Part 2

Economic trends and prospects in developing Asia

Central Asia

Armenia
Azerbaijan
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

Largely on account of the rapidly growing nontradable sectors of construction and services, the economy continued to grow beyond expectations, at 13.4% in 2006. The fiscal deficit was kept in check through expenditure rationalization and tax reforms. Higher remittances, public spending, and private investment supported growth in domestic demand. Rising fuel prices and a poor agricultural harvest put some pressure on prices, but inflation remained generally contained. A moderate deceleration is expected in 2007–2008 as production capacity limits are reached and the pace of growth in construction and services eases. Prospects are promising, but structural reforms have to continue, parliamentary and presidential elections must be seen to be democratic, and regional conflicts need to be resolved to allow closed trade routes to open.

Economic performance

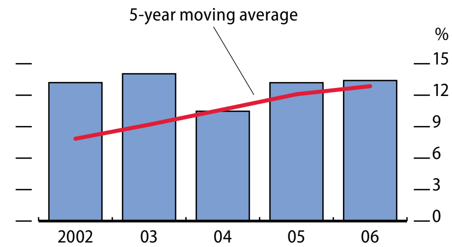
The economy showed substantial resilience as GDP grew by 13.4% in 2006, against the 11.0% projected in the 2006 budget program, continuing the double-digit growth trend of the past half decade (Figure 2.1.1). On the supply side, the main contributions came from rapid growth (37.1%) in industrial construction (for roads, mining, and energy infrastructure) and residential construction; services (20.2%); and retail trade (10.5%) (Figure 2.1.2). The share of construction in GDP now exceeds 20%.

GDP expansion would have been higher still but for the poor performance of manufacturing and agriculture. Manufacturing activity declined mainly due to disruptions in the external supply of raw diamonds for processing, but also due to low growth rates of jewelry, light industry, and chemicals, all reflecting low external demand. A narrow manufacturing production base remains a structural weakness and a constraint to sustaining high growth. Agriculture posted low growth of 0.4% on account of a poor harvest. On the demand side, government consumption and investment supported higher social and capital spending. Rapidly rising wages and remittance inflows bolstered private consumption.

The expansion in services and construction activities continued to help bring down the official level of unemployment from 8.1% in 2005 to 7.4% in 2006. Average monthly nominal wages rose by 23.5% in 2006, boosted by strong growth in public and private sector wages. Revised official estimates put poverty in 2004 at 35%, lower than the previous estimate of 39%. Sustained economic reforms, strong growth, and single-digit inflation reduced poverty further to 30% in 2005. Per capita GDP in US dollars has tripled since 2000, reaching almost $2,000 in 2006 compared with $1,524 in 2005, partly on account of the dram's appreciation (Figure 2.1.3).

Year-on-year inflation accelerated to 6.8% in July, reflecting a poor agricultural harvest, higher telecoms and other utilities tariffs, rises in import prices of energy and raw materials, as well as accelerated

2.1.1 GDP growth



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 9 January 2007.

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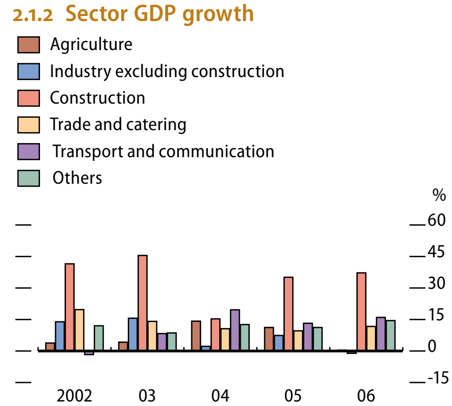
2.1.2 Sector GDP growth



Source: Ministry of Finance and Economy, available: http://www.mfe.gov.am, downloaded 12 March 2007.

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monetary growth (Figure 2.1.4) (due to sustained inflows of foreign exchange and limited ability to sterilize their impact). But inflation moderated to 5.2% by end-2006 on account of seasonal fluctuations in food prices and drops in sugar, gasoline, and diesel prices. Given deflation in the first quarter (Figure 2.1.5), average inflation for the year came in at 2.9%, just below the targeted 3.0%. In early 2006, the Central Bank of Armenia began a switch to a policy of inflation targeting from monetary targeting. It now issues regular inflation reports and is using a quarterly model for forecasting; it will shift to full-fledged inflation targeting over the medium term. The authorities will use short-term interest rates, central bank bonds, and monetary aggregates as control mechanisms.

The Government has pursued prudent fiscal policies and is now shifting its focus from expenditure contraction to revenue generation. The fiscal deficit continued its sustained reduction from over 5% of GDP in 1999 to 1.9% in 2005, falling to 0.6% of GDP in 2006 (Figure 2.1.6), well below the budgeted 2.9%. Lower than programmed budget expenditures and higher than expected GDP growth that helped boost tax receipts contributed to this outcome.

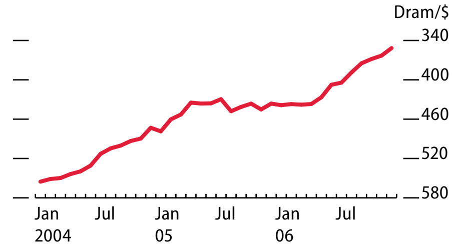
Although nominal tax revenues have been rising gradually, the tax-to-GDP ratio remains essentially stable (at about 14% of GDP) because of widespread tax evasion, weakness in tax administration, excessive exemptions that limit the tax base, and heavy reliance on indirect taxes (about 60% of total tax revenues). Consequently, the major contributors to economic growth—construction, services, and agriculture—have largely escaped the tax net. Lack of buoyancy in the services tax is partly because it is specific rather than ad valorem. Agriculture is not taxable until 2009, in accordance with an agreement with the World Trade Organization. According to the World Bank's *Doing Business 2007*, foreign and joint-venture companies form the top taxpayers while many large domestic enterprises avoid the tax net.

In 2006, the Government implemented several measures to boost tax revenues to finance higher spending in infrastructure and social services in line with commitments made in its poverty reduction strategy paper (PRSP). These included moves to broaden the tax base by reducing exemptions and loopholes and to improve the efficiency of tax administration. The State Tax Service amended the law to tax property above a threshold limit. The authorities prepared a draft bill to tax construction projects. With improved collection from value-added, income, and profit taxes, tax receipts improved marginally to an estimated 14.4% of GDP in 2006 from 14.3% the year before.

Recognizing that reducing the size of the shadow economy is vital to improve compliance, the parliament approved a financial disclosure bill making income and property declaration mandatory for citizens earning more than $19,000 per year, an amount that is more than 10 times the official average salary. The law is expected to come into force in 2008. The Tax Inspection Unit published the list of the 1,000 largest taxpayers. The Government envisages lowering dependence on external grants and meeting the budget targets through internally collected revenues to enhance sustainability of its resources.

Imports showed robust 21.8% growth in 2006, largely owing to a pickup in capital goods and mineral products, which reflected the

2.1.3 Nominal exchange rate



Source: Central Bank of Armenia, available: http://www.cba.am, downloaded 21 February 2007.

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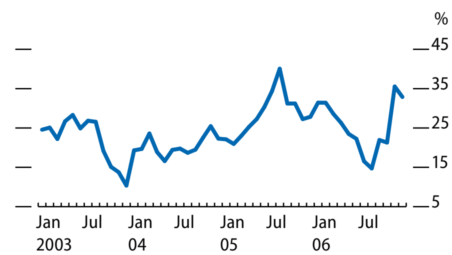
2.1.4 Money supply (M2x) growth



Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of Armenia, available: http://www.cba.am; both downloaded 10 March 2007.

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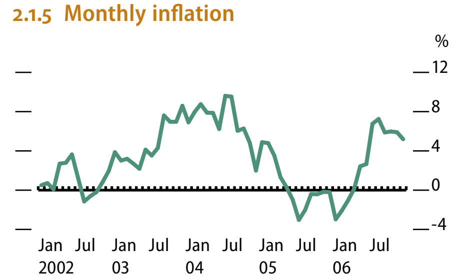
2.1.5 Monthly inflation



Sources: International Monetary Fund, *International Financial Statistics* online database; National Statistical Service of the Republic of Armenia, available: http://www.armstat.am; both downloaded 10 March 2007.

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expansion in construction and investment activity as well as higher commodity prices. Exports, though, achieved only low 3.1% growth, mainly because of a fall in base-metal exports (as modernization programs restricted activity), a drop in the diamond-processing trade (amid supply disruptions and stiffer competition from other countries), and stagnant foodstuff exports. The upshot was a widening of the trade deficit to $1,190 million or 18.6% of GDP (Figure 2.1.7). Considerable inflows of transfers and income from abroad helped narrow the current account deficit to about 5% of GDP. Gross official international reserves increased by $402 million in 2006 and stood at about 5 months of imports of goods and services.

Continued official emphasis on a sustainable debt-management policy has seen a marked reduction in external public debt as share of GDP in recent years. It remained at 20.5% of GDP in 2006 (Figure 2.1.8), while the debt service ratio was only 4.2%, as essentially all outstanding debt is on concessional terms.

In 2006, Armenia received an international credit rating for the first time. Moody's assigned a BA2 grade of foreign and local currency rating which signifies a medium level of creditworthiness and a stable outlook. Fitch's assigned a lower BB- sovereign credit rating indicating a relatively high risk of doing business, as the economy remains vulnerable to shocks due to its high degree of dollarization, underdeveloped financial services, low value-added economic activity, as well as the Nagorno-Karabakh conflict.

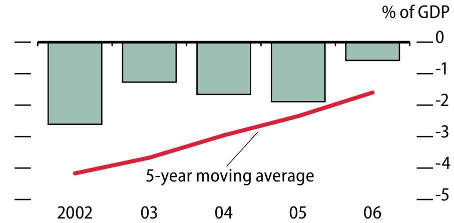
The banking sector has improved but the nonbank financial services market needs attention. The diaspora seems keen to maintain the significant flow of investment spending seen in the last several years. But owing to continuing weaknesses in business procedures, foreign direct investment (FDI) not only fell from 5.1% of GDP in 2005 to an estimated 3.1% in 2006, it has become lower than the mean levels of neighboring countries. Higher inflows of FDI, especially into the tradable sector, would support greater export volumes as well as upward labor mobility and international integration. Further efforts are needed to address corruption and other weaknesses (Box 2.1.1).

Economic prospects

Robust economic growth of the first few years of this century is providing the necessary support for building a coherent macroeconomic policy framework and pushing through wide-ranging structural reforms. It is expected that the PRSP update for 2007 and the recently released Medium-Term Expenditure Framework 2007–2009 (MTEF) will guide economic policy making in the coming years.

The average exchange rate is assumed to be stable in 2007–2008. The narrow export base will keep exports susceptible to changes in international prices. The general parliamentary election in May 2007 and presidential election in early 2008 are not expected to adversely influence the pace of economic reforms. Major bilateral donors, however, have stressed that proper conduct of the elections is an important concern. Prospect for securing an agreement with Azerbaijan in the long-standing dispute over Nagorno-Karabakh remain gloomy.

2.1.6 Budget balance



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 10 March 2007.

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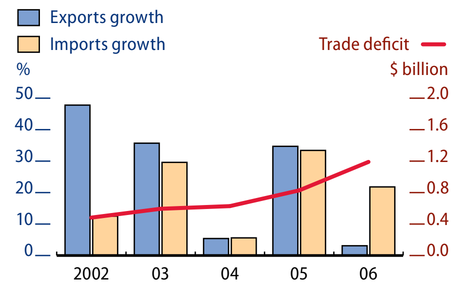
2.1.7 Trade indicators



Source: Ministry of Finance and Economy, available: http://www.mfe.gov.am, downloaded 12 March 2007.

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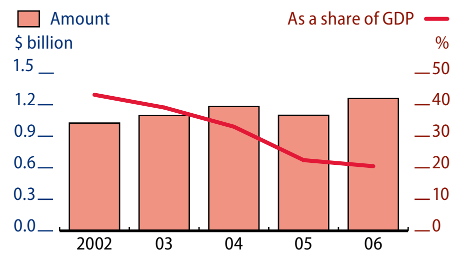
2.1.8 External public debt



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 12 March 2007.

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2.1.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-5.0	-5.0

Source: Staff estimates.

The economic outlook is positive. However, growth momentum is expected to moderate, to 10% in 2007 and 9% in 2008, as a result of a high base and a deceleration in growth that has already begun in construction, services, and retail trade. The central bank forecasts falls in the growth rates of construction to 12.9% and services to 11.3% this year, and these declines are unlikely to be offset by higher production in agriculture and industry. However, output in these two sectors is set to rise on account of planned investments in irrigation, transport and communications, energy, mining, metallurgy, machine building, and chemicals, boosted by greater availability of private credit and external assistance. Higher public and private wages together with rising remittances will continue to support high growth in consumption spending.

Some inflationary pressures will result from growing domestic demand. Against this, the central bank's monetary program has set a 4.0% annual inflation target, which should be achievable if there is adherence to budgetary targets for financing, some recovery in the agriculture sector, and easing in international prices pressures. Further appreciation of the dram could damp inflationary pressures, though this outcome has not been assumed in the forecast.

Trade deficits will remain large in the forecast period as there will only be a slight improvement in export growth in the face of a continued rapid expansion in imports to support higher construction and investment activity as well as the necessary high volumes of food imports. Sugar importers will have to deal with higher world price while oil importers would benefit from the easing pressure of world prices.

The narrow base of the export basket will keep exports susceptible to changes in international prices. In particular, exporters will face mixed trends in global commodity prices as metal prices are expected to rise and the price of diamonds to fall. Export growth is limited because little relief appears in sight to end the structural problems in the diamond-processing sector and the narrow manufacturing base, though mining and metallurgy exports are expected to accelerate because of new investment.

If the trends of the last few years are maintained, increases in net income from abroad and large foreign transfers are expected to partly offset the trade deficit and contain the current account deficit at about 5% of GDP over the forecast period. Inflows of capital grants, FDI, and foreign development assistance are expected to be sufficient to allow a moderate increase in official reserves.

Fiscal deficits will widen from levels of the past few years to accommodate a rapid rise in defense spending and commitments to higher social and capital spending under the PRSP. This is also reflected in the MTEF. Based on a 9% assumed increase in GDP, the parliament has approved a 16% increase in 2007's budget spending, which includes a 40% rise in the military budget. More than one third of expenditures are earmarked for education, health care, social security, and other public services, with the average monthly wage of civil servants rising by 20% and full-time schoolteachers' salaries by 27%.

The proposed public investment program under MTEF will help streamline investment spending. Higher revenue collection through tax reforms and improvements in tax administration are expected to raise the

2.1.1 Poverty and corruption

The most important development challenges are high levels of poverty, especially in rural areas, and of corruption. Weak investment and productivity increases have led to low farm incomes and a high poverty risk in agriculture. With limited nonfarm employment opportunities, any trickle-down of economic growth to rural households through job hires and self-employment has been minimal.

The official unemployment figures mask the real situation as survey-based sources place unofficial estimates of national unemployment at 20–30%. This is largely due to low overall productivity and returns from farming activity, low growth in the off-farm rural sector, a dearth of well-paying jobs for the educated unemployed, and limited access and high cost of finance for rural enterprises. The public benefits and private transfers forming the bulk of rural households' income are inadequate. Lack of basic infrastructure and effective public services delivery are binding constraints.

Corruption is pervasive, especially in the public sector, and is encouraged by ineffective systems of accountability and weak tax administration in the civil service and the State Tax Service. It is manifested in bribery, tax evasion, and underreported profits. This has led to lower receipts from value-added, income, and profit taxes than in its neighbors, even with similar tax rates. Another stimulus is the stark disparity in wages between the public and private sectors, which too often encourages "inducements."

To its credit, the Government is improving tax administration and is considering performance-based pay system to retain high-quality staff in the civil service, and has signed up to various international anticorruption schemes. But the absence of legal sanctions against corrupt officials has left the public skeptical about the Government's capacity to curtail corruption. Deeper institutional reforms are key to moving forward.

tax-to-GDP ratio by about 1 percentage point, but this may not match the additional resource requirements. The budget deficit is targeted at 2.3% of GDP in 2007. This would be largely financed by external assistance and grants with a need for moderate deficit financing.

Until its initiatives generate adequate revenues, the Government will need alternative sources of financing to meet its rising spending commitments. While it is currently maintaining a zero limit on contracting new nonconcessional debt, robust economic growth and improved creditworthiness have strengthened its capacity for such borrowing. Its ability to repay external public debt is strong, as reflected in low and falling levels of the debt-to-GDP ratio and the debt service-to-exports ratio as well as in rapidly rising per capita incomes.

This observation is consistent with the positive results of the Government's debt-sustainability analysis. Improvements in sovereign credit ratings will promote Armenia's foreign partnerships and attract investment in large-scale projects. A favorable macroeconomic outlook and emerging investment opportunities bode well for the Government to borrow on nonconcessional terms.

