in both US dollars and as a share of GDP) remains below the norm for Southeast Asia.

The surplus in the balance of payments put substantial upward pressure on the currency; the central bank tried to mitigate the effect by accumulating foreign exchange reserves. Gross reserves rose by $4.5 billion in 2006 to $23.0 billion, or more than 4 months of import cover, enabling the Government in December to pay back early about $220 million of loans from the International Monetary Fund and about $83 million from the Asian Development Bank.

The banking system's accumulation of net foreign assets fueled liquidity. Broad money (M3) growth has accelerated in the last few years, driven primarily by this accumulation (Figure 2.26.6). In 2006, net domestic credit also reversed from a decline in 2005 to contribute 7.8 percentage points to M3 growth, in large measure reflecting a recovery in credits to the private sector. A decline in the risk premium (based on improved fiscal performance), expectation of peso appreciation, accommodative monetary policy, and buoyant liquidity exerted downward pressure on interest rates. The nominal yield on 91-day treasury bills declined below comparable US treasuries in November (Figure 2.26.7) for the first time in 25 years.

Inflation slowed markedly in the second half of 2006 (Figure 2.26.8) as the impact of a 2 percentage point rise in the value-added tax (VAT) rate early in the year receded. Lower inflation was also helped by a stronger

2.26.4 Contributions to export growth



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., downloaded 8 February 2007.

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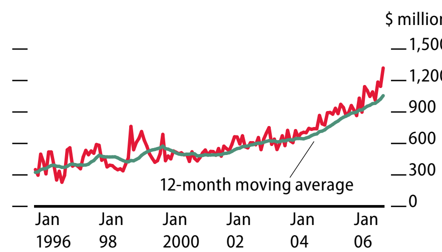
2.26.5 Monthly remittances



Sources: Datastream, downloaded 6 January 2006; Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 20 February 2007.

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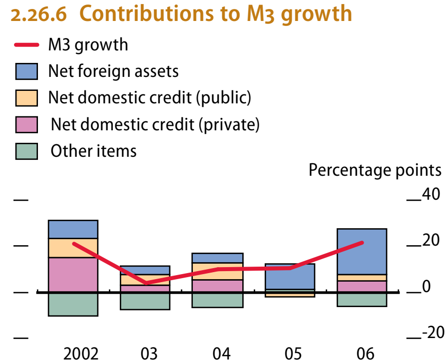
2.26.6 Contributions to M3 growth



Source: Bangko Sentral ng Pilipinas, available: http://www.bsp.gov.ph, downloaded 15 January 2007.

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exchange rate, declining world oil prices, and a moderating increase in domestic food prices. The deceleration in inflation and the peso's strength enabled the central bank to pursue an accommodative monetary policy. While policy interest rates were kept steady, the central bank adopted a tiering scheme in November 2006 to dissuade banks from depositing funds with it and to encourage them instead to lend to the public. Under the tiering scheme, banks' deposits with the central bank earn a lower rate of interest, the higher the amount of their deposits.

A narrowing in the fiscal deficit to 1.0% of GDP (from 5.3% in 2002; Figure 2.26.9) was attributable to a 20% jump in revenues, reflecting the increase in the VAT rate and an expansion of the tax base, set against a rise in expenditures of just 8%. Compared with the Government's target, the deficit was narrower by about half. Revenues slightly exceeded the target, while expenditures were about 5% down as the Congress' disapproval of the 2006 appropriations bill led to the reenactment of the prior year's budget. A stronger currency and lower domestic interest rates also resulted in lower than expected interest payments, accounting for about half the shrinkage in the deficit relative to the target.

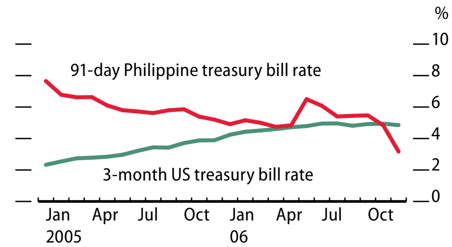
Excluding interest payments, the primary fiscal balance switched to a surplus of 4.1% of GDP in 2006, from a deficit of 0.6% of GDP in 2002. Coupled with lower interest rates, a stronger currency, and an improvement in economic growth, this contributed to a reduction in the Government's outstanding debt from a recent peak of 78.5% of GDP in 2004 to 64.2% in 2006 (Figure 2.26.10). This figure excludes about 9.5% of GDP in contingent liabilities, comprising the national Government's guarantees on debt of government-controlled corporations and financial institutions. Debt levels are still high in spite of the favorable trend, and interest payments consume close to a third of revenues, compressing the fiscal space for development expenditures.

The privatization program gained some traction last year, with the realization of P5.8 billion (more than twice receipts in 2005). The Government sold its stake in the Philippine National Oil Corporation–Energy Development Corporation through an initial public offering for P4.6 billion. In early 2007, the sale of the stake in the Philippines Long Distance Telephone Company yielded P25 billion (0.4% of 2007 GDP).

The Government made encouraging progress in privatizing its assets in the power sector as well. Its aims are to reduce the sector's drain on public finances and to provide an adequate and efficient supply of energy through the private sector. In September 2006, the Power Sector Assets and Liabilities Management Corporation, the agency set up to manage and privatize the generation and transmission assets of the National Power Corporation, sold a 112 megawatt plant for $129 million. In January 2007, it finalized the sale of another 360 megawatt plant for $530 million.

Prior to these sales, only five small plants with a total generating capacity of 8.5 megawatts had been sold for $5.2 million. These sales, however, represent only about 12% of total generation capacity to be sold. In February 2007, an attempt to sell a 25-year concession of the transmission grid failed for the fourth time, as only one of three potential bidders submitted a bid.

2.26.7 Treasury bill rates



Sources: CEIC Data Company Ltd., downloaded 8 February 2007; Board of Governors of the Federal Reserve System, available: http://www.federalreserve.gov, downloaded 17 January 2007.

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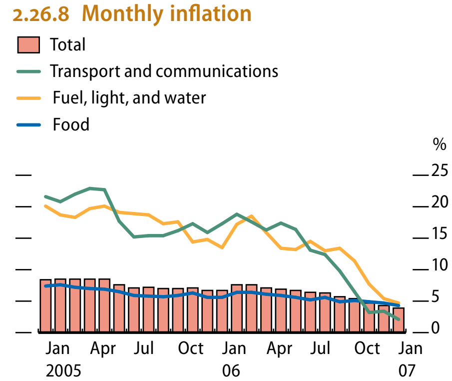
2.26.8 Monthly inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., downloaded 8 February 2007.

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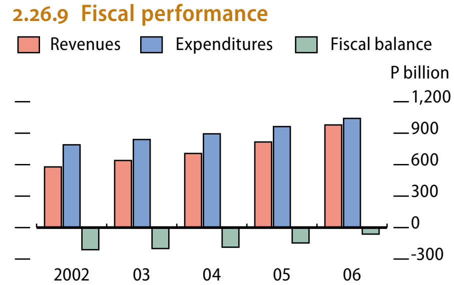
2.26.9 Fiscal performance



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 7 February 2007.

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Economic prospects

The modest growth trajectory is projected to be maintained this year and next. The baseline international assumptions are for the global economy and trade to slow from last year's pace. With its share of exports (on a national accounts basis) close to 50% of GDP in 2006, and its dependence on capital inflows, the Philippines is closely tied to the global economy and to sentiments in international financial markets. This is offset somewhat by the seeming independence of remittances to global disturbances, likely reflecting their diversified origins. Low real interest rates and higher fiscal spending on priority projects should also support growth.

Against this backdrop, GDP is projected to grow by 5.4% this year before picking up to 5.7% in 2008 on the expectation of a more favorable external environment (Figure 2.26.11). The key domestic assumption underlying these projections is that fiscal reforms remain broadly on track. Another assumption is that the current El Niño weather phenomenon remains mild.

The services sector will remain the main contributor to growth on the supply side, expanding by a forecast 6.3% in 2007 and continuing its secular increase as a share of GDP. Agricultural production is likely to grow slightly below its trend rate of 4.0% (Figure 2.26.12). The enactment of the Biofuels Act in January 2007, which mandates a gradual phase-in of ethanol blends in fuel, is likely to boost cultivation of sugarcane and cassava for ethanol production.

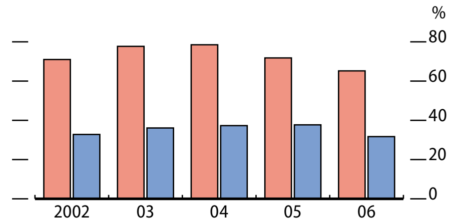
Construction will benefit from the planned upturn in public spending on infrastructure. However, the expected softening of the global electronics market and the slowdown in overall external demand will crimp manufacturing output. Industry as a whole is expected to grow by 4.8%, again underperforming aggregate GDP growth. The shares of the economy that agriculture and industry accounted for will thus continue to decline.