The medium-term outlook clearly faces risks, among which external factors loom large. For example, heavy dependence on remittance flows, a limited export base, and a highly dollarized economy make Armenia vulnerable to shocks from external demand, international prices, and exchange rate fluctuations. Further appreciation of the dram poses difficult challenges for monetary management and, if sustained, could cause "Dutch disease," impinging on the international competitiveness of exports and import-competing goods. (These issues are discussed further in Box 2.1.2.)

The Russian Federation is the largest trading partner and a leading investor in energy. A 2006 bilateral agreement allows Armenia to pay the Russian company Gazprom a highly discounted price of $56 per 1,000 cubic meters of gas until end-2008, a trade-off for the sale of a power plant to Gazprom. However, the start of 2009 may bring with it considerably higher gas prices. The Government has, though, incorporated the impact of such a possible rise in designing the targets in its 2007 budget.

2.1.2 Dynamics of the dram-dollar exchange rate

Armenia is a highly dollarized economy. An estimated $1 billion is held in US currency notes by residents—about 16% of GDP and three times the value of dram notes in circulation. Close to 65% of bank deposits and 70% of bank loans are denominated in US dollars. Over 90% of total public debt (domestic and external) is denominated in foreign currency, increasing the vulnerability of public sector balance to exchange rate shocks.

Strengthening capital and financial accounts and rapidly growing remittances and foreign investments in real estate continue to fuel appreciation of the dram in a freely floating exchange rate regime. The dram has registered a substantial nominal appreciation in its dollar value since January 2004, rising by 15% in January–September 2006 alone. This has had a significant impact on trade and inflation.

A new law requiring certain transactions to be conducted only in local currency as part of the Government's drive toward dedollarization has led to an increase in the demand for dram, as has its recent marked appreciation. Given large foreign investment flows into real estate, a proposal to tax construction projects is expected to reduce the upward pressure on the currency.

The Central Bank of Armenia has been carrying out sterilization interventions since June 2006 to moderate short-term fluctuations in the exchange rate without trying to fix its level. The central bank's approach is to keep inflation low and the exchange rate floating without a predetermined path for the dram, which moves according to market forces.

International Monetary Fund estimates show that the real exchange rate against the dollar is now close to its market equilibrium level.

Azerbaijan

Phenomenal economic growth was recorded in 2006, powered by soaring production and exports of oil and gas. Foreign investment, primarily for hydrocarbons, is beginning to taper off as large projects in the sector become operational. The Government is bullish that much higher domestic public investment, especially non-oil, will partly offset this decline. Yet rapid and deep structural reform is imperative for such investment and—along with controlling inflation and preventing excessive exchange rate appreciation—is the key challenge.

Economic performance

GDP leaped by 32% in 2006 (Figure 2.2.1). The oil and gas sector, accounting for about 54% of GDP (a sizable rise from 42% in 2005), was the key contributor to the acceleration, as production and volume of exports surged by 48% and 60%, respectively. This was mainly due to a production upsurge at the Azeri-Chiraq-Guneshi (ACG) oil fields, operated by the Azerbaijan International Operating Company (AIOC). The Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which can transport up to 1 million barrels a day, was formally inaugurated in July. This pipeline greatly increased oil transportation capacity from the ACG fields to international markets—AIOC increased its oil production by 88% in 2006.

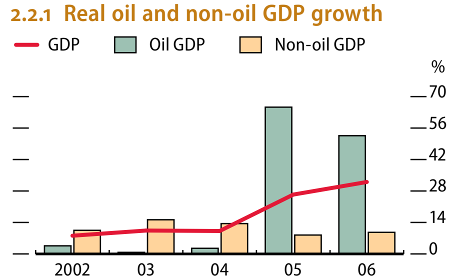
The huge growth in oil and gas completely dwarfed modest non-oil growth, and hydrocarbons' share of GDP is expected to rise further. Still, services grew respectably, at 12.6%, with communications and transport the main contributors. The former increased by 24% due mainly to tariff reforms and rapid expansion of services in the regions; the latter rose by 16%, predominately from transit activities through Azerbaijan and oil transport through the BTC pipeline, which is classified under transport. Construction activities decelerated to 14% from 16% growth in 2005, because of the completion of the BTC pipeline and tougher government regulations on residential construction.

Agriculture expanded by 9.5%, well above recent rates. The Government introduced concessional lending and assistance to the sector and established a state-owned agricultural leasing company to encourage adoption of new agricultural machinery.

In recent years, investment in hydrocarbons, most of it from foreign companies, has been the predominant driver in fast-growing total investment, which in turn has been the main stimulus to rapidly expanding GDP. In 2006, growth in total investment was 15%. With completion of the BTC pipeline and the scheduled completion of other major investment projects at the ACG oil field and the Shah Deniz gas fields in 2007, foreign direct investment (FDI) is expected to markedly scale down.

The Government, however, is optimistic that domestic public investment could cushion this fall. In 2006, such investment jumped

2.2.1 Real oil and non-oil GDP growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

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by 49% to $3.5 billion, of which 75% was from state-owned enterprises (SOEs), 12% from the state budget, and 8% from commercial banks.

Domestic private investment by local businesses and individuals is modest. In recent years, most of this has been in residential dwellings. And given the limited progress made in improving the business environment, it is unlikely that domestic private investment will rise significantly.

The Government ran an expansionary fiscal policy in 2006. Rising by 67%, state spending was mainly on public sector wages, pensions, social services, defense, and infrastructure development. With substantial gains in both world prices for oil and in domestic production, tax revenues (mainly associated with oil and gas) surged by over 80%. About one third of budget revenues come from the State Oil Company of the Azerbaijan Republic, and 17% from transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). The general budget deficit amounted to 3.3% of GDP (Figure 2.2.2), most of which is attributed to increased infrastructure investment.

Financial assets of SOFAZ reached $1.8 billion at the end of 2006. As well as outlays from the government budget, SOFAZ spent from the oil fund on infrastructure development, assistance to internally displaced persons, and investment in the BTC pipeline. SOFAZ derives its revenues mainly from oil sales, income from oil transport, bonuses paid by foreign oil companies, excess between market and projected oil prices, and income from financial investments. SOFAZ spends its oil revenues mainly on social programs and infrastructure, in compliance with the long-term strategy for managing oil and gas revenues.

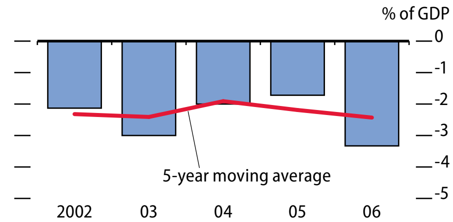
Average official consumer price inflation in 2006 was 8.3% (Figure 2.2.3). It accelerated over the year and averaged just over 11.3% year on year in the fourth quarter. However, independent analysts have suggested that it is much higher. Several factors ramped up prices, including the surge in petrodollars and the limited ability of the National Bank of Azerbaijan (NBA) to sterilize much of the inflow, leading to an excess supply of manat in the economy. M2 jumped by 87% (Figure 2.2.4); reserve money by about 130%; and M1, mostly currency in circulation, by 145%.

Buoyed by burgeoning oil-related revenues, the Government boosted spending on all fronts, putting further pressure on inflation. It issued several decrees to reduce subsidies for utilities services, such as electricity and gas. In response, public utility monopolies raised tariffs to consumers. While reducing subsidies was a positive step toward structural reform, the one-time price rise will pump up inflationary pressures this year. Private monopolies also took advantage of the strong economy to raise prices.

Recognizing the threat of accelerating inflation, the Government introduced various anti-inflationary measures, including agricultural product fairs and price controls on certain agricultural products. However, some of these measures are superficial in nature and distort the pricing mechanism. In addition, NBA tightened monetary policy, lifting the discount rate by 50 basis points to 9.5%. NBA also mopped up excess petrodollars by purchasing over $1 billion in the foreign exchange market. Despite these moves, the manat appreciated by 5.4% in 2006 (Figure 2.2.5).

NBA faces two formidable challenges in controlling inflation. First,

2.2.2 Budget balance



Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

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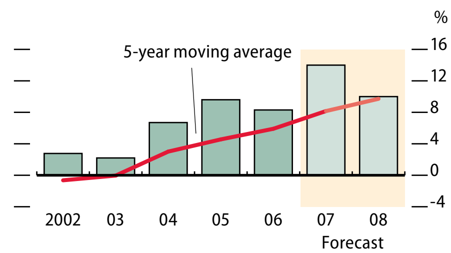
2.2.3 Inflation



Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

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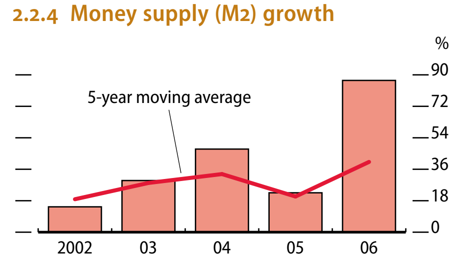
2.2.4 Money supply (M2) growth



Note: Includes foreign currency deposits.

Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 19 February 2007.

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Azerbaijan is still largely a "cash" economy, and therefore much economic activity will not be directly responsive to its measures (outstanding banking system credit is less than 15% of GDP). About two thirds of the monetary base is held as currency outside the banking system, mainly in the informal economy (which may account for as much as 60% of officially recorded GDP). Second, NBA has only limited capacity to conduct open-market operations, because of the rudimentary nature of domestic financial and capital markets. Given the limited monetary policy options, the authorities need to ensure closer coordination between monetary and fiscal policies, and to pay closer attention to expenditures of SOEs and SOFAZ.

Many analysts have called for a reduction in fiscal spending in the non-oil sector to a more sustainable level to combat the threat of escalating inflation, which could seriously jeopardize the good record of macroeconomic stability.

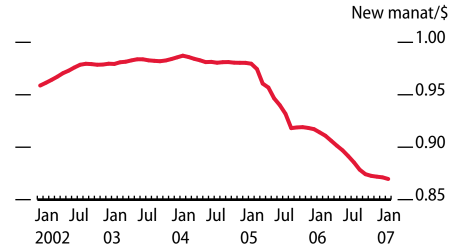
The trade account registered a record surplus of $7.9 billion (Figure 2.2.6) in 2006, propelled by burgeoning oil exports, which contributed 84% of total exports. Total exports surged by 60.7%. Growth in imports slowed to 4.5% in 2006, as machinery and equipment imports eased and investment in major projects wound down. However, strong domestic demand kept growth in consumer goods imports on the rise. The current account recorded a surplus of $1.8 billion (9.0% of GDP) in 2006. The capital account surplus fell significantly because of the steep drop in oil-driven net FDI. Gross official reserves more than doubled to $2.5 billion (Figure 2.2.7).

The major structural issues are similar to those of previous years, including market distortions from anticompetitive behavior of SOEs, lack of corporate governance of SOEs, a weak banking and financial system, and a poor business environment. Most of the SOEs operate as monopolies in their respective markets, such as electricity and gas, agriculture, and sea and air transport. In addition, most operate inefficiently, and, as in the power sector, incur heavy losses that are subsidized by the Government.

The financial and business practices of SOEs need to be reformed urgently, including corporate governance reform, to ensure greater transparency and accountability. There have been positive steps taken to improve this situation; for example, the Government has recently reduced the subsidies to SOEs. SOEs such as the State Oil Company have begun to implement measures under the Extractive Industries Transparency Initiative to improve corporate governance.

Moreover, the banking and financial segment faces an urgent need to reform, so as to promote confidence and efficiency in mobilizing savings for investment, and ultimately to enhance economic growth. Banking is dominated by two state-owned banks: International Bank of Azerbaijan and Kapital Bank, which together control over half of the assets in the sector. They are significantly undercapitalized and not interested in playing a part in modernizing the banking system. One encouraging sign is that major commercial banks have begun to adopt the principles under Basel II. The market dominance of International Bank of Azerbaijan and Kapital Bank is being slowly whittled away through rapid growth of private banks, which are supported by foreign institutional investors

2.2.5 Nominal exchange rate



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 8 March 2007.

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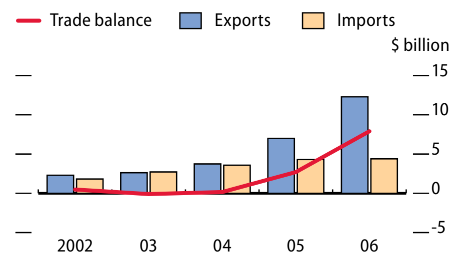
2.2.6 Trade indicators



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: http://www.nba.az, downloaded 30 January 2007.

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2.2.7 Gross international reserves

Source: National Bank of Azerbaijan.

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and multilateral development banks. Still, their market share and power remain largely intact.

Improving business conditions and the investment climate in the non-oil sector is crucial. While the business environment has improved slightly, according to the 2007 *Doing Business* report, the business climate in neighboring countries has improved much faster. In addition to other reforms required, intellectual property rights also need to be secured.

Economic prospects

Forecasts of key economic variables are based on the following assumptions: NBA monetary policy will aim to keep inflation in check and continue a flexibly managed exchange rate policy; petrodollars will continue to flow into the country; and production and exports of hydrocarbons will make another jump. Given the exceedingly large government spending in previous years, huge growth of money supply from oil revenues, and capacity constraints in the domestic economy, raising government spending to an excessively high level in 2007 and beyond may put at risk macroeconomic stability.

Growth peaked in 2006. It is forecast to grow by a still-sizzling 25% in 2007 (Figure 2.2.8), driven by oil production (from the ACG fields) and expected gas output (coming on stream from the Shah Deniz field) and their export, as well as an expansionary fiscal policy. It is seen slowing further in 2008 to 17%, as growth in production of oil and gas moderates and FDI falls, as hydrocarbons move to a less intensive phase of development. Some of this deceleration will be offset by increased inflows of development assistance.

The Government envisages, optimistically, domestic public investment as a key driver of growth in the coming years (the Ministry of Economic Development foresees it rising by one third a year). Growth in domestic private investment will likely remain modest. To boost it substantially, the Government will need to advance the pace of structural reforms. It forecasts the non-oil sector growing at an average rate of about 9.6% a year through 2009.

Parliament approved the state budget for 2007 in autumn 2006. State spending is projected to increase by up to 42% in 2007. A large portion of the increase is to be spent, as in 2006, on public sector wages and on pensions, as well as defense and infrastructure. The share of military spending is also rising rapidly.

The general budget deficit is planned to be 1.5% of GDP in 2007. A major concern is whether the economy has the capacity to absorb this increase. However, due to the lagged impact of fiscal policy, the decision to reduce expenditure when inflation accelerates may be too late to combat the threat of a marked increase in inflation. The announcement of increases in the prices of utility services—such as electricity, gas, water, and public transport—by up to 50% will add considerable pressure to inflation in 2007, expected to be 14%.

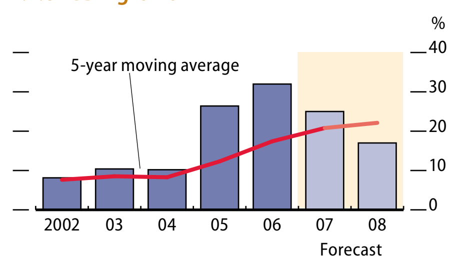
With the substantial increase in oil and gas export revenues, and as import growth is expected to ease, the current account surplus is set to rise to 20.5% of GDP in 2007 and 24.6% in 2008 (Figure 2.2.9). In addition, the authorities have said that there will be no imports of natural

2.2.1 Selected economic indicators

	2007	2008
GDP growth	25.0	17.0
Inflation	14.0	10.0
Current account balance (% of GDP)	20.5	24.6

Source: Staff estimates.

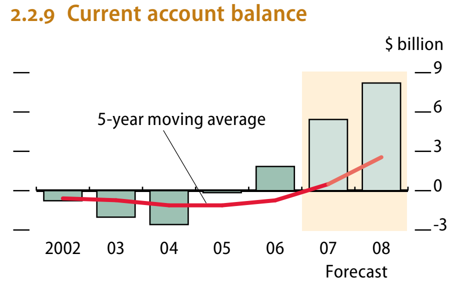
2.2.8 GDP growth



Sources: State Statistical Committee of Azerbaijan; staff estimates.

Click here for figure data

2.2.9 Current account balance



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: http://www.nba.az, downloaded 30 January 2007; staff estimates.

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gas from Gazprom (a state-owned Russian gas company) in 2007, having rejected an increase in the price of natural gas from that company.

The income balance will likely deteriorate as rising oil and gas profits are repatriated. Moreover, the Russian Government issued a decree in November 2006, which restricts activities of migrant workers in its territory. With over 2 million Azerbaijani migrant workers there, this will likely stanch remittances from the Russian Federation.