Private consumption and, to a lesser extent, net exports will support demand. Consumption should continue to benefit from buoyant remittances and low real interest rates, which for some maturities of deposits remained negative in 2006 (Figure 2.26.13). The contribution of net exports to growth will likely fall to less than 1 percentage point (from about 4 percentage points in 2006), against a backdrop of softer demand in external markets, a strong currency, and higher import requirements consistent with a modest recovery in investment.

Investment will likely recover to 4–6% growth, compared with 2.0% in 2006 and an average annual increase of just 0.4% in 2002–2006. It will be supported by higher government expenditures and low real interest rates. Bank balance sheets have strengthened (Figure 2.26.14), and so banks' willingness to lend may rise, especially as the lending–deposit spread is at the top of the range seen over recent years. However, businesses are unlikely to sharply lift spending on new plant and equipment without deeper reform of the investment environment.

The trade deficit is expected to widen slightly to about 6.6% of GDP in 2007, reflecting the trends in external demand, exchange rates, and investment, although the value of imported petroleum products (15.8% of total imports) should fall from the levels of 2006 (Figure 2.26.15).

2.26.10 Debt and interest payments



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 13 March 2007.

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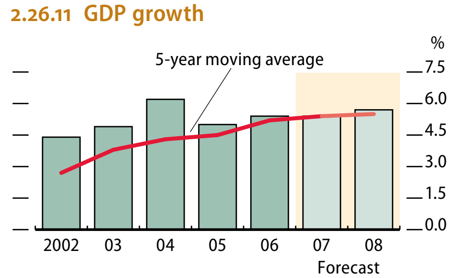
2.26.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.7
Inflation	4.8	5.0
Current account balance (% of GDP)	3.2	2.9

Source: Staff estimates.

2.26.11 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 31 January 2007; staff estimates.

Click here for figure data

Remittances are projected to remain at about 11% of GDP. Consequently, the current account surplus is likely to post a healthy, but smaller, surplus of about 3.2% of GDP in 2007. The privatization of several significant assets in late 2006 and early 2007 and the increase in FDI approvals (Figure 2.26.16) in 2006 suggest that FDI inflows may retain the gains made last year and contribute to a surplus in the overall balance of payments.

The peso is likely to maintain its strength, supported by foreign exchange inflows from the balance-of-payments surplus. However, to preserve the price competitiveness of exports against the backdrop of slowing external demand and the appreciation of the peso (in real trade-weighted terms), the central bank may again accumulate foreign exchange reserves to stem the pace of currency appreciation. Measures to liberalize foreign exchange outflows to be effective from April 2007 may also relieve some upward pressure on the peso. They include doubling the amounts of foreign exchange that residents can buy to pay for overseas services and investment abroad.

Some of the increase in reserves may be used to further prepay official external debt, in line with the Government's strategy to reduce the proportion of external debt to domestic debt (Figure 2.26.17). Inflation is likely to remain within the target of 4–5%, affording scope for monetary policy to remain accommodative.

Congress approved a budget for 2007 that envisages a continuation of fiscal consolidation with a rise in development spending. The deficit is programmed at about 1% of GDP, similar to the actual gap in 2006. Revenues are likely to be 14.3% stronger than the outturn in 2006, equivalent to 16.9% of projected 2007 GDP. This rate of increase is higher than the average annual 10% improvement in the 2001–2005 period, before VAT reforms led to a jump in revenues in 2006.

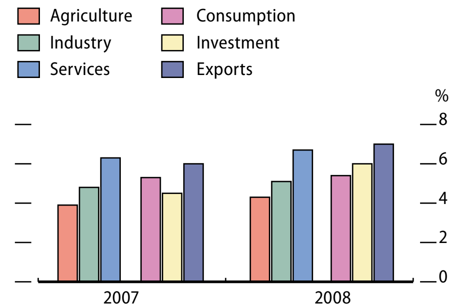
This suggests that, in the absence of new tax measures, efforts to enforce tax collection need to continue over the medium term both to finance higher expenditures on infrastructure and to reduce the deficit. For 2007, given privatization receipts from asset sales (counted as revenues, not a financing item) in late-2006 and early this year, the projected strengthening in receipts should be achievable.

Spending is programmed to go up by 13.5%, to 17.9% of projected 2007 GDP from 17.3% in 2006, the first pickup in its share of GDP in 5 years. Outlays on infrastructure are planned to increase by 16.4%, including a notable rise in spending for public works, transport and communications, and, to a lesser extent, education.

The main risk to the projections, apart from the extent of the slowdown in external markets, is the potential impact of the Congressional elections in May 2007. The elections need to be transparent and peaceful, and the fiscal and structural reforms kept on track. Steady progress on privatization will be an important signal to investors on the Government's commitment.

If reforms related to better tax collection and privatization stall, the country risk premium is likely to rise, with an adverse impact on capital inflows, the exchange rate, and interest rates, reversing some of the gains made in recent years and dimming the outlook for future growth. El Niño and the uncertain incidence of typhoons pose an additional risk.

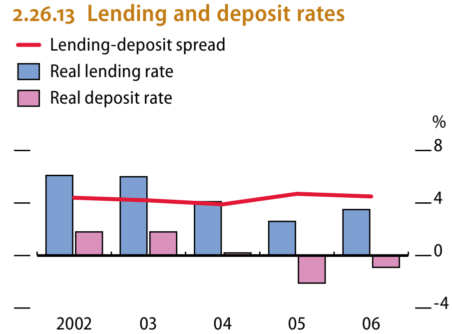
2.26.12 Growth of supply and demand components of GDP



Source: Staff estimates.

Click here for figure data

2.26.13 Lending and deposit rates

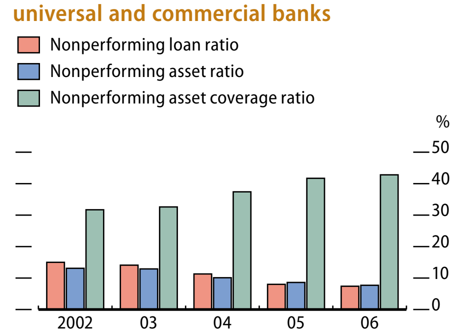


Note: Deposit rate refers to 61–90 day peso time deposit.

Source: CEIC Data Company Ltd., downloaded 8 February 2007.

Click here for figure data

2.26.14 Banking performance indicators: universal and commercial banks



Note: Data for 2006 are as of end-September.

Source: CEIC Data Company Ltd.; downloaded 9 February 2007

Click here for figure data

Development challenges

The key challenge is to move to a higher growth trajectory and create more and higher-quality jobs for the unemployed, underemployed, as well as new entrants into the labor force. Growth and employment have lagged behind the Government's medium-term targets of 6.8–7.8% in 2008 and 7–8% by 2010. Expanding at close to these targets, with the associated increase in employment by an average of 1.4 million–1.6 million annually, will require sustained efforts to improve the investment climate. Inadequate investment is the main factor that has curtailed growth and employment. The medium-term targets, for example, were based on investment picking up at double-digit annual rates in 2006–2010 to reach 28% of GDP by 2010, almost twice the current level.

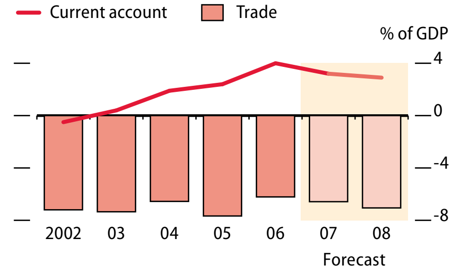
In agriculture, which accounts for 36% of employment, investment has been weak because of factors that include farmers' poor access to credit and support services, expensive inputs, high costs of transport, and the incomplete land reform program. In manufacturing, sampled firms in a 2003 survey of the investment climate cited as the major constraints: macroeconomic instability (at that time) and uncertainty in economic policies; inadequate infrastructure services, especially of power and transport; and corruption and the costs of complying with regulations, especially related to customs, trade, and labor markets.

Improvements in the fiscal position have since fostered greater macroeconomic stability. Nevertheless, the still-high debt and the large share of interest payments in the budget expose the economy to swings in sentiment in financial markets and underscore the importance of containing the risk premium with steady progress on reforms. Further increases in revenues as a share of GDP, reduction of debt and interest payments, and restraint in other current expenditures are required to deploy necessary resources toward development spending on infrastructure and social programs.