While prospects remain positive, GDP growth is expected to trend downward to a less abnormal level, but still rely on oil and gas, and on transit activities. However, large and unfettered increases in government expenditures will likely stoke inflationary pressures if supply-side factors are not tackled—production capacity needs to be enhanced and productivity improved. The Government's key challenge is to create an enabling environment to attract private sector investment to the non-oil sector. To do this, it would need to lift the pace of domestic reform.

The major risk to the bright economic outlook centers on properly managing oil revenues to maintain macroeconomic stability and avoid excessive appreciation of the exchange rate. The latter would damage competitiveness in the non-oil sector and limit its development. A very sharp downturn in oil prices would put pressure on both the budget and the current account, and would constrain the rapid economic transformation needed to reduce unemployment and poverty.

Development challenges

The country is now at a crossroads—the Government recognizes that it has to implement the necessary reforms and policies that would allow the economy to grow after the oil reserves are depleted. Expectations among the local populace are high, as the Government attempts to deliver on its promises for improved standards of living within the context of limited institutional capacity, highly centralized decision making, and an ineffective legal system. The presence of monopolies and corruption pose further challenges. With a severe gap between those living in Baku and the regions, the country faces the risk of immeasurable wealth with limited development.

Kazakhstan

Strong prices for oil and gas, rapid growth of domestic consumption, and a rebound in investment continued to propel the economy. But these very strengths carry within them the seeds of future challenges—immediately, keeping rising inflation in check, and improving banks' risk management of their loan portfolios; further out, diversifying the economy, pushing through structural reforms, enhancing competitiveness, and ensuring more equitable development. These measures, plus fiscal and monetary policy coordination, are needed to ensure sustainable growth.

Economic performance

The economy continued to expand at a high and steady rate in 2006. Soaring minerals prices (i.e., oil, gas, and mining), as well as robust private and public consumption and investment, were the main drivers of 10.6% GDP growth (Figure 2.3.1). The oil sector increased at around 5% year on year, after an average rate of about 14% in 2000–2004. Oil and gas play a crucial role in the economy, although growth in the non-oil sector has been faster over the last couple of years.

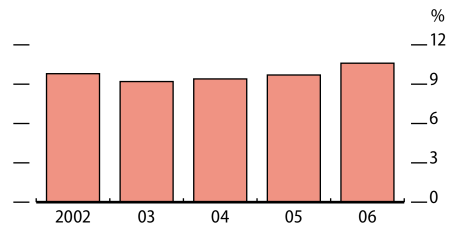
Wage increases and substantial expansion of bank credit fueled private consumption spending. Investment in the resources sector recovered from a recent slowdown and fixed capital investment rose by 18.0% in 2006. Most of this investment consisted of foreign direct investment in minerals, especially in the Kashagan oil and gas field. Fiscal expenditures were augmented to fund increases in minimum wages, pensions, and allowances as well as infrastructure development and social programs. High commodity prices for oil, gas, and metals have significantly raised the value of exports and contributed to raising aggregate demand.

On the supply side, industrial value added rose by 7.0% in 2006 (against 4.6% in 2005), mainly because of mining, industrial processing, and production and distribution of electricity, gas, and water. Construction expanded by 38%, largely in residential dwellings. In manufacturing, real appreciation of the domestic currency, the tenge (T), affected some industries, and capacity constraints in others.

Services, now constituting slightly over 50% of GDP, continued powering ahead at 10.7%, underpinned by a surge in finance (35%), telecommunications (26%), and transport (6.7%). Agricultural production was also buoyant at 8.0%, much higher than the 5-year average of 6%. The sector seems to have benefited from higher productivity arising from investments made in earlier years. Grain and animal husbandry were the two largest contributors to agricultural production growth, picking up by 9.4% and 4.3%, respectively.

Expansionary fiscal policy was another contributor to the surge in demand last year. The budget deficit was T126.2 billion, or 1.3% of GDP (Figure 2.3.2). Rising commodity prices boosted tax revenues from the

2.3.1 GDP growth



Source: Agency of Statistics of the Republic of Kazakhstan.

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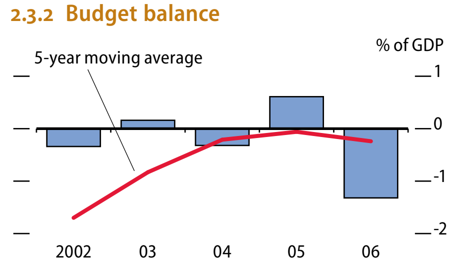
2.3.2 Budget balance



Sources: Agency of Statistics of the Republic of Kazakhstan; Ministry of Finance.

Click here for figure data

resources sector. Fiscal revenues amounted to T1.53 billion in 2006, or 16.1% of GDP, while public expenditures came in at T1.66 billion, or 17.4% of GDP. The major expenditure items were public sector wages and pensions, and public investment programs. High oil prices also helped lift the assets of the National Fund of the Republic of Kazakhstan (NFRK), which rose by $6 billion over the year to $14.7 billion.

Inflation intensified in 2006, and the consumer price index was up by 8.6% for the year (Figure 2.3.3). Several major sources stoked inflationary pressure: a substantial influx of oil revenues; greater public spending on wages and pensions and social programs; and excessive domestic demand largely due to a hefty expansion of credits from commercial banks (up 82%). Structural rigidities that limit competition in certain segments of the market for goods and services as well as capacity limits also contributed to rising inflation.

In its quest to control inflationary pressures, the National Bank of Kazakhstan (NBK) took steps to reduce excess liquidity: it raised the refinancing rate in 2 steps from 8% to 9%; strengthened the minimum bank reserve requirements; issued short-term notes to partly sterilize petrodollar inflows; and allowed nominal appreciation of the tenge. These measures have not been effective as reserve money increased by 131% and broad money surged by 80% in 2006 (Figure 2.3.4). Increasing the refinancing rate may have limited impact because most domestic banks borrow from abroad.

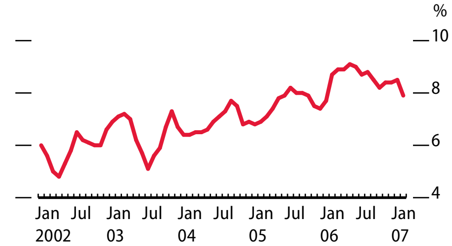
Soaring world commodity prices helped ramp up the value of exports by 35.2% to $38.3 billion in 2006. Crude oil and oil-related products made up just over two thirds of total exports, and metals and metal-related products about one sixth. Imports leaped by 31.7%, largely driven by purchases of machinery and equipment, nonprecious metals, and petrochemical products. The trade surplus increased by 41%. But the deficit on the services, income, and transfers account widened sharply. This stemmed from greater payments for construction, freight, insurance, and information technology services, as well as a near doubling of income payments to foreign direct investors. Nearly all income payments were associated with oil sector development. The current account surplus in 2006 was about $400 million (Figure 2.3.5).

The official reserves at NBK more than doubled to total $19.1 billion at end-2006 (equivalent to 5.4 months of imports of goods and services) while foreign assets of NFRK were $14.1 billion (Figure 2.3.6). The stock of foreign debt stood at $59.6 billion in September 2006 (Figure 2.3.7). Private sector external debt (excluding oil and gas intracompany debt) increased sharply by $11.1 billion to $35.5 billion. The upsurge in private debt in recent years—mainly local bank borrowing for onlending—has largely been in response to the differential between available foreign borrowing rates and domestic lending rates.

The tenge continued to strengthen against the US dollar in 2006, reflecting high export earnings, augmented foreign direct investment, and a surge in private external borrowing. It appreciated by 5.5% over the year, breaking the psychological threshold of T120/$1 in June 2006. It remained below this level in July before NBK intervened and induced a depreciation to around T125–130/$1 (Figure 2.3.8).

Increased credit risk has accompanied the rapid credit growth. Based

2.3.3 Monthly inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 7 March 2007.

Click here for figure data

2.3.4 Money supply (M2) growth

Note: Includes foreign currency deposits.

Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz; both downloaded on 7 March 2007.

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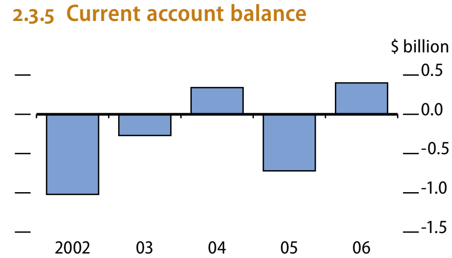
2.3.5 Current account balance



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 28 February 2007.

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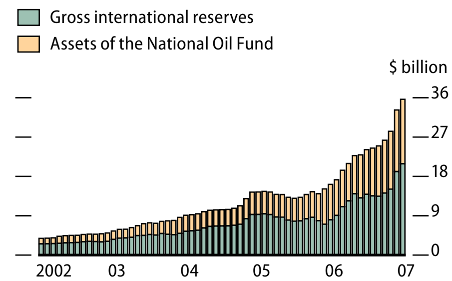
on data from the Agency on Regulation and Supervision of Financial Market and Financial Organizations (AFN), the proportion of bank loans of second-tier banks classified as doubtful loans and bad debts remained extremely high in 2006 at 46%, only down slightly from 48% in 2005. Recognizing the potential problem in the banking sector, NBK and AFN implemented several measures to reduce excessive liquidity and to mitigate risks associated with the deteriorating quality of banks' loan portfolios. The banks' liquidity ratio was increased and asset classification requirement was tightened.

The speed of progress in structural reforms has varied. Robust economic growth seems to have induced some complacency, but new efforts to put Kazakhstan on a more competitive footing and create a favorable environment for business were launched in 2006, including the Kazyna Fund for sustainable development, and Samruk, a new holding company to oversee effective management of state assets (Box 2.3.1). Other measures to improve the business environment included revisions to the law on monopolies and greater powers for the agency regulating them. Substantial progress was made toward joining the World Trade Organization.

2.3.6 Official reserves and assets of the National Oil Fund



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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Economic prospects

The economic outlook remains positive but rests heavily on continued high world commodity prices; a sustained increase in oil and gas and minerals production and export; strong domestic consumption; and continued government commitment to prudent macroeconomic management and market-oriented policy reforms.

GDP is expected to grow at 8.6% and 8.9% in 2007 and 2008, respectively. The major contributors to growth will remain unchanged. The non-oil economy is expected to expand at an average of around 10% a year, driven mainly by key sectors such as construction and services.

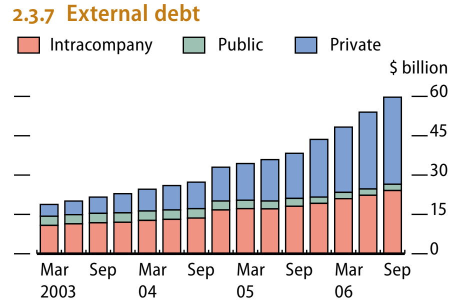
In December 2006, Parliament approved the budget for 2007, and the Government will continue to run an expansionary fiscal policy. Government revenues are expected to be the equivalent of about 17.9% of GDP, and expenditures about 19.2% (the latter an increase of 30%, primarily to fund increases in public sector wages and pensions).

In July 2006, the NFRK was fully integrated into the budgetary system; receipts from all extractive companies will first be accumulated in the NFRK, which will be drawn on as required to fund public investment and government development programs. This will help ensure transparency by demonstrating how the oil fund is being used and separating oil and non-oil transactions.

As part of the Government's initiative to raise the competitiveness of the economy, a variety of tax incentives were introduced to boost the non-oil economy. The VAT rate will be reduced from 15% to 14% in 2007, and a further 1% reduction is scheduled in 2008 and 2009. New tax concessions were introduced to encourage the development of high-value added industries and capital investment. The Government also plans to introduce a flat 10% personal income tax and cut payroll taxes by up to 30% in 2008.

Exports are projected to rise by 15.0% and 9.3% in 2007 and 2008, respectively, largely on higher production from existing oil fields and

2.3.7 External debt



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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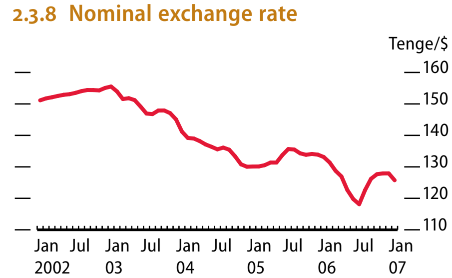
2.3.8 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz, both downloaded 17 March 2007.

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new production from the Kashagan oil field in 2008 as well as increased export transport capacity through the Baku-Tbilisi-Ceyhan oil pipeline. Non-oil exports are also expected to increase, mainly on metals and metal-related products, as well as grain.

Rising incomes and excess domestic demand will spill over into imports, projected to rise by 20.4% and 13.3%, largely due to purchases of machinery and equipment for ongoing oil investment projects. Strong exports will keep the trade account in surplus. With the deficit rising in services, income, and current transfers as payment outflows grow, the current account is expected to be in deficit, though it will be readily financed by foreign direct investment and external borrowings. The liberalization of capital account on 1 January 2007—full convertibility of the tenge—will likely take some of the upside pressure off the currency as domestic investors seek out overseas investments.

Inflation is put at 8% in 2007 and 2008, despite NBK's efforts, and the inflationary pressures remain the same.

Over the medium term, the hydrocarbons sector will remain a key locomotive of growth. Its share in GDP will increase as large projects in the Kashagan oil field come on stream in 2008. The Government is likely to continue developing the nonextractive sectors, and construction and services will be key drivers of growth. The Government is also expected to carry on implementing measures to improve competitiveness—including developing Samruk and Kazyna.

In view of large oil-related cash inflows in the coming years, risks are associated mainly with an overheating economy. The focus of monetary policy should be to minimize inflationary pressures. Effective monetary and fiscal policy coordination is also needed to damp excess demand. While the rapid expansion of domestic credit demonstrates confidence in the domestic financial system, it also creates a potential risk in terms of the quality of the loan portfolio of local commercial banks. NBK and AFN recognize this risk, though, and are developing appropriate measures.

Development challenges

Diversifying from oil and mining is a high government priority, though the prospects for developing business services around these industries should not be underestimated. The potential for maturing industries (mostly private but some state owned) to invest in neighboring countries is likely to continue. This will provide a natural incentive for improving competition and productivity of domestic companies.

The private banking sector with major investments in the Kyrgyz Republic and the Russian Federation is leading the way. The efforts to develop Almaty as a regional financial center is praiseworthy but activities need to be carefully thought out. Priority needs to be given not only to the development of laws and regulatory procedures but also, more importantly, to upgrading that city's aging physical infrastructure.

Finally, sustainable and balanced development of the Caspian region represents a major challenge as past significant investment has not translated into efficient utilization of the labor force in the region. Regional cooperation is also important to promote cross-border business activities.

2.3.1 Selected economic indicators

	2007	2008
GDP growth	8.6	8.9
Inflation	8.0	8.0
Current account balance (% of GDP)	-1.6	-2.1

Source: Staff estimates.

2.3.1 Kazyna and Samruk

The Kazyna Fund for sustainable development was established in April 2006. Its objectives are to effectively manage state investments, stimulate investment and innovation activities, and increase the economy's competitiveness. Kazyna identifies and implements investment projects in non-extractive sectors through coordinating various institutions involved in national development. Kazyna identifies investment opportunities and local partners as well as provides administrative support and long-term financing in the form of debt and equity.

Samruk was established in early 2006 to improve the government asset-management efficiency and set a new benchmark for corporate governance. It will act as an active shareholder in the following state corporations: KazMunayGaz, KazakhTelekom, Kazakhstan Temir Zholy (railways), KazPost (post), and KEGOC (electricity). The intention is to expand the coverage to include an additional 17 state companies, including Air Astana and Kazmortransflot (shipping).

Such state-driven industrialization may, though, carry risks in terms of favoring certain firms, unless mechanisms are developed for transparency and accountability for these two entities.

Kyrgyz Republic

Nearly 2 years after the Tulip Revolution, political stability remains elusive. Although the new Government made real efforts to maintain macroeconomic stability, tensions between the different power centers have distracted the authorities and hampered structural reforms, including the passage of key economic legislation. In addition, an accident at the Kumtor gold mine, the largest industrial contributor, has slowed growth. The medium-term outlook, though positive, is clouded by governance concerns, a poor business climate, and political uncertainty.

Economic performance

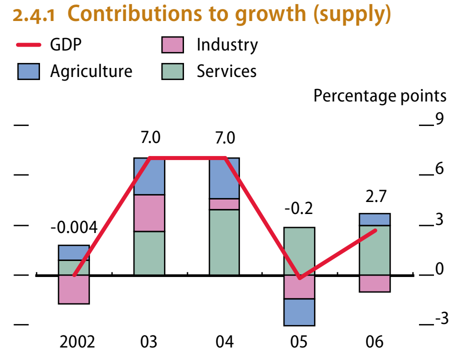
One of the least geographically accessible, and least endowed, countries in Central Asia, the Kyrgyz Republic faces challenging conditions. This partly explains its inadequate physical infrastructure. Recently it has also been buffeted by political turbulence, and almost 2 years after the Tulip Revolution of 2005, political stability has yet to be achieved, which is undermining economic development. A high level of political activity marked 2006, including major protests, government resignation, and two changes of the constitution.