Certainly the requirements for investment in infrastructure, education, and health are huge. According to the Medium-Term Public Investment Program 2006–2010, such investment needs total P2,915 billion over the 5 years, including P1,711 billion for infrastructure. Of the infrastructure investment, P775 billion is set to be financed by the national Government, P460 billion by the private sector, and the remainder mainly by government-controlled corporations and state financial institutions. Given that around P100 billion is allocated to infrastructure in the 2007 budget, the targeted average of P155 billion a year in investment by the national Government seems ambitious, and underscores the importance of policy reforms to encourage greater private sector participation in infrastructure.

A 2006 study of progress toward the 2015 Millennium Development Goals by countries in Asia and the Pacific indicated that, although the Philippines is on track to achieve (or has already achieved) several targets, including reducing the proportion of the poor (based on $1-a-day criterion), it is behind targets in some health, education, and environment indicators. An important contributor to this regression is the declining share of resources devoted to social spending. Improvement of the investment climate to boost growth and employment, and further efforts to expand the tax base and enforce collection, are required.

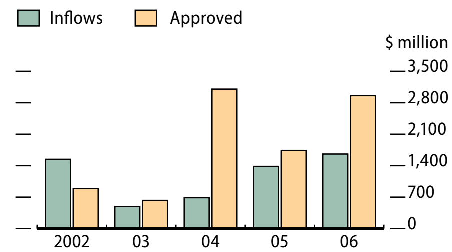
2.26.15 Current account and trade balances



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

2.26.16 Foreign direct investment

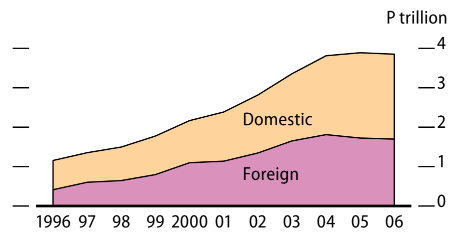


Note: Data for 2006 are for January to September.

Source: CEIC Data Company Ltd., downloaded 8 February 2007.

Click here for figure data

2.26.17 National government outstanding debt



Source: Bureau of the Treasury, available: http://www.treasury.gov.ph, downloaded 13 March 2007.

Click here for figure data

Singapore

Growth in 2006 remained well above the economy's trend rate for the third year running. External demand was the main driver, although domestic demand, especially investment, also picked up. The pace of growth is expected to decelerate in 2007 to a still-strong but more sustainable rate. Closer links with global economic networks and structural reforms have contributed to the healthy performance, but also led to widening income gaps, posing challenges for the longer term.

Economic performance

Supported by a favorable international economic environment and accommodative domestic policies, the economy expanded by a robust 7.9% in 2006, well above its trend rate of 4–6%, for the third year in a row. Growth of manufacturing moderated on a quarter-on-quarter basis in the first and second quarters, reflecting a cyclical softening in global information technology markets, a contraction in the computer hard-disk industry, and a dip in production of pharmaceuticals. In the second half, manufacturing growth rates picked up to double-digit levels, lifted by a strong performance in semiconductors, transportation engineering, and pharmaceuticals.

Services maintained robust growth over most of the year, providing a buffer against cyclical swings in manufacturing. Overall, quarterly growth in 2006 was less volatile than in previous years, which suggests that the economy has indeed become more diversified (Figure 2.27.1).

For all of 2006, manufacturing grew by 11.5%, led by the transport engineering and biomedical subsectors. The marine and offshore engineering industry expanded by 40.7% in 2006, boosted by strength in global shipbuilding, ship repair, and oil-rig building. Biomedical manufacturing output rose by 22.5% in the year, double the rate of 2005, driven by rapid growth in pharmaceutical exports to Europe. Electronics recorded a modest rise of 3.2%, well down from 2005, as expansion in semiconductors was largely offset by declines in production of hard disks, consumer electronics, and computer peripherals.

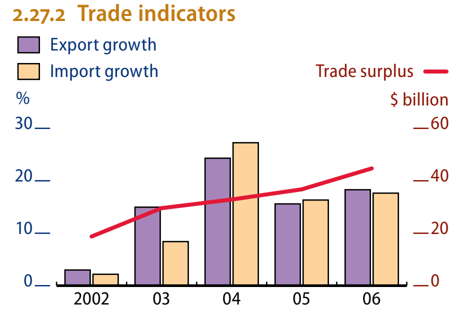
In line with a rebound in property market activity, construction accelerated a little to 2.7% from 0.7% growth in 2005. A vibrant economy, robust demand for high-end housing, as well as major planned projects—including two casino-resorts, the renovation of a major shopping district, and the building of a new business district—have lifted confidence among property investors and developers. Services expanded by 6.7% in 2006, underpinned by continued robust growth of wholesale and retail trade and of financial services.

On the demand side, the external arena was again the key driver of growth. Merchandise exports increased by 18.3%, with pharmaceuticals and petrochemicals particularly buoyant. However, exports of domestically made electronic products rose more modestly, by 9.3%,

2.27.1 Quarterly GDP growth

saar = seasonally adjusted annualized rate.
Source: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007.
Click here for figure data

2.27.2 Trade indicators



Source: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007.
Click here for figure data

weighed down by the secular contraction in hard-disk drives. Led by growth in reexports of semiconductors, Singapore's entrepôt exports rose rapidly by 22.2%, supported by the trend toward regional production networks and booming regional demand (particularly from the People's Republic of China).

Merchandise imports expanded by 17.6%, largely matching exports (Figure 2.27.2), and reflecting domestic investment in machinery and equipment. Net exports of goods and services in national account terms rose by 10.4% and contributed 3.1 percentage points to total GDP growth (Figure 2.27.3).

Private fixed investment jumped by 16.3%, underpinned by a cyclical rebound in machinery and equipment investment and a pickup in construction (spurred by the recovering property market and strong foreign investment). However, public investment fell by 11.8%, trimming total fixed investment growth to 11.5%. Despite stronger economic expansion last year, growth in private consumption moderated to 2.5%, partly a result of sluggish wages growth. Also, a reduction in the employers' mandated contributions to the national pension fund in 2003 has likely encouraged employees to increase their own retirement savings.

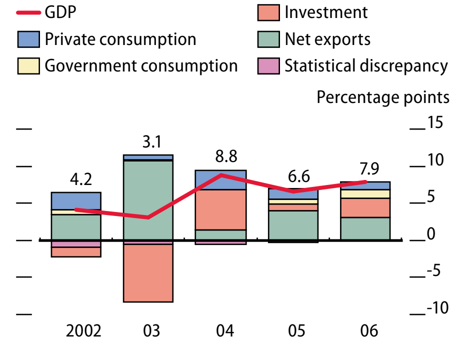
Overall, domestic demand accounted for 4.7 percentage points of total GDP growth in 2006, with a contribution of 2.5 percentage points from total investment (including inventory investment), 1.0 percentage point from private consumption, and 1.2 percentage points from public consumption.

Labor market conditions continued to improve on the back of vigorous economic activity: total employment expanded by 7.6% over the year. Accordingly, unemployment fell from an annual average rate of 3.1% in 2005 to a 5-year low of 2.7% (Figure 2.27.4). Nominal wages rose by just 3.2%, slightly below the pace of 2005 (Figure 2.27.5), even as the labor market tightened. An increase in the number of foreign workers (accounting for 49% of employment growth in 2006) alleviated some of the tightness. Domestic cost pressures were well contained, but the pass-through of higher oil prices intensified. Moreover, prices of imported food rose. As a result, inflation edged up to a year-average 1.0% from 0.5% in 2005.

Against the backdrop of sustained economic growth and rising inflation, the Monetary Authority of Singapore maintained its policy, in place since April 2004, of a modest and gradual appreciation of the trade-weighted nominal effective exchange rate to maintain price stability. Over the year, the Singapore dollar appreciated by 8.5% and 10.1% against the US and Japanese currencies, respectively, but weakened slightly against the euro.

In tandem with US rate hikes in the first half of 2006, Singapore's 3-month interbank interest rate rose by 31 basis points to 3.56% by June, before ending the year at 3.44% (Figure 2.27.6). However, overall liquidity conditions remained loose. Domestic credit creation turned up after a long period of sluggishness, supported by lending to corporations, particularly those in the construction, and the transportation and communications, industries. Partly pushed by the increased credit activity, money supply growth (M2) surged to 19.4% in December 2006, its fastest pace in 8 years (Figure 2.27.7).

2.27.3 Contributions to growth (demand)



Source: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007.