Despite the challenging political environment, the Government managed to maintain macroeconomic stability and keep the Poverty Reduction and Growth Facility (PRGF) program with the International Monetary Fund (IMF) on track. Yet an accident (much less serious than the previous year's) in July at Kumtor—the country's largest gold mine and accounting for about one third of industrial output and 5% of GDP—resulted in gold output falling by about a third, to about 9 tons. This slowed economic growth to 2.7% (Figure 2.4.1), well below the authorities' earlier forecasts of 5–8%. Excluding gold production, GDP grew by about 5%.

On the demand side, private consumption continued to be the driving force of growth, financed by higher incomes (a significant amount of which comes from the shadow economy, with some estimates placing it at up to 60% of recorded GDP); rising workers' remittances from abroad; and higher wages. A positive development was a sizable increase in fixed investment year on year. This stemmed from augmented investment in transport (mainly roads), mining, and construction. Strengthened exports to the traditional destinations of People's Republic of China, Russian Federation, and Kazakhstan provided further impetus.

Sectorally, the drivers were services, construction, and agriculture. Services grew robustly at 8.4%—driven by trade, tourism, catering, and other retail services—and it still has significant room for expansion, given its narrow and low base. Tourism rebounded in 2006 with a record 1 million tourists visiting the Issyk-Kul Lake, the country's main tourist destination. Agriculture—accounting for about a third of the country's GDP and a half of employment—recovered from a fall in output in the previous year, posting a moderate 1.5% expansion. A reported drop

2.4.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic.

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in crop productivity together with an outbreak of contagious animal diseases accounted for the sector's modest rebound in 2006. Industry overall experienced a contraction of about 7.4%, reflecting the drop in gold production, but nongold output was encouraging, bolstered by construction (up 8.5%), garments (19%), and some processing industries. The food-processing industry is still undeveloped, with most agricultural output processed in Kazakhstan and the Russian Federation.

Increases in world oil and commodity prices (partly mitigated by a stronger currency) and price hikes of communal services, as well as higher personal incomes and money supply growth, gently stoked price pressures in 2006. Consumer price inflation rose moderately, averaging 5.6% for the year (Figure 2.4.2). Monetary growth, however, expanded by more than 50% (Figure 2.4.3). This came both from a rise in net foreign assets, as a result of higher remittances and increased foreign capital flows, and from more dynamic activity by the private sector, which was reflected in credit expansion of 48%.

The inflationary impact of this large increase in the money supply was partly softened by continuing exchange rate appreciation, by 8.3% against the US dollar (Figure 2.4.4). This occurred despite interventions by the National Bank of the Kyrgyz Republic (NBKR) in the foreign exchange market throughout the year, which lifted gross international reserves by an estimated $205 million. Overall, however, given the low level of monetization of about 22% of GDP, and with adherence of NBKR to a policy of price stability, the monetary expansion experienced in 2006 is unlikely to lead to significant inflationary risks this year.

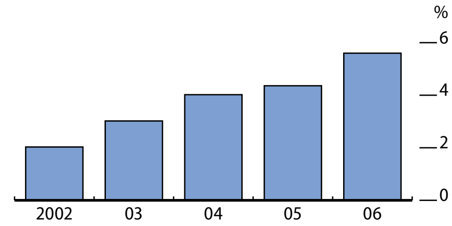
Wages rose by 12% in real terms, with mining seeing the largest gains, but with sizable movements also in public sector wages. Nevertheless, in absolute terms, the average monthly wage (excluding small enterprises) of $76 a month is still low, not much above the government-set minimum consumption budget.

In this low-wage setting, migration has become a growing issue, with estimates of people working abroad varying widely from 0.5 million to 1 million, attracted by the higher incomes in Kazakhstan and the Russian Federation. Increasingly, skilled workers such as doctors and teachers are working abroad, which may lead to a "brain drain" if the issue is not addressed.

According to Ministry of Finance estimates, remittances in 2006 were substantial, in the range of $520 million–750 million, or 20–25% of GDP; the two ex-Soviet countries account for about 80% of the total. Although an important cushion for maintaining living standards and for poverty reduction, migration involves high social costs, as evidenced by the separated families and the children cared for by others than parents.

In 2006, the authorities continued to implement prudent fiscal policy. According to preliminary estimates, all quantitative fiscal performance criteria under the PRGF program were met, including the budget deficit target of 3.2% of GDP (as compared with 4.0% in 2005) (Figure 2.4.5). Although total revenues decreased in relation to GDP (to 22.2% compared with 24.1% in 2005), they increased in nominal terms by about $20 million, mainly as a result of the continued improvements in tax and customs administration and higher import volumes. Revenue performance reflected important tax changes adopted for 2006 to lower

2.4.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 4 March 2007.

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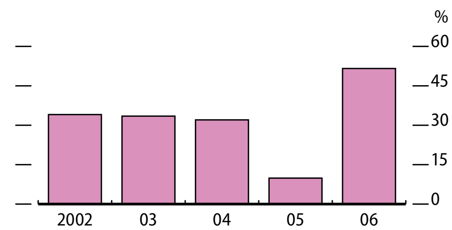
2.4.3 Money supply (M2x) growth



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 28 February 2007.

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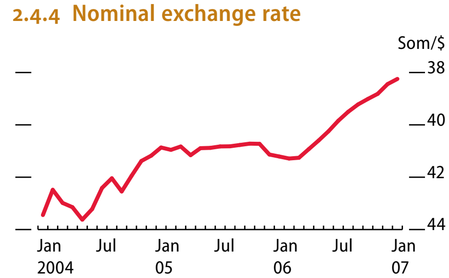
2.4.4 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* database; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg; both downloaded 4 March 2007.

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the burden on labor and capital, so as to promote private sector growth and to lessen incentives for taking part in the informal economy. These changes included a flat corporate and personal income tax of 10%, value-added tax exemption for agricultural products and imported basic capital goods, a reduction of payroll taxes from 31% to 29%, and abolition of eight inefficient local taxes.

Total expenditures picked up by about 12% in 2006. However, an important shift took place toward greater social outlays and some economic subsidies. Spending on education, health care, and social security all rose by around a quarter (year on year) in nominal terms, and expenditures on utilities and housing by about a third. Public investments stayed tightly constrained (to 3.1% of GDP) due to limitations on external borrowings for debt-sustainability reasons.

The authorities managed to resist parliamentary pressure to lower the retirement age, and are planning to design a comprehensive pension strategy. Preparatory work has also continued on a transition from a four-tier to a two-tier budgetary system, which would comprise the center and local communities (i.e., bypass the provincial and municipal authorities). The aim is to strengthen decision making at the grassroots level. Introducing the new system will face some challenges in the coming years, and will require simultaneous capacity building in local governments.

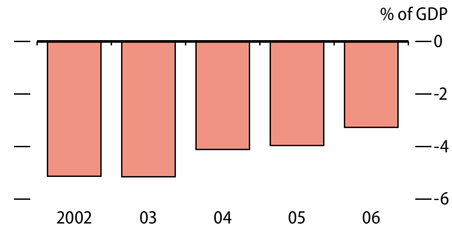
The current account deficit increased sharply (Figure 2.4.6) from 8.3% of GDP in 2005 to an estimated 14.7% in 2006 (or $414 million), mainly due to the widening trade gap (although improvement in the statistical coverage of the significant "shuttle trade" may also have played a part). Imports of investment goods increased as a result of value-added tax exemption of basic capital assets; other factors were rising energy prices, stronger domestic demand, and speculation (e.g., reexports of fuel resources).

Import growth vastly outpaced that of exports, largely due to decreased production of gold at Kumtor. However, gold remains the largest export item (with about one quarter of the total). Nongold exports were underpinned by greater sales of fruit and vegetables, reexported oil products, and construction materials, spurred by robust demand in neighboring countries.

The trade gap was partly offset by inflows of remittances. The current account deficit was financed by a rise in net foreign direct investment (FDI) and by foreign loans. These capital account inflows have allowed a strong buildup of gross official reserves to $817 million at the end of December (Figure 2.4.7). FDI expanded rapidly after the 2005 revolution, and was estimated at $109 million (for the first 9 months of 2006), directed mainly into finance, telecommunications, and food-processing. The largest inflows came from Kazakhstan (30%), UK (19%), Canada (7%), and Turkey (6%).

Though coming down (Figure 2.4.8), the country's external debt is still the highest relative to GDP among the Commonwealth of Independent States countries, at about 70% of GDP. The 2002 and 2005 reschedulings of the country's debt by the Paris Club of official creditors has not alleviated the external debt burden. As part of the debt-reduction strategy, the authorities refrained from borrowing or guaranteeing external loans

2.4.5 Budget balance



Source: National Statistics Committee of the Kyrgyz Republic.

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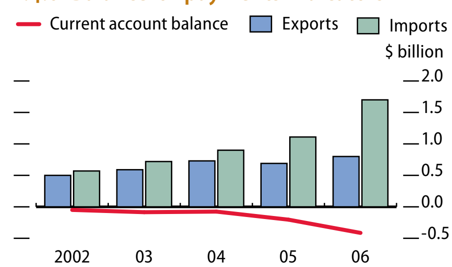
2.4.6 Balance-of-payments indicators



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 30 January 2007.

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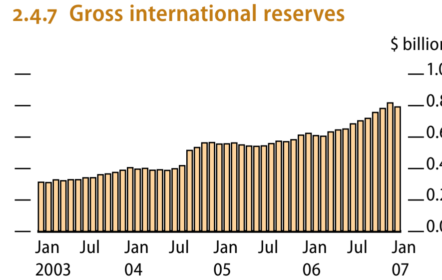
2.4.7 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 10 March 2007.

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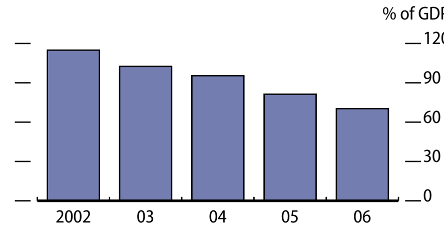
on nonconcessional terms. In mid-October 2006, IMF formally declared the country eligible to participate in the enhanced Heavily Indebted Poor Countries initiative. This prompted national debate and general public and political resistance, in view of what was taken to be loss of "face" and erosion of the country's sovereignty. In February 2007, the new Government made a decision not to pursue further interest in the initiative.

Progress on structural reforms has been uneven (Box 2.4.1). Delayed passage of key legislation hampered several government initiatives. For example, the new tax code and regulations on enhancing central bank independence, among others, are still awaiting parliamentary approval. The slow pace of reform largely stems from preoccupation with political issues, but also reflects weakened coordination between the different branches of government in implementing core reforms.

Banking sector reforms remained largely on track, except for the delays with privatization of the Kyrgyz Agricultural Finance Corporation. The central bank made some progress in modernizing the payments system; upgrading its accounting and internal controls; and enhancing bank supervision, with the creation of the Agency for Financial Surveillance and Reporting to assess market, operational, country, and foreign exchange risks. Parliament passed legislation to combat money laundering and terrorism financing. To improve stability in the banking system, the central bank upped the minimum capital requirement for banks to $1.5 million, which is to be raised further to $2.5 million by the end of this year.

2.4.8 External debt



Source: National Statistics Committee of the Kyrgyz Republic.

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Economic prospects

The underlying assumptions for economic projections are as follows: the political situation stabilizes as both the Government and Parliament make headway to resolving the prolonged standoff; key legislation is passed quickly; structural reforms are carried out soon; two promising gold deposits, Jerui and Taldy-Bulak, start mining production; growth stays strong in People's Republic of China, Russian Federation, and Kazakhstan; the price of gold stays favorable; and, importantly, the new Cabinet will demonstrate commitment to announced economic policy goals and reforms.

In this scenario, GDP growth is projected to be around 4% in 2007 and 5% in 2008 (Figure 2.4.9), underpinned by the rebound in Kumtor gold output and the launch of the new mines, and by a sustained increase in nongold industry and services. Needless to say, this scenario will only unfold if the political situation stabilizes, before all else.

With continuing government efforts in improving the tax administration, and greater compliance encouraged by reduced tax rates and some "formalization" of the shadow economy, it is expected that the fiscal balance will remain within limits agreed with IMF—3% of GDP and to be covered by external resources and privatization proceeds. The draft state budget for 2007 envisages a further reduction in the payroll tax from 29% to a medium-term target of 25%, with the associated revenue losses to be offset by the results of greater efforts to curb tax and customs evasion.

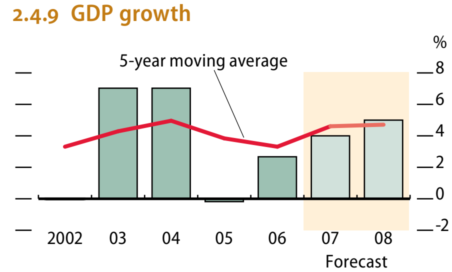
Given the currently low levels of public salaries, and in its efforts to

2.4.1 Selected economic indicators

	2007	2008
GDP growth	4.0	5.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-12.2	-10.7

Source: Staff estimates.

2.4.9 GDP growth



Sources: National Statistics Committee of the Kyrgyz Republic; staff estimates.

Click here for figure data

deliver the promised improvement in living standards, the Government plans in the coming year to lift state sector wages and pensions by a further 10%, and social spending to about 16% of GDP. These moves are to be funded from public services and administration streamlining, and cuts in the number of public officials. Other priorities in the fiscal area include passage of the tax code, further improvements in tax and customs administration, a strengthening of the Large Taxpayers' Unit, enhanced public financial management, and increases in nonagricultural land taxes.

Inflation should remain manageable. Further gains in remittances, as well as the increase in the price of gas imports from Uzbekistan (to $100 per 1,000 cubic meters, from $55 previously) may exert additional price pressures in 2007. However, continued prudence in monetary and fiscal policies is expected to keep inflation at about 5%. The current account deficit is estimated to narrow to around 10–12% of GDP in the next 2 years, aided by an upswing in export volumes. The deficit is to be financed by FDI, other private inflows, and concessional assistance. The domestic currency is set to appreciate in both nominal and real terms in the medium term.

The overriding risk to the economic outlook is continued political uncertainty. Another relates to evolving intentions of the authorities to boost development spending to seek higher rates of investment and employment creation to meet the expectations—still largely unrealized—brought about by the March 2005 revolution.

The second Cabinet, formed in February 2007 after a long bout of political horse-trading, faces a formidable task of stimulating aggregate demand while maintaining high-quality standards for investment, and keeping inflationary pressures in check. This task is exacerbated by the current context of widespread governance issues, and a strong public resistance to foreign-funded aid. Policy stimulation for economic growth is understandable, but entails the risk of excessive state intervention, including through aggressive industrial policy.

2.4.1 Reforming the business environment

The new Government announced improvement of business environment and combating corruption as priority issues. A Country Development Strategy for 2007–2010 was submitted to Parliament for consideration.

The authorities' efforts to stimulate the economy and attract FDI include, for example, cuts in profit and income tax rates and efforts to establish a national development fund. However, tangible advances in improving the investment climate and the business environment, and in fighting corruption, is less evident. Poor public and corporate governance, bureaucratic and administrative constraints, a weak financial sector, and a pliable judiciary remain major obstacles to private business activities.

The country continues to face major challenges in resolving governance weaknesses and stamping out bribery, both of which have diverted scarce resources and depressed productivity growth over the years.

Although the Government has kept the macroeconomic backdrop stable, attracted certain foreign investment over the past year, and announced and initiated wide-ranging reforms, progress in actually pushing through reforms has been slow, again because of political diversions.

Tajikistan

The economy expanded at a robust rate despite higher costs of oil and gas in 2006. Burgeoning remittances spurred demand, as supply shocks from higher oil, utility, and food prices pushed inflation back into two-digit territory. Medium-term economic prospects are promising, if the expansion in externally financed infrastructure projects is supported by the broad reforms of the development strategy, so creating a favorable environment for private sector-led growth.

Economic performance

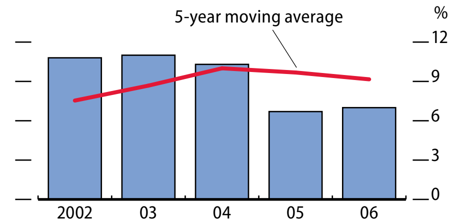
Aluminum and remittances, the mainstays of the economy, continued to drive growth (of 7.0%) in another strong year (Figure 2.5.1). Buoyed by spending of soaring workers' remittances, the subsectors of retail trade, transportation, and finance boosted services, though these inflows were strong disincentives for their recipients to continue working in their traditional occupation, agriculture. The protracted land-reform process and the long-standing issue of reforming cotton farmers' debts compounded the problem. The upshot is that agriculture in 2006 accounted for only 22% of GDP, down from 36% in 1991. Services and industry accounted for 50% and 28% of GDP, respectively.