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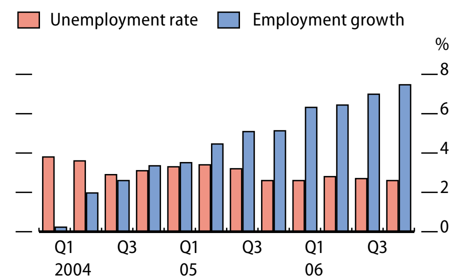
2.27.4 Labor indicators



Source: Ministry of Manpower, available: www.mom.gov.sg, downloaded 7 March 2007.

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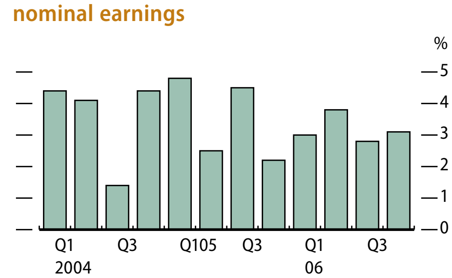
2.27.5 Growth in average monthly nominal earnings



Sources: Ministry of Manpower, available: www.mom.gov.sg; Ministry of Trade and Industry, available: www.mti.gov.sg; both downloaded 7 March 2007.

Click here for figure data

The primary operating fiscal balance, boosted by 2 years of strong economic growth, swung into surplus by S$1.2 billion (0.6% of GDP) from a S$665 million deficit (0.3% of GDP) in 2005. Government operating revenues, which exclude investment income, interest income, and capital receipts, rose by 10.5%, driven by higher corporate income tax collections (which reflected stronger corporate profits). Total government expenditures increased modestly by 3.8%, mainly on a reduction in development spending with the completion of transport infrastructure projects.

In the external account, the surplus of trade in goods rose to US$44.7 billion in 2006, and the current account surplus advanced to US$36.3 billion, equivalent to 27.5% of GDP. The net outflow in the financial and capital accounts was slightly higher than that in 2005, yet gross international reserves still rose to US$136.8 billion by end-2006.

Economic prospects

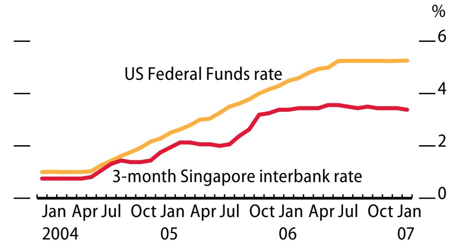
Global growth, after an above-trend period, is expected to moderate, but remain robust, in 2007 and 2008. The global electronics market is projected to grow at a slower pace this year than last. In domestic policies, Singapore's budget for FY2007 (starting 1 April 2007) targets a small deficit of 0.3% of GDP. The corporate tax rate will be lowered from 20% to 18% in an effort to attract more foreign investment. Partly as a means to offset this revenue loss, the Government will raise the goods and services tax (GST) by 2 percentage points to 7.0% from 1 July this year. To compensate for an expected rise in costs for consumers induced by the GST hike, the budget for FY2007 includes a S$4.0 billion offset package over 5 years.

On the monetary side, domestic inflationary pressures will likely pick up in 2007, though the risks from imported inflation are tempered somewhat by lower international oil prices. The labor market is at its tightest in 5 years and, with the increase in foreign workers unlikely to continue at 2006's rate, this will eventually feed into wages growth. Moreover, the recent liquidity surge, strong asset prices, and the GST hike will also generate pressures, lifting inflation to 1.6% in 2007. The monetary authorities are likely to maintain the current moderately tight stance (Figure 2.27.8).

On the basis of these assumptions, economic growth is expected to ease to 6.0% in 2007 and 5.5% in 2008 (Figure 2.27.9). Domestic demand is likely to play an augmented role in supporting growth. Consumer sentiment will continue to improve because of employment growth, gains in real wages, planned assistance for low-income groups, and the positive wealth effects from the recovering property market. Private consumption growth is forecast to accelerate modestly to 3.5% in 2007. The growth of fixed asset investment is set to continue at a rapid clip, driven by both the public and private sides.

Momentum in manufacturing investment will moderate, slowed by decelerating global economic growth and softening electronics demand. However, construction investment is likely to accelerate in 2007–2008, underpinned by the two major resorts, some public infrastructure projects, and the strong residential property market. Import growth, spurred by solid domestic demand, will outpace the forecast deceleration

2.27.6 Interest rates



Sources: Monetary Authority of Singapore, available: www.mas.gov.sg; US Federal Reserve, available: www.federalreserve.gov; both downloaded 2 March 2007.

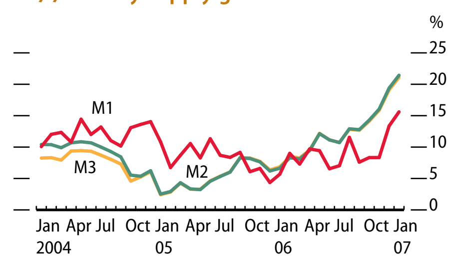
Click here for figure data

2.27.1 Selected economic indicators

	2007	2008
GDP growth	6.0	5.5
Inflation	1.6	1.0
Current account balance (% of GDP)	27.0	27.0

Source: Staff estimates.

2.27.7 Money supply growth



Source: Monetary Authority of Singapore, available: www.mas.gov.sg, downloaded 2 March 2007.

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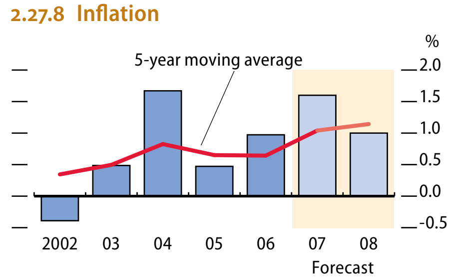
2.27.8 Inflation



Sources: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007; staff estimates.

Click here for figure data

in exports. The current account surplus as a share of GDP is seen falling slightly to 27.0% in 2007–2008 (Figure 2.27.10).

This outlook would be undercut by a harder than expected landing of the US economy and, to a smaller extent, by a sharp inventory adjustment in global electronics. Conversely, a broadening of the domestic property market rebound could burnish it. There are signs that the rise in prices of high-end housing could spill over to other categories of the private residential market. A broader property rebound could provide additional impetus to investment and consumption growth.

Development challenges

Over the past decade, Singapore has undertaken a range of structural reforms in response to challenges posed by accelerated globalization and increased competition from other Asian economies. The Government has reduced corporate and personal income tax rates, lowered the employer's contribution to the national pension fund, adopted more flexible policies on employment of foreign labor, and stimulated the private sector by divestment of government-linked companies.

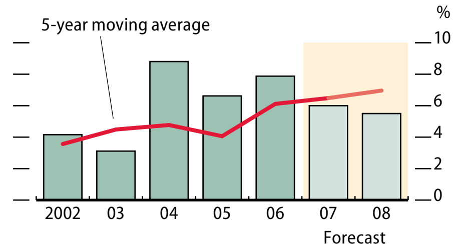
These supply-side reforms have helped make the city-state one of the world's winners in globalization, with a rising share of world trade, increased inflows of foreign capital and talent, and sustained, above-trend growth. The more flexible labor supply response and increased foreign investment have lifted the growth potential above the 3–5% range previously regarded as a longer-term limit.

But not all Singaporeans benefit from linking the economy into global networks. Many older and less educated workers have been left behind as manufacturing and services move up the value-added ladder. Consequently, some structural unemployment has persisted, and wages for low-skill jobs have stagnated. The Government is trying to balance a need for structural reforms with concerns over income inequalities that may undermine social cohesion and the political support for further policy changes. Support for low-income households through retraining and targeted social programs is likely to be a priority of fiscal policy.

The authorities also face challenges in maximizing the effectiveness of future structural reforms. Given both the significant cuts to corporate and personal income tax rates since 2001 (Figure 2.27.11) and the diminishing returns to lowering tax rates further, against a background of needing to support low-income groups and an aging population, additional aggressive tax cuts are unlikely. Instead, supply-side reforms should put more emphasis on investment in education, research and development, and public services.

Tapping into regional and global manufacturing, trade, and financial networks has helped boost growth, diversify its sources, and reduce vulnerability to downswings in the global electronics market. But closer links with the rest of the region, amplified by Singapore's growth as a regional financial center, have increased its exposure to some other risks. These include interruptions in the regional production chain, financial weaknesses in regional economies, and economic or political instability in countries where Singapore has made significant investments.

2.27.9 GDP growth



Sources: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007; staff estimates.

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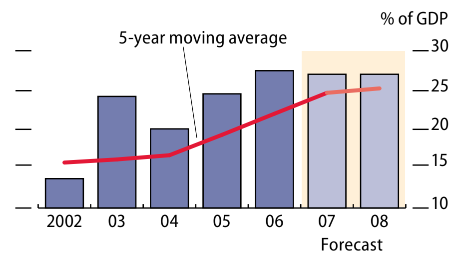
2.27.10 Current account balance



Sources: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007; staff estimates.