A pickup in foreign direct investment financing for infrastructure projects and other construction investments, including a boom in private housing, lifted domestic demand, while a surge in aluminum exports (the main export commodity) underpinned strong export growth. More important, aggregate demand was driven by higher private consumption expenditure that, in turn, drew strength from the higher workers' remittances as well as a hike in domestic wages. The number of people finding better work opportunities outside the country and migrating, mainly to the Russian Federation, is on the rise, and the poor especially have benefited from remittances in terms of being able to afford a better standard of living. However, increasing dependence of family members on remittances, alongside sluggish private sector reforms, especially in agriculture, is hampering productivity improvements and risking failure to realize the country's economic potential.

The wave of remittances has not led to growth in the domestic savings or investment rates. Private investment is chronically low at 5.4% of GDP; public capital investment (mainly infrastructure projects) is also low. These levels are insufficient to sustain high growth. Incentives to channel remittances toward private investment are therefore needed to stimulate broader-based growth.

Inflation accelerated in 2006 into double digits after 18 months below that threshold (Figure 2.5.2). The preliminary estimate is a high 11.9%, from 7.1% in 2005. Supply shocks emanating from higher fuel prices and regional food prices, higher private spending, and increases in utility and transport tariffs, all played a part. Core inflation for 2006, as

2.5.1 GDP growth



Source: State Statistical Committee of the Republic of Tajikistan, available: http://www.stat.tj, downloaded 30 January 2007.

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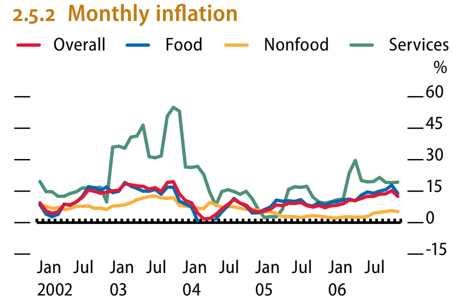
2.5.2 Monthly inflation



Source: National Bank of Tajikistan, available: http://www.nbt.tj/en, downloaded 27 February 2007.

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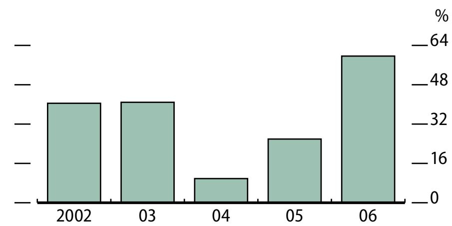
calculated by the National Bank of Tajikistan (NBT, the central bank), which excludes major food items and utilities, was lower at 7.3%. Higher incomes and greater demand for staple foods and lower grain production contributed to a surge in food prices.

NBT signaled its concern about growing inflationary pressures by raising its refinancing rate in steps from 8.5% in August to 12% in December. Prior to this, it had lowered banks' reserve-requirement ratio from 15% to 12% in April in an attempt to reduce the cost of attracting deposits by commercial banks, increasing banks' liquidity. Reserve money grew by about 17%, adding even further to banks' ability to expand credit, helping to push up the money supply by 60% (Figure 2.5.3).

2.5.3 Money supply (M2) growth



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 28 February 2007.

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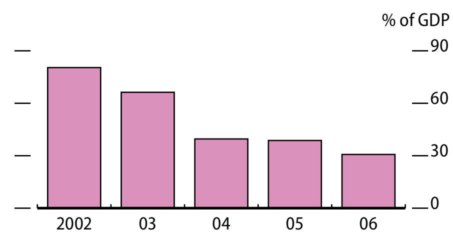
Weak institutional capacity and the underdeveloped nature of the financial sector severely hinder the conduct of monetary policy. NBT started to give more attention to managing growth of reserve money by holding frequent and regular meetings at the operational and policy levels.

The fiscal situation was healthy in 2006, despite elections, as robust economic growth and better tax administration helped revenues exceed their targets and showed a 0.4% of GDP surplus (excluding the foreign-financed public investment program). Measures for enhancing tax collection introduced in 2006 included replacement of the sales tax on aluminum exports with a tax on aluminum processing, a higher value-added tax (VAT) threshold, and elimination of tax exemptions. But fiscal space is still tight. Expenditures on the social sector are rising, albeit from a very low base (8% of GDP in 2006 as against 5.5% in 2002). One way to enlarge the fiscal space is through improvements in expenditure efficiency and revenue measures.

Other sources of resource mobilization hold little promise. Grants are constrained because of heightened global competition for such funds. The scope for higher domestic borrowing is very limited and external borrowing is also restricted as the country is close to the sustainable ceiling for external debt. After a debt-equity swap with the Russian Federation in 2004 and a debt write-off by the International Monetary Fund (IMF) of $99 million in 2006, outstanding external debt was brought down to 31% of GDP at end-2006 (Figure 2.5.4), from 108% in 2000. New borrowings for infrastructure point to the ratio rising again, offering little room for taking on additional debt if the authorities are to keep debt at sustainable levels.

2.5.4 External debt



Source: National Bank of Tajikistan.

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IMF in September 2006 projected the deficit on the trade account for 2006 to be unchanged from the previous year, at $0.5 billion. A higher import bill offset the export gain, reflecting higher oil and gas prices and imports for building the Sangtuda 1 hydropower plant. Exports strengthened mainly because of large price and volume increases for aluminum, even though Tajikistan did not benefit fully from international price rises due to production cost-sharing arrangements. In 2006, remittances leaped to an estimated $1.2 billion from $0.6 billion in 2005. IMF estimated the current account deficit at 4.2% of GDP (3.4% in 2005; Figure 2.5.5).

The somoni depreciated by 6.6% against the US dollar in 2006 (Figure 2.5.6). Despite the strength of the ruble and the euro—the currencies of the country's major trading partners—the somoni recorded a moderate depreciation of 3.8% in real effective terms due to inflation

differentials. As a result, the country retained competitiveness in the European and Russian export markets.

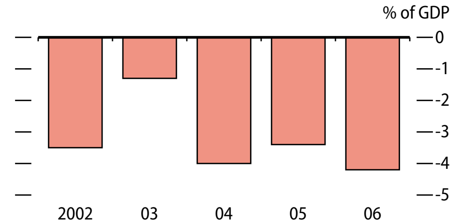
The Government has a wide-ranging reform agenda. It is about to finalize a 10-year national development strategy, and, pursuing that strategy's vision, is drafting a poverty reduction strategy for 2007–2009. The latter strategy identifies as priorities promoting private sector development, strengthening public sector management, and improving health and education services.

The Government had public administration reform high on its agenda in 2006, and it took some steps to put through various measures, including reducing the number of ministries. It also made some headway with key reform measures that represent a fundamental shift for budgeting systems. The Medium-Term Budget Framework, to be pilot tested in 2007, allocates the state budget to sectors on the basis of strategic sector priorities. The central treasury established a cash management unit in April 2006 to enhance the efficiency of budget execution. In July, the Government launched public expenditure tracking surveys, with World Bank support. The authorities continued, slowly, to strengthen tax administration so as to bolster revenues and bring more of the informal economy into the tax net.

In the power sector, the utility attempted to improve payment collection, but low tariffs still make it difficult for it to allocate resources for operations and maintenance. Current steps to tackle the problem include gradually raising electricity tariffs to eliminate large operating losses at the utility and providing a compensatory mechanism for the poor against power hikes.

Banking supervision was further strengthened, and, in line with World Trade Organization commitments and to enhance competition in the sector, the authorities lifted legal restrictions on foreign banks. Minimum capital requirements for banks were increased to $5 million and those that did not comply were merged or reorganized into nonbank credit institutions. Competition among nonbank financial institutions also improved, widening people's access to microcredit.

2.5.5 Current account balance



Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

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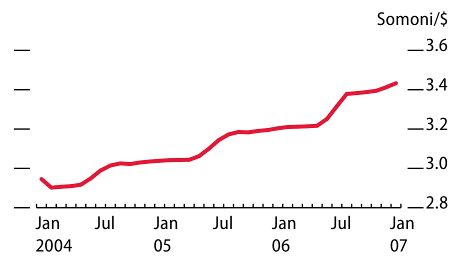
2.5.6 Nominal exchange rate versus US dollar



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2007.

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Economic prospects

Mixed price trends are predicted for the main traded commodities. Prices of aluminum have been supported by high demand but are expected to fall. Global prices for cotton, the second-largest export, are expected to rise by 18% cumulatively over the next 2 years. Prices for natural gas from Uzbekistan, the main supplier, were increased to $100 per 1,000 cubic meters in early 2007 and this will have a marked impact on the import bill and domestic prices.

The economy is forecast to expand by 7.5% and 7.1% in 2007 and 2008. Externally funded investments in infrastructure, including energy and transportation, will boost aggregate demand, though the major source of growth will continue to be remittance-backed consumption.

On the supply side, services will continue to be an important source of growth, partly as a spillover from greater investment activity but mainly because of rising consumption. Aluminum production will continue to drive industry's contribution to overall growth, but cotton's

contribution to agricultural growth is expected to diminish, despite favorable price dynamics. The timely resolution of cotton debt by implementation of the Road Map for the Farm Debt Resolution Strategy will be crucial to releasing agriculture from outmoded central planning-era practices.

To bring inflation back to single digits, NBT will work within the macroeconomic framework of IMF's policy support instrument (under discussion). However, the targets are ambitious and remain vulnerable to shocks in terms of trade, in particular from prices on energy and foodstuffs.

Fiscal policy will adhere to the budget framework that envisages a deficit of 1% of GDP in 2007 and 2008, excluding the externally financed public investment program. Tax reforms are likely to raise revenues but modest domestic borrowing will have to be made to offset the higher spending in the budget for 2007. Spending on infrastructure is set to rise due to cofinancing of large-scale infrastructure projects, while expenditures on social sectors will also increase (but at a slower pace than in 2006).

The size of externally funded projects will rise in the medium term to accommodate the new bilateral loans contracted in 2006 from the People's Republic of China. The loans finance construction of the north-south power transmission line and rehabilitation of the road that connects the major industrial cities of the country with Uzbekistan.

The external debt-to-GDP ratio is set to rise to 46.1% and further to 52.4% of GDP, in 2007 and 2008. The space for new borrowing is very limited as the external debt indicators are now hitting sustainability levels.

2.5.1 Selected economic indicators

	2007	2008
GDP growth	7.5	7.1
Inflation	7.0	5.0
Current account balance (% of GDP)	-4.8	-5.0

Source: Staff estimates.

Development challenges

The main challenge is increasing savings and productive private investment to sustain economic growth. There is hope though, since some recent developments seem to offer scope for greater private investment, including macroeconomic stability; surging remittances; the elimination of high fees on money transfers and so greater remittances channeled through banks; government attempts to attract foreign capital to infrastructure projects; and business regulatory reforms (including cutting much red tape).

Risks remain of course: macroeconomic stability is highly vulnerable to external shocks due to the economy's openness and narrow import dependence; spiraling remittances may create disincentives to work, especially in agriculture; and infrastructure projects may entail higher taxes on the private sector, possibly hurting its willingness to invest.

Turkmenistan

The economy continued to grow rapidly in 2006, but the exact figure for actual growth was likely lower than the official estimate. It is uncertain whether the newly elected president will embrace reform and engage with the international community. The country is heavily dependent on exports of gas and oil, a situation that is likely to continue over the medium term. The key development challenges are to effectively channel oil and gas revenues toward productive investment, implement market-oriented reforms, and rebuild human capital.

Economic performance

The economic situation stayed very healthy in 2006, with GDP growth of over 20% (based on official data). However, official statistics tend to overestimate growth, and actual rate was likely around 9%, according to staff estimates. Either way, growth was sustained by increased gas prices (renegotiated with the Russian Federation) and exports. While the gas and oil industry grew rapidly in 2006, the cotton crop experienced shortfalls for the sixth consecutive year.

Official estimates for inflation are unavailable, but according to figures from the International Monetary Fund, it moderated somewhat from 10.7% in 2005 to 9.0% in 2006 (Figure 2.6.1). This was achieved through wage freezes, cuts in pension payments, price controls, and restrictions on cash withdrawals from banks, resulting in a situation of repressed inflation. A dual exchange rate regime exists: one dollar buys 5,200 manats at the official rate, but 24,000 on the black market.

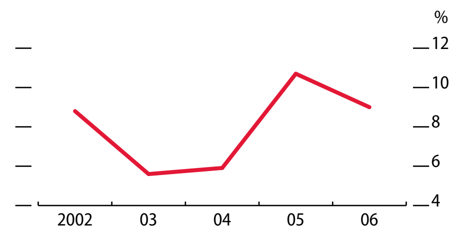
The fiscal surplus edged up from 0.9% of GDP in 2005 to 1.1% (Figure 2.6.2), reportedly due to improved revenue collections, but the non-oil fiscal deficit as a share of non-oil GDP was estimated at 9.5% (2005). There are unofficial reports of a budget contraction, causing the accumulation of public sector wage arrears and education spending cuts. Public sector revenues are largely from oil and gas incomes that are off-budget, and these are managed with other funds directly by the president. These off-budget funds go unreported in the official statistics.

Another large surplus ($1.5 billion) on the trade balance account was estimated due to booming oil and gas export revenues. Although both exports and imports grew in 2006, exports grew much faster, propelled by surges in both volumes and prices of natural gas. The current account surplus was estimated to have grown to 5.7% of GDP (Figure 2.6.3), while gross official international reserves were estimated at $6 billion, equivalent to some 15 months of merchandise imports.

Although there are no official labor statistics, unemployment is likely to be high because many school graduates are unable to find jobs, as opportunities are few and they lack the necessary skills.

A central element of the social protection system remains the provision to the entire population of basic consumer goods and

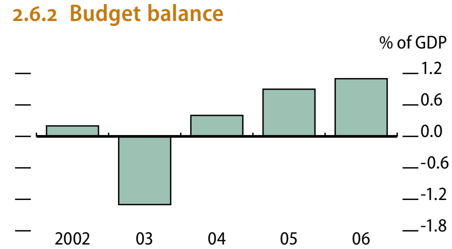
2.6.1 Inflation



Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

Click here for figure data

2.6.2 Budget balance



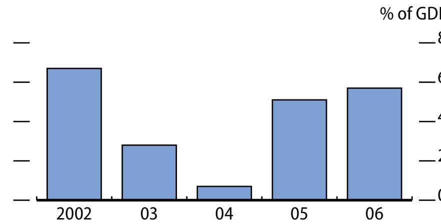
Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

Click here for figure data

utilities free of charge or at subsidized rates. While this enables people to meet a minimum subsistence level and alleviates income poverty, non-income poverty indicators continue to worsen. Social services, including education and health, have been hit by underfinancing, a shortened compulsory education period, excessive state intervention in school curricula, a reduction in the number of university students, and deteriorating health services. Following the death of President Niyazov in December 2006, the new president has announced some reforms in the social sector.

Key areas for reform that the new Government now needs to carry out include a reduction of state intervention of economic activities, liberalization of the domestic market, a shift from setting agricultural and industrial production targets to market-determined production, liberalization and privatization of the banking sector, and unification of the exchange rate. Oil and gas revenues should be managed transparently and incorporated in the national budget.

2.6.3 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; staff estimates.

Click here for figure data

Economic outlook

While there is currently some uncertainty about the likely direction of the post-Niyazov economy, it will likely maintain its heavy reliance on exports of natural gas and cotton. With potential discovery of new gas fields (though not proven), Turkmenistan would both increase exports of natural gas to the Russian Federation and Ukraine, at the same time as attempting to diversify its gas export destinations, to include, most likely, the People's Republic of China and, possibly, Afghanistan, India, and Pakistan.

Three growth scenarios can be formulated for 2007–2008. With political turmoil, growth could decelerate to 3–4%. Without it, two possibilities emerge. Under a "no reform" scenario, GDP could grow by 8–9% a year on the back of higher exports of natural gas with continued stagnation in agriculture. Under a "with reform" scenario, growth could increase to 10–11%. Reforms in this context would include liberalizing prices, eliminating subsidies, improving the business environment, revamping the education and health sectors, upgrading delivery of other basic services, and developing rural areas.

2.6.1 Selected economic indicators

	2007	2008
GDP growth	8.5	8.5
Inflation	8.0	8.0
Current account balance (% of GDP)	7.4	6.3

Source: Staff estimates.

Uzbekistan

Continued strong—but narrowly based—growth was driven by increased net exports, a pickup in workers' remittances, and productivity gains in agriculture. Major challenges over the medium term are to continue managing monetary and fiscal policies to cope with inflationary pressures, integrate the economy with the rest of the region (and world) via more open trade and investment policies, advance structural reforms in banking, restructure state enterprises, and remove state controls hindering private sector development. Further diversification away from the commodity and energy sectors would also help sustain growth.