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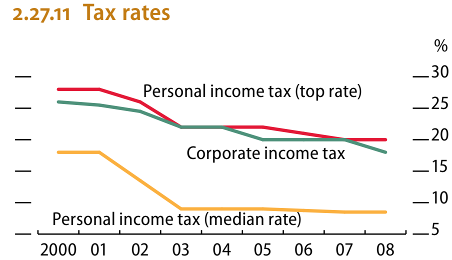
2.27.11 Tax rates



Source: Inland Revenue Authority of Singapore, available: www.iras.gov.sg, downloaded 7 March 2007.

Click here for figure data

Thailand

Strong exports drove a pickup in economic growth last year, since domestic demand was damped by several factors including rising interest rates and inflation in the first half, flooding, and political uncertainties for much of the year. Inflationary pressures eased in the second half, paving the way for the central bank to start lowering rates early in 2007. Economic growth is projected to slow this year, and the outlook for next year depends heavily on elections actually being held and on the incoming government providing a clear and credible economic program.

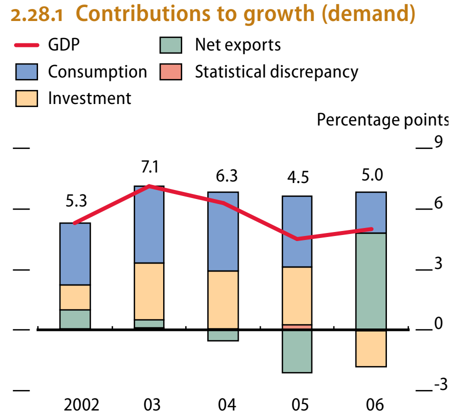
Economic performance

Economic growth picked up by a half percentage point to 5.0% in 2006, though that still left it nearly 1 percentage point below the 2002–2005 average. Driven by strong exports and a slowing in imports, net exports of goods and services contributed nearly all the overall GDP expansion (Figure 2.28.1). Domestic demand weakened, hurt by the rise in global oil prices, inflation and rising interest rates, flooding, and most important, political uncertainty throughout most of the year. Results of elections held in April were annulled, and a caretaker government took office pending new polling in October. However, in September, after a coup, the military took over the administration, suspended the 1997 constitution, and installed an interim government. A new constitution is being drafted, on which a referendum will be held, and national elections are planned before the end of this year.

Growth stepped down over 2006 from 6.1% on a year-on-year basis in the first quarter to 4.2% in the fourth (Figure 2.28.2), mainly as a result of heightened political uncertainty and of flooding in the northern and central regions, which affected farm incomes. The index of consumer confidence declined from the second quarter. For the year, private consumption growth decelerated to 3.1%. Fixed investment growth slowed to 4.0% as firms waited for political and policy positions to become clear. In addition, most of the large public infrastructure investments planned by the previous government were delayed.

This program targeted investment of as much as $42 billion over 2005–2009 on physical and social infrastructure. The interim government did not scrap the program, but has been reviewing it and changing the priorities. This delayed some projects, in particular new mass transit rail lines for Bangkok. A few projects under the program were implemented through the 2006 budget, including construction of power plants and gas pipelines, improvement of water supply systems, and provision of low-cost housing. Investments under the infrastructure program are now expected to be extended well beyond 2010, which is a more realistic schedule than originally planned given the size and complexity of the investments. Investment overall was a drag on GDP growth in 2006 for the first time since 1998, subtracting 1.8 percentage points.

2.28.1 Contributions to growth (demand)



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 9 March 2007.

Click here for figure data

2.28.2 Quarterly GDP growth

Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 8 March 2007.

Click here for figure data

Average inflation in 2006 accelerated to 4.6%, the highest rate in 7 years. The elimination of fuel subsidies in July 2005 pushed up inflation over the next 12 months. As world oil prices eased and the impact of the elimination of the fuel subsidies faded, price pressures subsided (Figure 2.28.3). To lean against inflation, the Bank of Thailand, which follows an inflation targeting policy, had hoisted its policy interest rate seven times between early 2005 and July 2006. As inflation pressures then diminished, the central bank kept the policy rate steady until early 2007, when it cut its benchmark in January and again in February, to 4.7% (Figure 2.28.4), in a context of moderating inflationary pressures and weakening economic growth.

Merchandise exports grew by a nominal 17.4% as a result of strong external markets and high prices for export commodities, including natural rubber and rice. Import growth, in contrast, pulled back sharply to 7.0%, reflecting weakness in both consumption and investment demand. This saw the trade balance switch to a surplus of $2.2 billion, from a deficit of $8.5 billion a year earlier. The services balance was in surplus by $4.3 billion, supported by a recovery in tourism from the impact of the December 2004 tsunami (tourism receipts rose by nearly 30% in 2006).

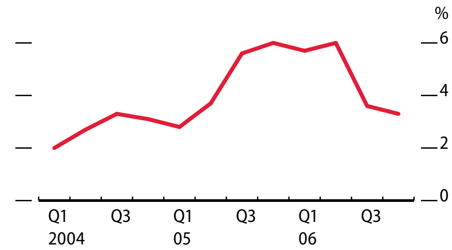
The current account surplus amounted to $3.2 billion, or 1.6% of GDP, turning around from a $7.9 billion deficit in 2005. The return to a current account surplus, together with large inflows of equity portfolio investment and a surge in foreign purchases of domestic debt securities, boosted official foreign exchange reserves to a record $65.1 billion in December (Figure 2.28.5), partly reflecting Bank of Thailand intervention to stem rapid appreciation of the baht.

The current account surplus, allied with significant capital inflows, put strong upward pressure on the baht: it averaged B37.9/$1 in 2006, compared with B40.2/$1 a year earlier, and it hit a 9-year high of B35.1/$1 in mid-December (Figure 2.28.6). On 18 December the monetary authorities, aiming to curb capital inflows and slow currency appreciation, announced controls, in the form of a 30% noninterest-bearing reserve requirement on many capital inflows. If the reserve-associated funds are withdrawn from Thailand within 1 year, only two thirds of the reserve will be released, equivalent to a tax of 10%.

That decision prompted, on 19 December, a plunge in the stock market. The Bank of Thailand that day stated it would exempt inflows into the stock market from the reserve requirement. In the following weeks it further rolled back the restrictions and indicated that controls would eventually be lifted.

Despite the controls, the baht ended 2006 strongly, at B36.05/$1. The clampdown on capital inflows, in addition to shaking the stock market, exacerbated concerns about the broader investment climate. It also led to the baht trading at different levels onshore and offshore. Thai banks could sell US dollars for baht only in the offshore market, and importers had to pay for imports in US dollars. This limited the supply of baht offshore, causing it to appreciate by as much as B2/$1 against its onshore value. The gap may encourage speculators to arbitrage by buying dollars offshore and selling them onshore.

2.28.3 Quarterly inflation



Source: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 30 January 2007.

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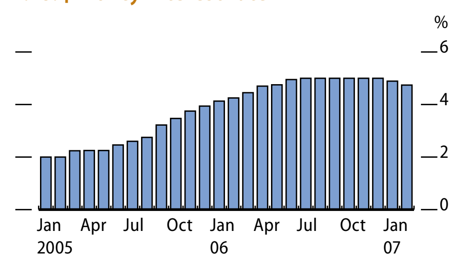
2.28.4 Policy interest rate



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 17 March 2007.

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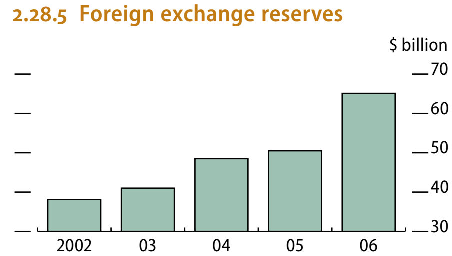
2.28.5 Foreign exchange reserves



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2007.

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Economic prospects

The projections for 2007 and 2008 assume that national elections will take place not later than the fourth quarter of this year. With an elected government in place, if it quickly adopts a credible economic program, business and consumer confidence should start to pick up, which would revive domestic demand in 2008. The incoming government will need to carefully prioritize and accelerate infrastructure investment, which has lagged in recent years and contributed to an erosion of industrial competitiveness.

Net exports look likely to play a smaller role in driving economic growth over the next 2 years, with domestic demand picking up some of the slack. Export growth will ease in 2007 from the fast pace of recent years, based on expectations of a softer global economy and on baht appreciation. Exports in nominal terms are projected to grow by about 7.9% in 2007, with exports of manufactures in particular curbed by the appreciation.