Economic performance

The economy has shown robust performance over the past 3 years, and continued to do so in 2006, turning in GDP growth of 7.3% (Figure 2.7.1). Exports, too, showed real vibrancy, fueled by favorable price movements in international commodity markets (Figure 2.7.2), and to a degree, heady growth of noncommodity exports.

Productivity gains in the agriculture sector also contributed. The transformation of large, agricultural cooperatives, *shirkats*, into private farms nearly finished, with 666 of them becoming 74,000 small private farms during the year. This change has improved the incentive structure for production—and so productivity—especially in fruits and vegetables.

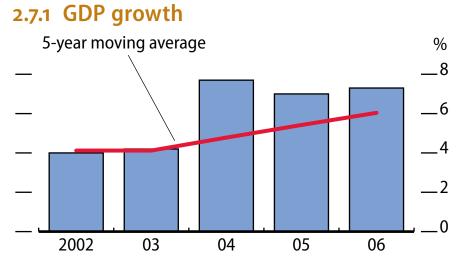
Vigorous export performance coupled with surging remittances has led to a huge current account surplus of 19.5% of GDP (Figure 2.7.3). Gross official reserves are reported to be equivalent to 12 month of imports.

The authorities have maintained a conservative fiscal stance over the past few years. In 2006, the consolidated state budget posted a small surplus at 0.5% of GDP compared to the planned deficit of 3% GDP. Continuation of the conservative external borrowing policy ("zero net borrowing"), has helped improve debt indicators.

Despite their cautious fiscal stance, the authorities have to tackle the risk of higher inflation due to the mounting foreign exchange inflows and rapid reserves accumulation. In 2005, partial sterilization led to a sharp increase in broad money supply of over 50%. In 2006, in order to tighten monetary policy, the central bank conducted sterilization operations using its own paper and treasury bonds. This brought money supply growth down to about 35% (Figure 2.7.4). Nevertheless, controlling money aggregates and associated inflationary pressures remain substantial challenges.

The Government established the Uzbekistan Reconstruction and Development Fund (URDF) in 2006 to absorb the excess liquidity. The total authorized capital for URDF is $1 billion, with $500 million already in place. The establishment of URDF is intended to help buffer the economy from price shocks stemming from volatile foreign exchange inflows. The remaining challenge now is how to channel the fund toward productive investments.

2.7.1 GDP growth



Sources: State Statistical Committee of Uzbekistan; staff estimates.

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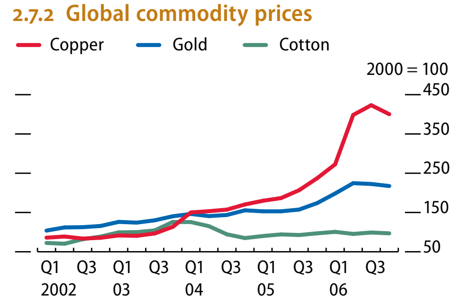
2.7.2 Global commodity prices



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 30 January 2007.

Click here for figure data

Official data indicate that consumer price inflation has declined since 2004, with the official inflation rate estimated to be at 6.8% in 2006. However, this is an area for debate, created by the gap between official and International Monetary Fund estimates for consumer price inflation (though the gap reportedly fell slightly in 2006). A technical assistance agreement recently reached between the Government and the Fund should help resolve the issues of inflation estimate.

Fiscal reforms continued in 2006 in the development of a treasury system. Steps were made to establish a consolidated Treasury Single Account for improvements in budget execution efficiency. The Treasury Law took effect in January 2006. A pilot treasury program introduced in 2005 in the region of Samarkand and Tashkent was extended to cover a total of six regions (*oblasts*). Many banking accounts in the commercial banks held by executing budgetary organizations were closed. As a result, this has eliminated the function of these commercial banks in budgetary execution.

Tax reform continued, to ease the burden on enterprises, broaden the base, and strengthen administration. Tax rates for personal income, corporate profits, dividends, and small and medium enterprises were further reduced, yet despite this, total tax receipts rose.

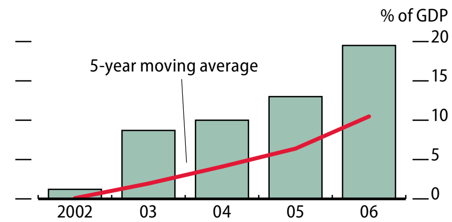
Banking sector reform could be faster, especially in privatizing large stated-owned banks. Total banking deposits are very low, reflecting the population's low confidence in the system. Banking regulations need to be further simplified and clarified to allow banks to operate commercially.

Despite official commitment to currency convertibility, it is reported that enterprises still face difficulty in converting local currency into foreign exchanges for trade. The authorities argued that the current convertibility continued, however, the introduction and implementation of the recently approved antimoney laundering policy imposed additional reporting requirements, and these may on occasions have delayed the process of meeting requests for foreign exchanges.

The Government is developing a comprehensive financial sector reform program. One component is to eliminate the distinction between cash and noncash payments. Currently, the civil code requires all transactions between enterprises to be settled in noncash form (bank transfers). Intended to combat the shadow economy, money laundering, and tax evasion, this requirement may have hit normal business activities.

The trade regime remains restrictive, ostensibly to protect domestic industries. Relatively high effective rates of protection for consumer goods, including discriminatory excise taxes and administrative restrictions on imports, have suppressed imports and encouraged informal trade—partly explaining the large current account surplus.

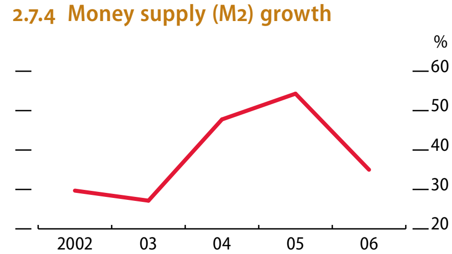
2.7.3 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

2.7.4 Money supply (M2) growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

Economic prospects

International prices of the country's major exports look favorable for the next couple of years. Following an estimated 7% increase in 2006, the cotton price is expected to continue climbing, reflecting a rundown of global stocks. Gold prices, too, seem set to rise further. In addition, the economy will likely continue enjoying the benefits of higher energy prices, after securing a significant increase in the export price of its gas.

External demand for exports should remain favorable, especially with the likely continued strong economic performance of the Russian Federation and neighboring transition economies. In the absence of major shocks, buoyant exports are seen boosting the economy. Growth in the forecast period is penciled in at over 7%. Trade and current account balances will likely maintain hefty surpluses. The associated increase in foreign exchange reserves will remain a major source of monetary expansion and an inflationary risk.

The Government is targeting inflation of 5–7% this year. The central bank intends to limit broad money supply growth to about 30% through sterilization and use of other indirect monetary instruments. The authorities intend, too, to maintain a prudent fiscal policy to combat inflation. Still, it will be difficult to achieve the inflation target, given the early stage of treasury debt market development, limited sterilization options, and rising pressures from wage and social expenditure increases.

Monetary control is rendered more difficult by exchange rate policy, because the authorities have allowed the domestic currency to depreciate in real terms to stimulate exports. In combating inflation, the Government may want to consider adopting a more flexible foreign exchange rate system, allowing nominal appreciation to resolve the difficulty of monetary control.

Over the medium term, the economy faces many challenges. Certainly, it has yet to realize its full potential. And to sustain current rates of expansion, more investment, especially from the private sector, will be required. The economy also needs to diversify to create the jobs needed by its relatively young and growing population.

Structural reforms are crucial, and will require the Government's continuing to open up the economy and integrate it with the rest of the world. This should introduce more competition, and improve productivity and efficiency. It is also crucial to establish a stable environment in which to attract investments from all possible sources. Banking reforms need to be accelerated, since the economy's full potential will only be achieved when banking mobilizes domestic savings and puts them to productive use. In this regard, it is crucial to build, and then keep, the trust of the population in the system.

The current favorable economic environment provides an opportunity to push through structural reforms. However, the same environment could also lead to a sense of complacency among policy makers. Commitment to economic reforms and transition to a market-based economy are crucial to sustaining the country's long-term development.

The Government's poverty strategy aims to reduce the poverty rate to 20% by 2010, to meet the Millennium Development Goals. Expected strong export growth may well help achieve the objective, but growth should shift from overdependence on external demand to investment. Both the quantity and quality of investments need to be raised, since public investment cannot do the job alone. Both domestic and foreign private investment will need to be welcomed.

The availability and quality of economic data provides a sound basis for economic management. Further improvements are necessary in access to and quality of the data. Improved economic data compilation and analysis will help provide a reliable picture of underlying performance.

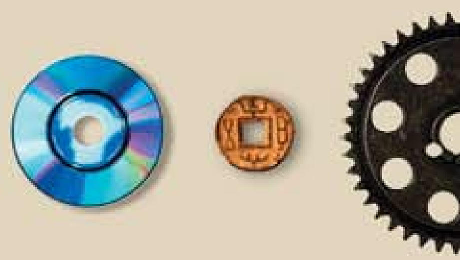
2.7.1 Selected economic indicators

	2007	2008
GDP growth	7.4	7.1
Inflation	9.0	8.2
Current account balance (% of GDP)	10.0	9.2

Source: Staff estimates.

East Asia

People's Republic of China
Hong Kong, China
Republic of Korea
Mongolia
Taipei,China



People's Republic of China

Economic growth exceeded 10% for a fourth consecutive year, driven by strong investment. A gradual tightening in monetary policy and the use of administrative tools moderated investment growth in the second half of the year. In 2007 and 2008, softer external demand and policy curbs are expected to pull growth down gradually. In the short run, the Government is likely to restrict investment growth and cool the economy. In the medium to long-term, the aim is to achieve a more balanced and inclusive economy, dependent less on exports, investment, and industry, and more on private consumption and services. This evolution will probably mean lower GDP growth rates.

Economic performance

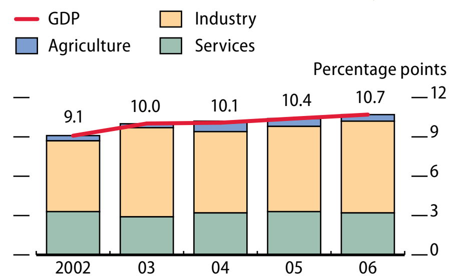
The People's Republic of China (PRC) recorded a strong economic performance in the first year of its 11th Five-Year Program. GDP in 2006 grew by 10.7%, a 10-year high and a fourth year of double-digit growth. Concerned about overheating in some sectors, the Government imposed restrictions that slowed growth modestly, from 11.5% in the second quarter to 10.4% in the fourth.

Industry, including manufacturing and construction, contributed 7.0 percentage points, or 65% of total GDP growth, and services another 3.2 percentage points, or 30% (Figure 2.8.1). Agriculture made a minor contribution. On the demand side, the economy continued to be driven by strong investment, which contributed 4.4 percentage points, or 41% of total GDP growth (Figure 2.8.2). As the contribution of net exports declined to 21% in 2006, that of total consumption edged up to 38%. Private consumption grew robustly, but by less than GDP growth.

Investment surged in the first half of 2006 as a result of accelerating urbanization, the drive of local governments (which have incentives to push growth through investment), and excess liquidity (which made access to credit easy for some firms). As the Government's efforts to cool the economy took effect, the growth of fixed asset investment slowed from about 30% in the first half of the year to 21% in the second (in nominal terms). Investment slowed sharply in industries that have built excess production capacity, such as textiles, coal mining, and electricity (Figure 2.8.3).

The relationship between investment and industry is key to understanding the PRC's growth acceleration. Certainly, growth was helped by economic reforms that made labor and capital more productive, and by a favorable global environment. However, the reinvestment of large profits into new industrial activity was perhaps the most important driver. Higher investment allows more capital deepening, which in turn increases labor productivity and potential GDP. Profits of industrial enterprises grew faster than industrial value added for much of last year, which indicates a decline in the share of wages in GDP. This, together

2.8.1 Contributions to growth (supply)



Sources: National Bureau of Statistics; staff estimates.

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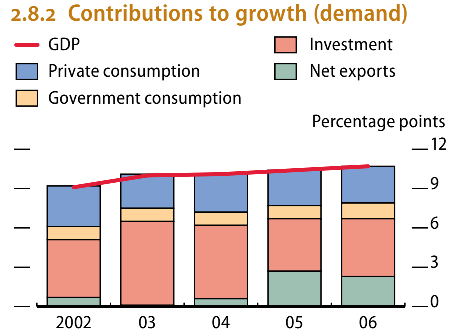
2.8.2 Contributions to growth (demand)



Sources: National Bureau of Statistics; staff estimates.

Click here for figure data

with low inflation and impressive productivity gains, helped keep the growth of unit labor costs under control. The gap between growth in nominal industrial profits and nominal industrial value added widened from 3.1 percentage points in the first 5 months of 2006 to 7.8 percentage points in the 11 months to November (Figure 2.8.4), encouraging companies to lift investment.

Faster growth in exports than imports (Figure 2.8.5) boosted the trade surplus by $60 billion to $194 billion in 2006. Bilateral surpluses with the United States (US) and European Union (EU) surged, while the deficit with the rest of Asia continued to widen. This is consistent with the growth of supply chains, where manufacturing plants in the PRC import intermediate inputs from the rest of Asia. (See also *Uncoupling Asia: Myth or reality* in Part 1.) Processing trade, which involves the assembly and export of imported intermediate items (with most inputs exempted from customs tariffs), is the largest contributor to the trade surplus (Figure 2.8.6).

The surge in the trade surplus, coupled with higher tourism receipts and interest income on the large official foreign reserves, boosted the current account surplus to around $227 billion, equivalent to 8.6% of GDP. Foreign direct investment for the year totaled $69.5 billion. Besides these inflows, short-term speculative capital flowed into property and stock markets. Foreign exchange reserves reached $1.07 trillion by year-end (Figure 2.8.7), prompting discussions on how to use reserves more efficiently, and calls from some trading partners for faster appreciation of the yuan. In a move to liberalize the capital account, a pilot program was introduced to allow PRC residents to purchase foreign securities through the Qualified Domestic Institutional Investors plan.

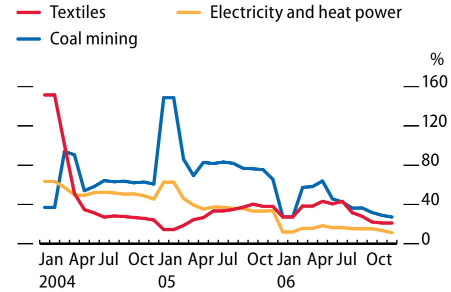
About 11.8 million new jobs were created in urban areas last year, well above target. The private sector and small and medium enterprises generated about 80% of these jobs, mainly in manufacturing, construction, and services. But millions of migrants from the countryside, new graduates, and laid-off workers still went without work. The National Development and Reform Commission estimated at the beginning of the year that urban areas needed about 25 million new jobs in 2006 to absorb all newcomers to the labor market.

The overall fiscal deficit narrowed to an estimated 0.4% of GDP. Revenues rose by 24.3%, helped by gains in incomes and rising corporate profits. Expenditures also rose rapidly, by 18.5%. Given buoyant private investment, the Government reduced its issuance of special treasury bonds used to finance public investment, from the equivalent of about $10 billion in 2005 to $7.4 billion in 2006.

As a result of the excess capacity in some industries and strong competition in manufactured products, inflation slowed to 1.5% in 2006. Late in the year, though, food prices accelerated, reflecting a sharp rise in global grain prices. Housing prices in several big cities grew rapidly because of excessive liquidity, speculation, and some structural imbalances in housing supply.

Worried about possible overheating, the Government took several steps to curb credit expansion and to slow investment. The People's Bank of China, the central bank, tightened credit five times, with increases in commercial banks' reserve-requirement ratio, beginning in mid-2006 and

2.8.3 Growth of investment, selected industries



Note: Heat power refers to hot water and steam for city heating systems.

Sources: National Bureau of Statistics; staff estimates.

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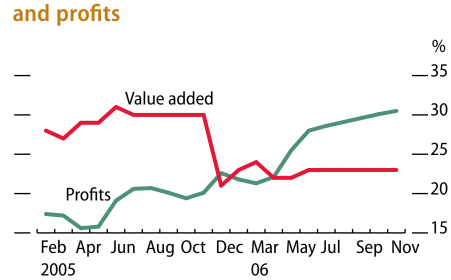
2.8.4 Growth of industrial value added and profits



Sources: National Bureau of Statistics; staff estimates.

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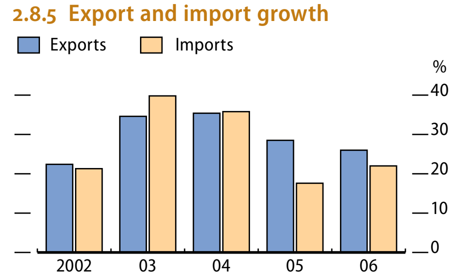
2.8.5 Export and import growth



Sources: National Bureau of Statistics; staff estimates.