Imports will accelerate somewhat as companies rebuild inventories, though sluggish domestic demand is likely to keep import growth to about 8%. Imports should rise faster after the elections, when both private and public investment is expected to revive. The trade balance this year is forecast to notch up a surplus of $2.3 billion, but that will shrink in 2008. The current account is projected to record a surplus of 1.3% of GDP this year, but move into deficit in 2008 (Figure 2.28.7).

Retail sales data late in 2006 showed a slowdown of private consumption, already suggesting weakness heading into 2007. Subsequent bombings in Bangkok, which killed seven people during the new year's celebration, helped bring down consumer confidence to a 5-month low in January, and it remained weak in February.

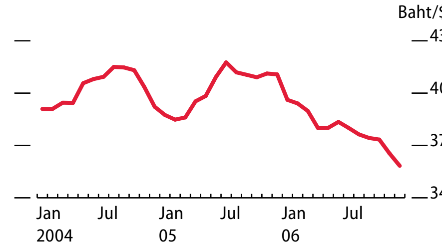
Government consumption spending in 2007 is expected to rise significantly as a result of a decision to accelerate budget disbursements and because of the elections. Hence, total consumption is projected to grow by about 4% in 2007, up slightly from 3.2% in 2006.

Private investment is likely to be modest owing to the political uncertainties and dented foreign investor sentiment, though it will no doubt strengthen in 2008 if confidence in the economy comes back. Public investment will pick up in 2007 and gain pace in 2008 as the Government moves ahead with some infrastructure investments. Contract bidding for new mass transit rail lines was expected to start in May 2007. Five lines have been approved, but construction will probably start on only two this year. Growth in fixed investment in 2007 is projected at 5%, accelerating to 8% in 2008. The mixed outlook on the demand side suggests that GDP growth in 2007 will fall to around 4%, before rising to 5% in 2008 (again, if confidence returns).

The budget for FY2007 (ending 30 September 2007) projects a deficit of B142.6 billion, equivalent to 1.7% of GDP. However, revenue collection could again fall short of the target if economic growth is weaker than the official projection of 4.5–5.5% (set in late 2006). The budget deficit will raise public debt to about 41% of GDP this year, though still well within a 50% ceiling under the Government's fiscal sustainability framework.

Average inflation this year and next is forecast to decelerate to 2.5%, from 4.6% in 2006, in large part a result of lower international oil prices

2.28.6 Exchange rate



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 22 February 2007.

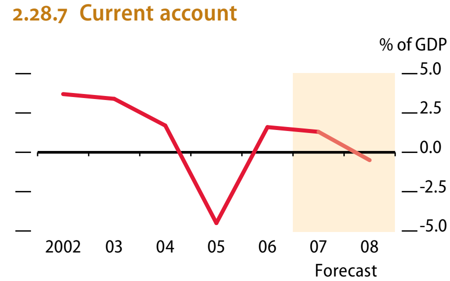
Click here for figure data

2.28.1 Selected economic indicators

	2007	2008
GDP growth	4.0	5.0
Inflation	2.5	2.5
Current account balance (% of GDP)	1.3	-0.7

Source: Staff estimates.

2.28.7 Current account



Sources: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2007; staff estimates.

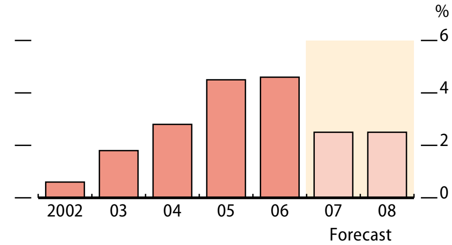
Click here for figure data

(Figure 2.28.8). This could pave the way for further reductions in the policy interest rate.

Thailand's ambitions to become a financial center have been hurt by the imposition of capital controls, the political turmoil, and a halt to privatization of state-owned companies. A capital market plan adopted early in 2006 set a target to double the size of the domestic bond market by 2010. The plan also called for more privatization to broaden the equity market. However, privatization has been on hold since a late-2005 decision by the supreme administrative court that a share offering by EGAT, the state power generating company, may violate the constitution, and no privatization is expected until a new government is elected. The interim government plans to pursue reforms in the financial sector this year with amendments to the Bank of Thailand Act, the Securities and Exchange Act, and the Insurance Act. These amendments aim to free the three regulatory bodies from political interference.

Domestic risks for the economy stem mainly from political uncertainties. A delay in returning to an elected government would most likely lead to public agitation, which would worsen consumer and investor sentiment. Alternatively, an elected government seen to be weak and without a clear economic program would also prolong uncertainty, and result in continued low growth. Violent outbreaks in southern provinces so far have had limited impact on the national economy. Finally, more cases of avian flu were reported in Thailand early in 2007. This disease has the potential to damage the economy because Thailand is a major exporter of poultry products.

2.28.8 Inflation



Sources: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 30 January 2007; staff estimates.

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Development challenges

The political and policy uncertainties generated over the past year need to be resolved if faster growth is to be achieved. In addition to the capital controls, followed by backtracking on those measures, the Government put forward amendments to foreign investment regulations that jolted international companies. The amendments, which were intended to clarify rules on the use of local nominees by foreign-invested companies, mainly affect the services sector. Changes proposed would cause some foreign investors to reduce their shareholdings and limit their voting rights.

Moreover, the Government is advocating the concept of a "sufficiency economy," which underpins the formulation of the 10th National Economic and Social Development Plan (2007–2011). The concept centers on the idea of building economic resilience to outside shocks, keeping investment and household debt within sustainable levels, and ensuring inclusive growth. The Government has given assurances that the sufficiency economy philosophy does not mean backing away from market principles or from welcoming foreign investment. However, many international businesspeople have expressed misgivings about the concept, worried that it may presage a more inward-looking stance.

Viet Nam

The economy maintained a rapid rate of growth in 2006, supported by robust exports, rising consumption spending, and strong investment. Inflation also stayed high. Membership of the World Trade Organization (WTO) from January 2007 has added impetus to development and market-oriented reforms. Provided that further progress is made on structural reforms, further brisk economic growth is projected this year and next.

Economic performance

The economy expanded by an estimated 8.0% in 2006 (against a government-estimated figure of 8.2%), above its trend rate of the past 5 years. Demand was strong for the country's exports of commodities, crude oil, and manufactures. Private investment and private consumption recorded robust growth, too. Growth in private consumption was supported by rising incomes and inward remittances of about $4 billion. Retail sales of goods and services increased by 20.9% in 2006 (about 13% after adjusting for inflation; Figure 2.29.1).

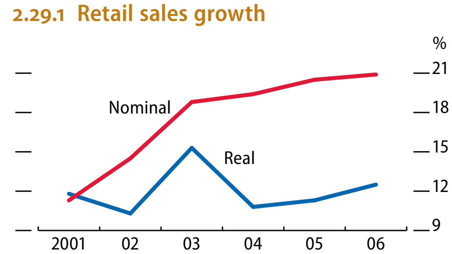
Investment levels remained high at an estimated 39.4% of GDP in 2006. Private investment was encouraged by further simplification of administrative procedures for businesses and moves toward equal treatment between state enterprises and the private sector and between domestic and foreign enterprises. The domestic private sector accounted for 33.6% of total investment in 2006 (Figure 2.29.2). That proportion is up sharply from 22.6% 5 years earlier. Foreign direct investment (FDI) commitments rose to $10.2 billion last year, the highest since the country opened to investment in 1986.

On the production side, the industry and services sectors contributed more than 90% of total GDP growth in 2006 (Figure 2.29.3). Industry expanded by a robust 10.4%, slightly below the year-earlier pace. The manufacturing and the utilities subsectors maintained strong growth (12.4% and 11.6%, respectively; Figure 2.29.4). But mining production barely grew because of a fall in the volume of crude oil production from 18.5 million tonnes in 2005 to 17.0 million tonnes in 2006. Planned development of several new oil fields in coming years is expected to lift production.

Services, on the back of buoyant performances of trade, tourism, transportation, communications, and finance, grew by an estimated 8.2% (Figure 2.29.5). Surging demand for mobile phones is helping drive the expansion. As sales soared, the number of telephones per 100 people rose to about 31 in 2006 from 19 in 2005, and is expected to exceed 50 by the end of 2009.

Production in agriculture rose by 2.9% last year, below average for recent years, because of floods and typhoons. Rice output fell, partly due to a decrease in acreage planted. Agricultural land is being converted

2.29.1 Retail sales growth



Sources: General Statistics Office of Viet Nam, available: http://www.gso.go.vn; CEIC Data Company Ltd., downloaded 16 February 2007.