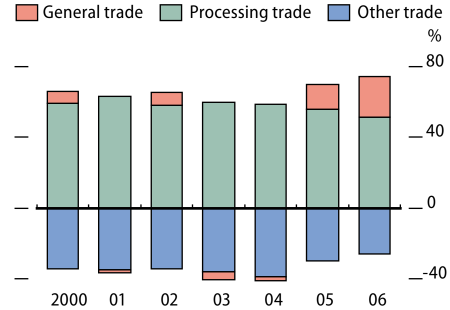
Click here for figure data

running through February 2007, from 7.5% to 10.0% (Figure 2.8.8); and three hikes in the benchmark 1-year lending rate through March 2007, from 5.58% to 6.39% (Figure 2.8.9).

Commercial banks with the highest growth in lending were required to purchase special central bank bills at below market interest rates. These measures moderated growth in domestic credit, but actual lending and broad money increased faster than targets set by the central bank at the beginning of 2006. To ease upward pressure on the yuan from the surging trade surplus and strong capital inflows, the authorities allowed a slightly faster appreciation of the currency in nominal terms (2.4% against the US dollar in the second half compared with 0.9% in the first; Figure 2.8.10). The real effective exchange rate depreciated by 1.6% over the year, indicating that PRC goods became more price competitive.

The stock market expanded significantly in 2006, with major domestic banks among companies to sell shares to the public. Share prices climbed (Figure 2.8.11), underpinned by strong economic expansion, high liquidity levels, and the conversion of nontradable, state-owned shares into tradable shares.

2.8.6 Shares of trade



Note: General trade refers to the import or export of goods by enterprises with import-export rights.

Sources: National Bureau of Statistics; staff estimates.

Click here for figure data

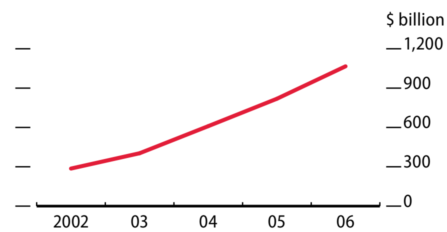
Economic prospects

Rapid GDP growth in 2006 set a high starting point for the 11th Five-Year Program (2006–2010), which has an indicative average annual growth of 7.5% for the period. This implies that overall macroeconomic policy should tighten in 2007. The projections assume that the authorities will keep the fiscal deficit below 1.0% of GDP. Also, it is assumed that the central bank will continue its current monetary policy stance by using interest rates, the reserve ratio, and open-market operations. Likewise, with rising profit growth and ample liquidity in the system, it is assumed that investment will again grow at a fast rate (although not at the 2006 pace) and will remain the main driver of growth. In the meantime, reforms will be implemented that, in the medium to long term, may have an impact on the structure of the economy.

Economic growth is projected to moderate in 2007 and in 2008, but will remain close to 10%, far from the indicative program target (Figure 2.8.12). Industrial growth is forecast to slow to 11.0% in 2007 and to 10.8% in 2008, from about 12% in the past 2 years, because of: significant oversupply in some sectors; slower growth in investment as a result of the tightening measures; and easing export growth caused by softer external markets. Agriculture is expected to benefit from a new official emphasis on rural development. Assuming no serious weather problems, agricultural production is projected to increase by 5.2–5.4% in the next 2 years, accelerating from an average of about 4% growth over the past half decade. Services are expected to grow by 10.4–10.5% (10.3% last year), supported by government efforts to promote consumption as well as expenditures associated with the Olympic Games in 2008.

Responding to various restrictions, especially those targeted at energy use and pollution, and others curbing property speculation, fixed investment growth is projected to moderate to 20%. It will be important that efforts be made to improve the efficiency of investment, so that a

2.8.7 Foreign exchange reserves



Source: National Bureau of Statistics.

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2.8.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.8
Inflation	1.8	2.2
Current account balance (% of GDP)	8.8	8.9

Source: Staff estimates.

given investment share can translate into a higher growth rate of capital accumulation.

Public investment will increase in priority areas including agriculture, education, and health: rural areas will get a larger share of infrastructure spending; schools fees will be eliminated up to the end of junior high school; and spending on health care will increase this year by 87%, and a medical insurance program launched in 2003 is expected to be extended to cover 80% of rural areas. These measures should support rural development and stimulate services. Private consumption will grow, reflecting projected increases in both urban and rural incomes, the latter assisted by government spending in rural areas and grain price guarantees. Retail sales have already risen by 14.7% in the first 2 months of 2007, up from a 12.5% pace in the year-earlier period, a sign of stronger consumer demand.

The softening in export markets and a reduction in PRC tax rebates for exports are expected to reduce the growth of merchandise exports to 18% in 2007, from 26% last year. Import growth will ease to about 18% (versus 22%) as investment decelerates. The large export base and the moderation in import growth suggest that the trade surplus in goods will climb to about $257 billion by 2008. Trade in services will remain in deficit, but the surplus in the income account is likely to increase sharply, reflecting earnings from accumulating foreign exchange reserves. Consequently, the current account surplus will rise further (Figure 2.8.13).

The acceleration in food prices late last year is not expected to continue through 2007, in part because the push on rural development is encouraging the planting of grain. Inflation will pick up, though, to about 1.8% in 2007 and 2.2% in 2008 (Figure 2.8.14), because of expected rises in labor costs (as a result of substantial productivity increases) and higher prices of water, electricity, and fuel. In the first 2 months of this year the consumer price index rose by 2.4%.

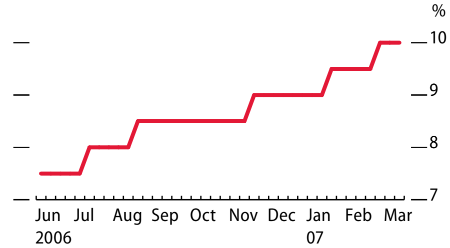
Domestic risks and uncertainties stem from two sources. First, if local governments do not fully respond to the central Government's restrictive measures—and they have not done in the past several years—GDP growth could surpass the above forecasts. (Urban fixed asset investment rose by 23.4% in the first 2 months of 2007, down slightly from the year-earlier pace.) Should investment continue to run at more than 20% a year, what has been a source of growth for many years could turn out to be a curse, if it leads to a further buildup in excess capacity and deflation.

Indeed, the combination of sometimes inefficient investment, overcapacity, and falling prices would erode profitability. To prevent this, the Government would need to step up its use of administrative measures to curb investment. Conversely, if all the measures to rein in growth are successfully implemented, GDP growth in 2007–2008 could slow more sharply, to about 9%. The main risk on inflation is that the Government may increase prices for administered utilities and services at a faster pace than anticipated, which would push inflation above forecast levels.

Over the medium term (2007–2011), GDP growth is expected to average about 9%. Inflation during this period will be higher than it is now, but probably less than 3% on average.

Several factors underpin the medium-term projections. The PRC will

2.8.8 Bank reserve-requirement ratio



Source: People's Bank of China.

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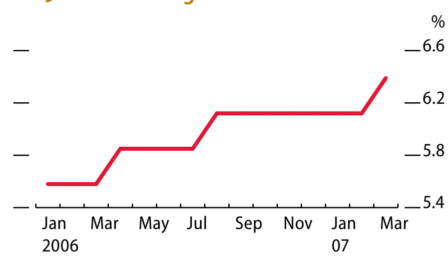
2.8.9 Base lending rate

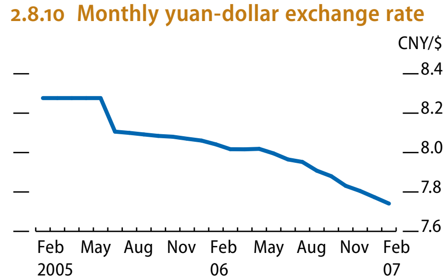


Note: One year rate for working capital.

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

Click here for figure data

2.8.10 Monthly yuan-dollar exchange rate



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

Click here for figure data

be industrializing rapidly for some time to come, so that investment will continue to support high levels of growth. The trend toward urbanization will also continue, which requires rapid development of urban infrastructure and housing. In the context of wide gaps in incomes and in development between urban and rural areas, the Government plans to promote the laggards rather than hinder the leaders. Moreover, large numbers of unemployed and underemployed people mean that pressure will be maintained on the authorities for many years to generate jobs, which requires high rates of economic growth. Finally, rising imports of technology, improved domestic productivity, and flows of foreign direct investment and other capital, support these imperatives for rapid economic expansion.

Further support will come from efforts being made to create the legal and regulatory structure that underpins development of a market-based economy. The third national financial work conference, held in January 2007, outlined a raft of financial reforms. To increase access to finance in rural areas, the China Banking Regulatory Commission issued rules to encourage private sector participation in rural finance, a change that will be first tried in five provinces. This move aims to address funding restrictions faced by farmers, who have little access to bank loans and generate only 15% of total bank loans and deposits. The conference also set plans for the PRC's three policy banks to open commercial operations so that they base lending decisions on commercial grounds. And it discussed management of the country's huge foreign exchange reserves.

In March, the Ministry of Finance announced that a foreign exchange investment corporation would be established to allocate a portion for strategic investments (e.g., international equity markets, natural resources, and as foreign direct investment). Although the portion of the reserves that could be managed this way was not determined, initial estimates indicate that a sizable amount could be transferred to the new corporation in phases. More active management of the reserves aims to increase returns. Independent estimates put at about 3% the central bank's return in 2006 on its reserves (the majority of which is invested in dollar-denominated instruments, mostly US treasury bonds). (See also Box 1.1.2 in Part 1.)

In other policy developments early in 2007, the Government decided to unify corporate tax rates paid by local and overseas enterprises, at a 25% rate from January 2008. Previously, domestic firms were taxed at up to 33% while foreign companies paid 15%. The National People's Congress in March passed a new property law (to come into effect in October 2007), following a change in the PRC constitution in 2004 to protect private property rights. The new law reassures the growing middle class that its assets (mainly houses) are secure. However, it does not give small farmers marketable ownership rights, nor does it allow them to use land as collateral to borrow and invest, which is what would help boost productivity in the countryside. Moreover, the state retains the right to appropriate farm land. Farmers do, though, get the right to renew land-use leases as they expire. (Rural land is "collectively owned" in the PRC and farmers are given 30-year leases.)

2.8.11 Shanghai stock exchange index, A-share

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

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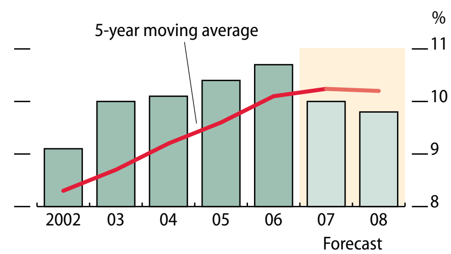
2.8.12 GDP growth



Sources: National Bureau of Statistics; staff estimates.

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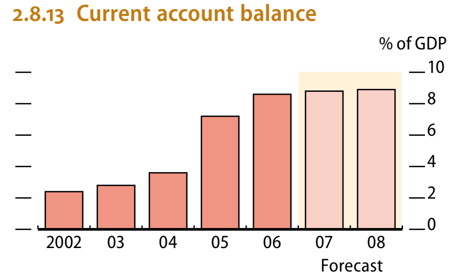
2.8.13 Current account balance



Sources: National Bureau of Statistics; staff estimates.

Click here for figure data

Development challenges

Four years of double-digit growth, rising government revenues, low inflation, and a manageable public deficit would be cause for celebration in most countries. In the PRC, this record has raised some concerns. The authorities believe that the economy can continue growing, but are aware that a number of corrections are necessary, in particular an overheated investment sector.

Efforts to cool the economy in the past 3 years have relied heavily on increases in bank reserve requirements and some increases in interest rates. But monetary policy, and in general the use of macro stabilization instruments, does not have the same impact in this economy as in a full market economy. Much of the PRC's bank lending is in the hands of autonomous local bank branches.

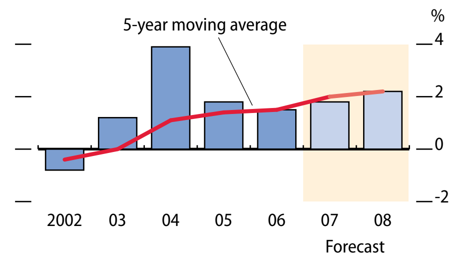
The most direct way for the authorities to control investment is by deciding what investments to approve on a case-by-case basis. Thus, while central planners were finally able to reduce the growth of investment toward end-2006, bank lending still grew at a rapid rate. This has resulted in an excess of bank-funded liquidity that is spilling over into the financial system. Under current methods, the only mechanism available is to continue using administrative measures, and perhaps extend them to the financial system to deal with excesses.

The need to rebalance the economy by reducing the emphasis on investment and export-led growth while lifting private consumption is embraced by the 11th Five-Year Program. Policy makers view economic rebalancing as not just an economic objective, but as part of an overall strategy to achieve "social justice." Since 2004, the Government has advanced a series of strategies to build what it describes as a "harmonious society." This involves achieving "five balances"—between rural and urban development, interior and coastal development, economic and social development, people and nature, and domestic and international development. The political leadership decided in 2004 to change the growth pattern from investment- and export-led to more consumption-led growth. During 2005 and 2006, policy makers reiterated that improving the quality of economic growth and rebalancing the economy would be a priority in the medium and long term.

Rebalancing implies altering the model followed for decades. This entails, on the demand side, reduced reliance on exports and investment for growth, in favor of private consumption; and on the production side, a shift from industry-led growth to more services-led growth. Policy measures taken in the past 3 years in pursuit of these goals have included raising minimum wages, reducing income taxes, increasing public spending, as well as taking the steps needed to contain rapid growth in investment and promote consumption.

The scorecard shows that limited progress has been made on most fronts. The dependence on external demand for growth is still high. Since the PRC joined the World Trade Organization in 2001, its foreign trade has grown annually at an average rate of more than 20%. External trade as a proportion of GDP rose from about 42% in 2002 to 66% in 2006 (Figure 2.8.15). Large bilateral trade surpluses have sparked more trade friction with the US and EU. Further, the huge trade surpluses, combined with growing surpluses in the capital account, have created a surge in

2.8.14 Inflation



Sources: National Bureau of Statistics; staff estimates.

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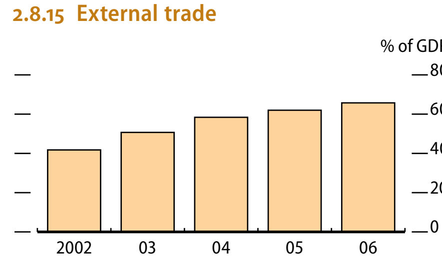
2.8.15 External trade



Source: National Bureau of Statistics.

Click here for figure data

foreign exchange reserves that complicates monetary policy operations and puts pressure on the yuan to appreciate. Currently, the PRC needs to conduct extensive sterilization operations to drain liquidity and prevent the extra money from fueling inflation.

The surge in investment and commercial bank lending has not yet been brought under control. Aside from monetary tightening, the Government has taken administrative steps to restrain investment. These include raising downpayment requirements for housing purchases to curb speculation and sending inspection teams to provinces to check if new investment projects violate land-use and environmental regulations.

But key targets were not met in 2006: fixed asset investment growth was 24% (Figure 2.8.16), while the target was for growth below 18%; broad money (M2) grew by 16.9% (target below 16%); and bank loans rose by CNY3.1 trillion (target less than CNY2.5 trillion). In a further sign of a lack of rebalancing, the share of gross capital formation in expenditure-based GDP rose from 36.3% in 2001 to 45.0% in 2006, while that of consumption (private and public) fell from 61.0% to 51.9% (Figure 2.8.17).

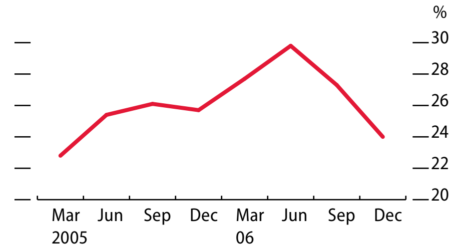
Environmental protection targets were not met either. The Government wanted to reduce energy consumption per unit of GDP by 4% in 2006. The outcome was a decline of just 1.2%. Similarly, there was slippage in achieving an emission reduction target. For example, sulfur dioxide emissions increased by 1.8%. Energy consumption (Figure 2.8.18) and pollution have increased and could become constraints on growth. Although the Government tried to induce local governments and enterprises to improve energy efficiency and cut pollution, these targets were not met.

Furthermore, the share of services in total GDP remains low—it actually fell from 41.7% in 2002 to 39.5% in 2006, lower than in other countries in Asia (Figure 2.8.19). The contribution of services to GDP growth fell from 38.7% in 2001 to 29.7% in 2006, while the contribution of industry rose from 56.3% to 65.2%. The concern is that continued industry-led growth requires more energy and natural resources and puts a heavy burden on the environment, so it may not be sustainable in the longer term.