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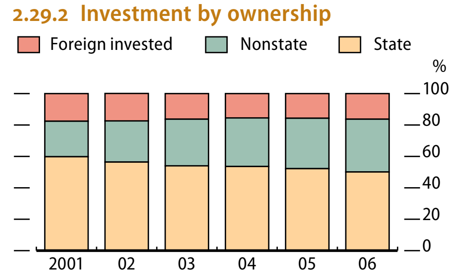
2.29.2 Investment by ownership



Source: General Statistics Office of Viet Nam, available: http://www.gso.go.vn, downloaded 16 February 2007.

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into industrial parks, which reflects the changing economic structure: agriculture's share of GDP declined to 20.4% in 2006 from 24.5% in 2000. Production of tea, coffee, and natural rubber was buoyed by high export prices. Strong external demand also underpinned growth in the fisheries subsector.

Exports performed strongly in 2006, rising by 23.0% in nominal US dollar terms. The ratio of exports to GDP increased from about 46% in 2000 to 66% in 2006, indicating the openness of economy even before Viet Nam joined WTO in January this year. The structure of exports is becoming more diversified—commodities such as crude oil, rice, marine products, and coffee remain important, but the share of manufactured products is rising. Exports of clothing, electronics, and wood products each expanded by at least 20% in 2006.

Robust domestic demand, particularly from investment projects, lifted imports by a third, widening the trade deficit to $4.5 billion. Vigorous expansion in both private remittances and tourism receipts helped limit the current account deficit to $1.3 billion, or 2.1% of GDP. Buoyant FDI inflows supported the balance of payments, resulting in a rise in gross international reserves to $11.4 billion, equivalent to 3.5 months of imports (Figure 2.29.6).

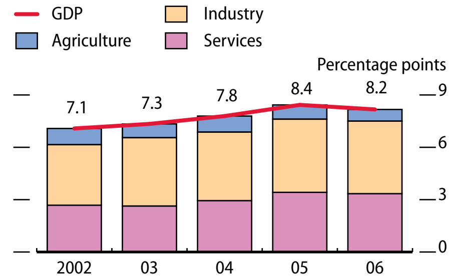
Inflation continued to run high, exceeding 7% on average during 2006 for the third year in a row (Figure 2.29.7). Rising food prices were one cause; increases in administered prices of domestic fuels and in transport charges were others. In February 2007 inflation was 6.5%, and is expected to stay around this level through the year. For employers, rapid growth in demand for workers and professionals pushed up payroll costs. The minimum salary of civil servants was increased by 30% in October 2006, a component of reforms to the civil service. Administered domestic fuel prices were raised in April and in August 2006, by a cumulative 18.5%, and then reduced twice by a cumulative 12.5%. Subsidies have been largely eliminated for gasoline and kerosene, and the Government plans to eliminate fuel subsidies completely next year. The International Monetary Fund has estimated that subsidies, mainly on diesel fuel, were still equivalent to 1.3% of GDP in 2006.

Moving to curb inflation, the State Bank of Viet Nam set a 2006 year-end target of 20% growth in credit, compared with rapid growth of 40% in 2005 (though actual credit growth was about 24% late in 2006; Figure 2.29.8). The slower rate of credit growth in 2006 was attributable to more cautious lending by state-owned commercial banks, which were following new prudential standards.

Officially, the authorities follow a managed float of the dong. The currency depreciated in nominal terms against the US dollar by about 1% in 2006 (Figure 2.29.9). In a step toward more flexible exchange rate management, the central bank widened the daily trading band for the dong against the US dollar, from 0.25% to 0.5%.

The overall fiscal deficit was high in 2006 at 5.0% of GDP as the Government pursued the building of infrastructure. Fiscal revenues surpassed the planned target by 10%, attributable to higher oil income (29% of the total), improvements in tax administration, and a growing number of tax-paying businesses in the formal sector (Figure 2.29.10). Receipts from value-added tax have increased significantly in recent

2.29.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; General Statistics Office of Viet Nam, available: http://www.gso.go.vn, downloaded 16 February 2007.

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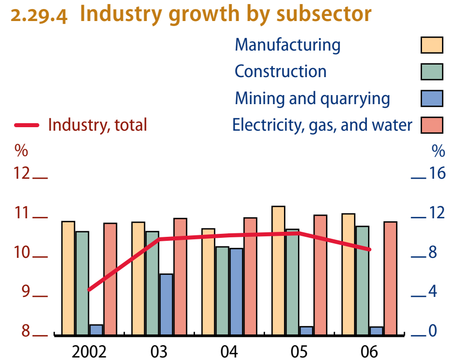
2.29.4 Industry growth by subsector



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

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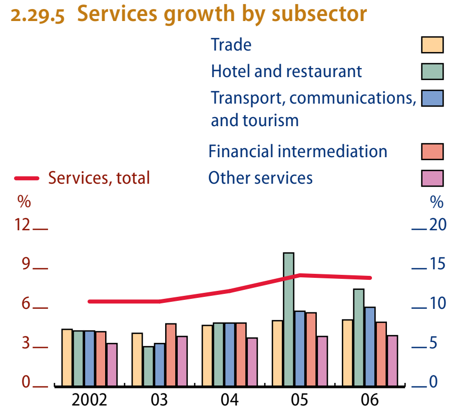
2.29.5 Services growth by subsector



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

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years. Strong revenue growth is critical to funding the state's 30% share of the estimated $140 billion investment required to achieve targets set out in the socioeconomic development plan for 2006–2010. Off-budget expenditures rose from 1.2% of GDP in 2004 to an estimated 2% of GDP in 2006. These are used mainly for investment in infrastructure and education. Investment in infrastructure now exceeds 9% of GDP and is expected to reach 11% in coming years. The off-budget expenditures are subject to National Assembly scrutiny, as is budgetary spending. Public and publicly guaranteed debt was an estimated 45.5% of GDP in nominal terms at end-2006. External debt was estimated at 32% of GDP. Moody's upgraded the country's Ba3 foreign-currency sovereign rating outlook to positive from stable.

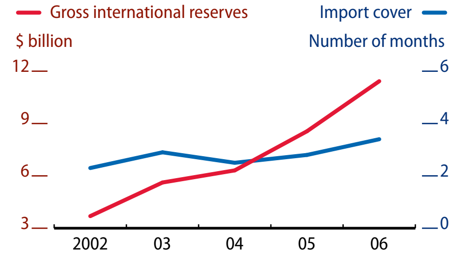
The growth of the private sector has been a significant feature of Viet Nam's economic development over the past decade. The nonstate sector accounted for more than half of GDP in 2006. Preliminary estimates show that private businesses generated almost 90% of the 7.5 million jobs created during the 5 years to 2005. Most of the 1.6 million new jobs Viet Nam needs to create annually in 2006–2010 are expected to come from the private sector. However, shortages of skilled labor have become apparent. The industrial park and export processing zone authority for Ho Chi Minh City has stated that the city's vocational schools can only supply about 15% of the 500,000 workers that the city's industry will likely need through 2010.

In the policy arena, the Government in May 2006 outlined a strategy for banking reform. The State Bank of Viet Nam is to be converted into a modern central bank with a mandate (and capacity) to manage monetary policy and supervise financial institutions. State-owned commercial banks are to be restructured in an effort to improve their performance, and are to be "equitized," or partly privatized, by 2010. The Viet Nam Foreign Trade Bank (Vietcombank) will be partially privatized in the second half of this year. A stock market boom has enabled many joint-stock commercial banks to raise equity capital and so increase their capital-adequacy ratios. Several domestic banks also took major international banks as strategic partners.

The securities market expanded beyond expectations in 2006. The number of listed companies rose to 193 from 41, and total market capitalization increased by almost 20 times from 2005 levels, to $14 billion, or 22.7% of GDP. The main index of share prices soared from 307.5 at end-2005 to 751.8 12 months later, and climbed further to 1,138 at the end of February this year (Figure 2.29.11). There are concerns that speculators using funds borrowed from banks may face repayment difficulties if stock prices dropped precipitously, and big fund flows could cause problems for the implementation of monetary and foreign exchange policies. With this in mind, the central bank warned commercial banks of the risk of increasing securities-backed loans and requested commercial banks to report on such loans.

Moves were made to improve corporate governance and market regulation. A law on securities and securities markets was approved, and came into force in January 2007. It provides a legal base for investor protection and market transparency, including disclosure requirements for publicly held companies. The maximum foreign ownership in listed

2.29.6 Reserves and import cover



Sources: International Monetary Fund, *International Financial Statistics* online database, downloaded 7 February 2007; staff estimates.

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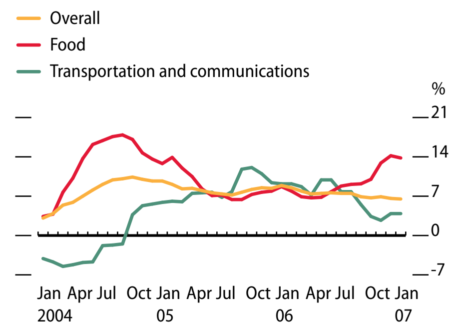
2.29.7 Monthly inflation



Sources: General Statistics Office of Viet Nam, available: http://www.gso.go.vn, downloaded 19 February 2007; International Monetary Fund, *Vietnam: Statistical Appendix*, November 2006.

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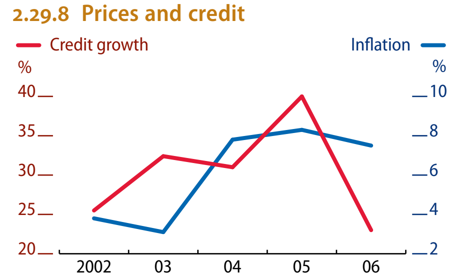
2.29.8 Prices and credit



Sources: International Monetary Fund, *International Financial Statistics* online database, downloaded 7 February 2007; staff estimates.

Click here for figure data

companies was lifted from 30% to 49%. The stock market boom also encouraged more state-owned enterprises (SOEs) to issue shares to investors. Subsidiaries of several major SOEs in areas such as hydropower made successful initial public share offerings. The prime minister in December approved a list of state firms to be equitized during 2007–2010, including major ones such as Viet Nam Airlines.

Economic prospects

Prospects for the economy are predicated on the assumption that WTO accession will maintain the momentum for structural reforms. Commitments given to liberalize the financial sector should speed up bank restructuring. Anticipated reforms to state banks, partnerships between foreign and domestic banks, and the boost to equity capital for joint-stock commercial banks likely will mean a strengthened banking system, a broader range of products for customers, and better access to finance, particularly for small and medium enterprises.

Similarly, the pace of reform in SOEs should be stimulated by additional competitive pressure that these firms will face as more international businesses enter the domestic market. The stimulus of the successful initial public offerings in 2006 and the record of SOEs improving their operating performances after equitization are expected to lift the pace of equitization, particularly of large SOEs. The country has also committed, under its WTO membership terms, to allow foreign ownership of services firms.

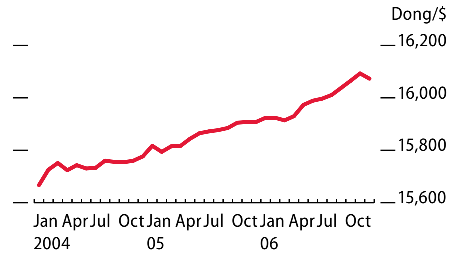
On these assumptions, the economy is predicted to grow by 8.3% in 2007 and 8.5% in 2008. Growth will be underpinned by strong private consumption, private investment, and FDI. Total investment as a share of GDP is projected to be about 40% in the next 2 years. Industry (projected to expand by 10.5%) and services (8.5%) will continue to drive overall growth (Figure 2.29.12). The Government aims to lift spending on infrastructure toward 11% of GDP in the medium term, from about 9% now, which will spur construction activity.

WTO accession also provides greater opportunities for exporters as the country becomes eligible for most-favored-nation treatment by WTO members and is no longer subject to quotas. This will benefit competitive industries such as clothing, wood products, footwear, and marine products. Exports are projected to maintain strong growth of around 18% this year and next. Robust consumption and investment demand will keep import growth high, and the trade account is estimated to be in deficit by 4.7% GDP in 2007, and 3.8% GDP in 2008 (Figure 2.29.13). However, buoyant inward remittances and tourism receipts are likely to mean small current account surpluses in the forecast period.

Fiscal policy will remain expansionary, with additional outlays on public sector wages and on infrastructure. Improved tax administration and the expansion of the formal sector of the economy will broaden the tax base. The impact on revenues of tariff cuts in compliance with WTO commitments will be slight: average tariffs come down just 4 percentage points to 13.4%, and this happens over 5–7 years. The fiscal deficit is projected to remain around 5%.

The political leadership has stepped up efforts against corruption,

2.29.9 Nominal exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 12 March 2007.

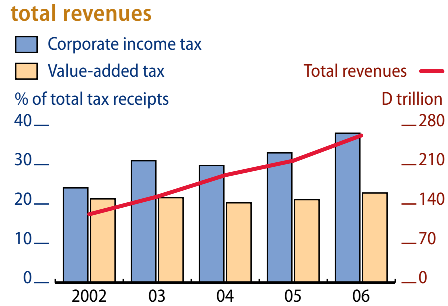
Click here for figure data

2.29.1 Selected economic indicators

	2007	2008
GDP growth	8.3	8.5
Inflation	6.8	6.3
Current account balance (% of GDP)	0.2	1.3

Source: Staff estimates.

2.29.10 Selected components of total revenues



Sources: International Monetary Fund, *Vietnam: Statistical Appendix*, November 2006; staff estimates.

Click here for figure data

and a committee headed by the prime minister was established to coordinate the campaign. A decision by the Communist Party in January 2007 to streamline its organization and to strengthen the transparency of enterprises under the defense and police ministries suggests a commitment by leaders to improve the performance of the public sector. The Government has this year made public administration reform a high priority.

Domestic risks to the projections include a possible backtracking in the Government's commitment to implementing reforms and controlling corruption, which would discourage investment. This risk currently appears low. Power shortages remain a problem, given an estimated 15% annual growth in demand. Power sector investment needs are large ($2.5 billion–3.5 billion) a year. Hydropower accounts for 56% of power supply, but this leaves the country vulnerable to droughts. A failure to meet energy demand and to reduce reliance on hydropower could undermine growth.

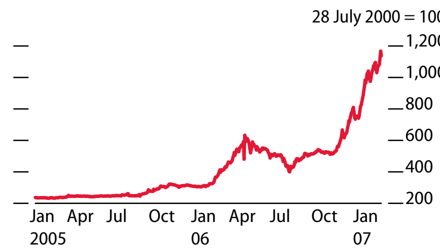
Development challenges

The socioeconomic development plan for 2006–2010 seeks high rates of economic growth (7.5–8.0% annual average) based on an investment-to-GDP ratio of about 40%. Investment levels already are high; the challenge now is to improve the efficiency of investment. Studies suggest little improvement in the productivity of capital in recent years. Worse, public investment is sometimes used inefficiently. The rising proportion of domestic and foreign private investment in total investment (it was 46% in 2001–2005) should improve the productivity of capital, and the restructuring of SOEs should do the same in the public sector. However, SOE reforms need to be accelerated, especially now that WTO entry will allow more foreign firms to operate in the country.

Related to the productivity issue is the shortage of skilled workers. This has been cited in surveys as the third most important constraint faced by manufacturers, after access to finance and to land. The education system is not up to the task at this time, with generally out-of-date curricula, a lecture-centered method of teaching, and research activities separated from teaching.

Another challenge is to maintain controlled development of the stock market in the face of the boom in share prices. A sudden reversal and capital outflows could jolt the economy. While the supply of securities has been increasing, demand has been even stronger, given limited outlets for savings. Investor education and better corporate disclosure would seem part of the answer. On the macro level, a timely and comprehensive set of data on capital flows is needed to guide policy making and to facilitate market functioning.

2.29.11 Ho Chi Minh City stock price index



Source: CEIC Data Company Ltd., downloaded 20 March 2007.

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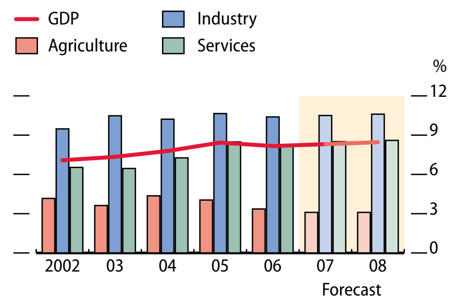
2.29.12 GDP growth by sector



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 16 February 2007; staff estimates.

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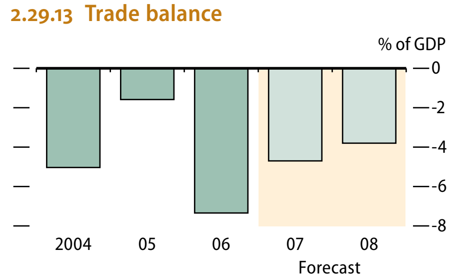
2.29.13 Trade balance



Sources: International Monetary Fund, *Vietnam: Statistical Appendix*, November 2006; staff estimates.

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