Income inequalities have worsened. The ratio between urban and rural nominal per capita incomes rose from 2.9:1 in 2001 to 3.3:1 in 2006. Real per capita household income rose by 7.4% in rural areas in 2006, against 10.4% in urban areas. Increasing income inequality impedes the growth of private consumption and adds to social tensions. Unemployment and underemployment have become serious concerns for policy makers.

Restrictive measures involving energy consumption, the environment, and land use are expected to have a greater impact in 2007 and 2008. In this regard, the Ministry of Land and Resources plans to crack down on the use of arable land for construction of buildings, especially for luxury housing and golf courses. Policies on energy conservation and environmental protection have been toughened. The State Environmental Protection Administration (SEPA) has decided to suspend project approvals for any region, sector, or large enterprise if the project violates SEPA's standards on energy consumption and pollution, until action is taken to meet the standards. In the first 2 months of 2007, SEPA

2.8.16 Growth of fixed asset investment



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

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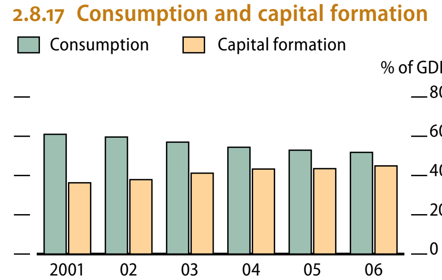
2.8.17 Consumption and capital formation



Sources: National Bureau of Statistics; staff estimates.

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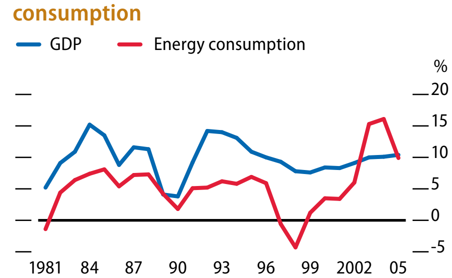
2.8.18 Growth in GDP and energy consumption



Sources: National Bureau of Statistics; staff estimates.

Click here for figure data

suspended more than 80 construction projects and four cities' rights to approve new projects.

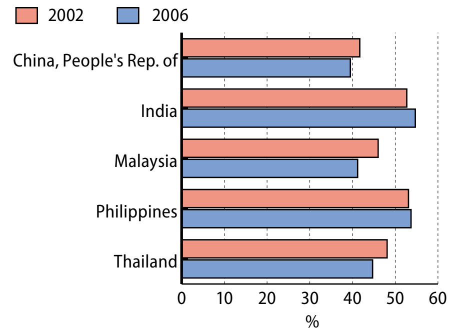
Steps to be taken during the next few years toward rebalancing the economy involve reforms to the social security system—including establishing a minimum living standard in rural areas, similar to that in urban areas. This aims to eradicate absolute poverty (i.e., poor people who live below the official poverty line) in rural areas and help diminish the income gap between rural and urban areas. The Government will spend more on rural areas and less-developed regions.

The authorities have already increased salaries for civil servants, in late 2006, which lifted their purchasing power. Importantly, a plan is being drafted for state-owned enterprises to pay dividends to the state rather than reinvest all their retained earnings. This should impel enterprises to be more selective with their investments and, at the same time, provide financial resources to the state for development of social infrastructure and the social safety net, which is likely to lead to gradually increased consumption spending.

Rebalancing the economy is not easy from the point of view of policy design, implementation, or consequences. It will most likely be associated with lower rates of economic growth over the longer term. An increase in the share of wages in GDP will lead to higher private consumption; but as the increase in the share of wages is mirrored in a decline in the share of profits, this will eventually lead to a decline in investment (potentially larger than the increase in consumption) and, as a consequence, in employment.

A transformation to a more services-oriented economy may bring benefits from the point of view of employment creation (e.g., labor-intensive urban jobs), but services are likely to deliver lower GDP growth rates. The PRC cannot afford this in the short run. One source of growth that should play a more important role in the future is the relocation of labor out of agriculture into activities of higher labor productivity. Given that the share of employment in manufacturing has been decreasing, the services sector will likely have to play a key role in this between-sector transfer. At the same time, growth rates of about 10%, fueled by investment that is leading to overcapacity, and by substantial and growing liquidity in the banking system, pose serious threats to macroeconomic management.

2.8.19 Share of services in GDP



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Hong Kong, China

Above-trend growth was recorded for a third year in a row, supported by domestic and external demand. GDP growth will be trimmed this year and next by the slowing in the economies of the United States (US) and People's Republic of China (PRC), although budget concessions will underpin domestic demand. Medium- to long-term challenges include broadening the tax base, preparing to meet the needs of an aging population, and maintaining high standards of financial infrastructure and regulation as the high-end services sector expands on the strength of closer ties with the PRC.

Economic performance

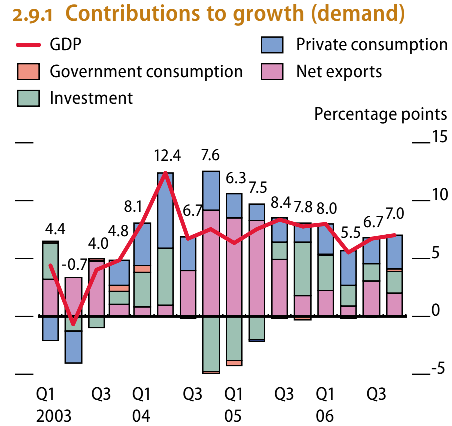
The economy grew robustly by 6.8% in 2006, a third successive year of above-trend growth, on strong support from domestic and external demand. Private consumption (accounting for 52% of GDP) grew by 5.1%, fixed capital investment (23%) grew by 7.9% on the strength of business optimism, and net exports (17.5%) expanded by 12.6%. Government consumption (7.5%) remained restrained.

The generally good year was punctuated by a brief deceleration in the second quarter (April–June; Figure 2.9.1) as trade slowed. Growth bounced back in the third quarter, pulled up by a recovery of exports just ahead of a fourth quarter recovery in the US. Declining oil prices contributed to the recovery of trade, as did booming PRC exports and the falling US dollar. Given that the US and Hong Kong dollars are linked, US dollar depreciation tends to reduce the international price of Hong Kong, China's exports. Corporate investment continued apace, as the economy consolidated its position as a popular entry point for companies doing business in the PRC. Private consumption also was robust in the third quarter. Consumption spending has strengthened over the past 3 years as unemployment has fallen, wages have risen (Figure 2.9.2), and tourism has continued to grow.

The balance of payments surplus grew during the first 3 quarters of 2006, even with a sharp concurrent rise (81.0%) in the merchandise trade deficit (Figure 2.9.3). This spike in the goods trade deficit mostly reflected the slowdown of exports in the second quarter. However, this deficit was small (7.8% of GDP over three quarters) compared with merchandise exports, which amounted to 167% of GDP over the same period.

This reflects the key role of goods reexport in Hong Kong, China, especially from the PRC. In value terms, 90% of exports are reexports. This includes an estimated margin of 17.5% added to goods reexported. The merchandise trade deficit arises because, given the economy's specialization in services (agriculture and industry together accounted for less than 10% of GDP in 2005), it consistently imports more merchandise for domestic consumption than it produces for export. However, net services exports more than compensated for the widening merchandise trade gap, growing by 23.4% and restoring the current account surplus to 9.7% of GDP.

2.9.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk, downloaded 1 March 2007.

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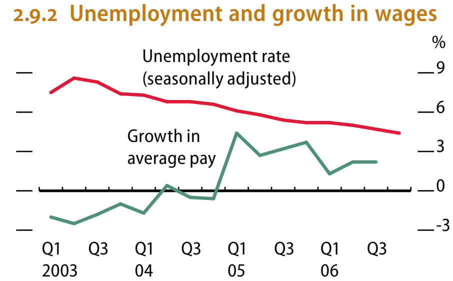
2.9.2 Unemployment and growth in wages



Note: Average pay includes wages, all bonuses, and overtime payments.

Source: Census and Statistics Department, available: http://www.censtatd.gov.hk, downloaded 9 March 2007.

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Robust net exports of services reflected a significant expansion of financial services. Indeed services (over 90% of GDP) continue to drive growth on the supply side. The development of new financial services with the mainland under the Closer Economic Partnership Arrangement has helped, as has the launch and subsequent expansion of yuan-denominated retail banking services in Hong Kong, China.

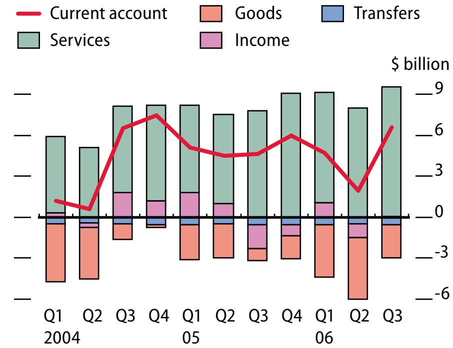
Financial services have also boomed outside retail banking. Initial public offerings (IPOs) have surged—with Hong Kong, China raising more funds through IPOs than the New York Stock Exchange in 2006. Corporate debt issuance is also on an upward trend. Hong Kong, China's sophisticated institutions assist PRC companies that seek access to international financial markets. With a large population in the PRC preparing for retirement, mainland banks are offering a growing array of retirement planning instruments, which are attracting considerable savings. These funds will require management, and financial institutions in Hong Kong, China are well placed to assist.

Thus, the economy is becoming increasingly specialized in high-end services. This is reflected in labor productivity growth rates, which between 2000 and 2005 were particularly high in the communications, international trade, and financial sectors (Figure 2.9.4). Labor market adjustments are apparent in the disaggregated unemployment figures, which, even as they show jobless rates falling for all classes of workers, display disparities by skill level. Only 1.9% of higher-skill workers were unemployed as of January 2007, compared with 4.8% among the lower skilled. The labor market is tightening faster higher up the skill spectrum. However, this tightening did not create inflationary pressures because aggregate labor productivity grew faster than wages in 2000–2006.

After climbing for over 2 years, property prices remained stable through 2006 (Figure 2.9.5), though rents, which usually follow property prices with some lag, continued to rise. With rents rising, inflation edged up, averaging 2.0%. Appreciation of the yuan against the Hong Kong dollar added upward pressure on food prices (Figure 2.9.6), since much food in Hong Kong, China, particularly perishables, is imported from the PRC. Large capital inflows (contributed, in part, by the successful IPOs), and the leveling-out of US interest rates, to which rates in Hong Kong, China are linked, in the latter half of 2006 contributed to liquidity growth (Figure 2.9.7).

Government revenues have grown rapidly on the strength of a strong economic performance since 2003. Accordingly, the budget for FY2007 (ending 31 March 2008) includes both tax cuts and new spending. Particularly noteworthy are: revisions of marginal income tax rates and brackets back down to FY2002 levels, a sizable tax waiver for FY2006 (50% of personal taxes up to a ceiling of HK$15,000), an additional month's social security payment, a 2-quarter holiday on rates assessed on almost all residential and most nonresidential property, increased tax deductions for education and child-rearing, higher allocations for social expenditures, and commitments to infrastructure development. These provisions are likely to provide a significant boost to demand, while serving to reduce key prices. Private-sector analysts have commented that the measures are affordable and leave room for largesse in future budgets.

2.9.3 Trade and current account



Source: Hong Kong Monetary Authority.

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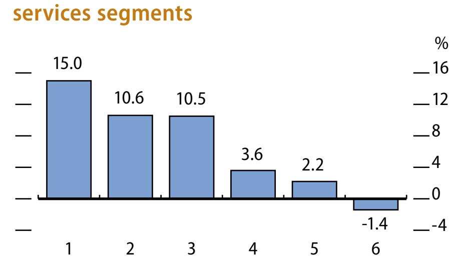
2.9.4 Productivity growth in selected services segments



1 = communications; 2 = import and export trade; 3 = financing; 4 = transport and storage (excluding land transport); 5 = wholesale and retail trade; 6 = restaurants and hotels.

Note: Refers to average productivity growth in 2000–2005.

Source: 2006 Economic Background and 2007 Prospects, Government of the Hong Kong Special Administrative Region (2007).

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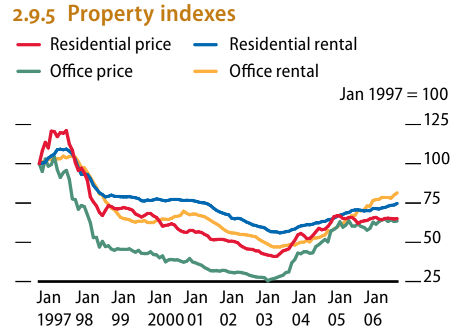
2.9.5 Property indexes



Source: Rating and Valuation Department, available: http://www.rvd.gov.hk, downloaded 19 February 2007.

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Economic prospects

Given the importance of trade and financial services, the economy's performance depends critically on external conditions. *Asian Development Outlook 2007* expects a slowing of growth rates in the PRC in 2007 and 2008. It is assumed that the US economy will decelerate in 2007, before recovering a bit in 2008. This outlook considers further, mild, and gradual appreciation of the yuan possible. The baseline forecasts assume the yuan will be stable relative to the currencies of Hong Kong, China and the US.

On the basis of these assumptions, growth is expected to slow to 5.4% in 2007 (Figure 2.9.8). Trade expansion will fall as the PRC and US economies decelerate, but domestic spending is expected to strengthen further, with consumer spending supported by the large budget givebacks. The returns to taxpayers amount to about US$2.6 billion, or 2.3% of consumption spending in 2006. The tightening labor market also supports consumption spending.

At the same time, the growth potential of new services facilitated by closer integration with the PRC will underpin a healthy rate of business investment. However, with trade slowing and domestic demand still healthy, the current account surplus is projected at 9.5% of GDP (Figure 2.9.9).

Budget initiatives will exert downward pressure on prices. The waiver of housing rates for 2 quarters as well as a waiver of public housing fees in February 2007 will arrest any inflationary pressures accruing from housing costs. Other budget concessions will also help, to a lesser extent.

Conversely, the budget (together with the strong domestic demand growth likely to follow) implies some upward price pressure, though in a small open economy heavily dependent on trade this is likely to be mostly felt through the prices of nontraded services. On balance, inflation of 1.6% is expected in 2007 (Figure 2.9.10). It could be slightly higher if the yuan appreciates further against the US dollar.

In 2008, since US interest rates are expected to ease and US economic growth is projected to turn up, trade volumes will grow faster, boosting reexports. Falling US interest rates will be matched in Hong Kong, China. Lower interest rates will limit the likely decrease in domestic spending as the effects of the 2007 budget on consumption fade. The trade deficit will therefore narrow, while GDP growth will slow slightly to 5.2%.

Continued expansion of financial linkages with the PRC will raise services exports. Tourism is likely to keep expanding, assisted by rising incomes in the PRC. The current account surplus is therefore projected to rise, to 11.5% of GDP in 2008. Inflation is likely to rise to 2.3%, as the effects of the FY2007 budget wear off and as monetary conditions loosen.

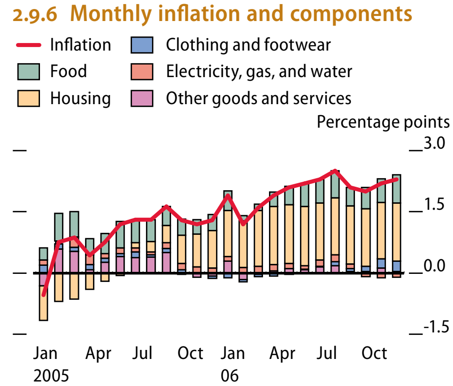
The key risks to this outlook are external. Reexports are volatile, and are very large relative to trade flows and GDP. Trade fluctuations therefore present a significant source of uncertainty for this economy. Moreover, given the loss of manufacturing jobs in North America and Europe, protectionist pressures abroad present a growing cause for concern.

2.9.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.2
Inflation	1.6	2.3
Current account balance (% of GDP)	9.5	11.5

Source: Staff estimates.

2.9.6 Monthly inflation and components



Note: Year-on-year rates of change from October 2005 were estimated using 2004/05-based consumer price indexes (CPIs). For earlier months, the year-on-year rates of change were derived from CPIs with a 1999/2000 base period.

Source: CEIC Data Company, Ltd., downloaded 19 February 2007.

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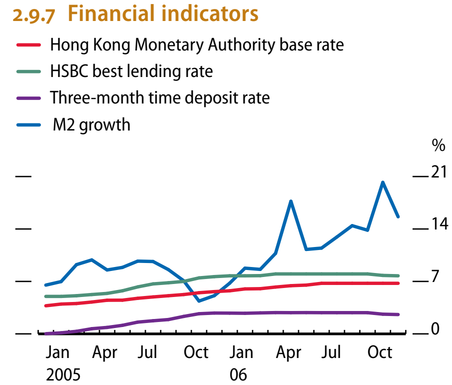
2.9.7 Financial indicators



Sources: CEIC Data Company Ltd.; Hong Kong Monetary Authority, available: http://www.info.gov.hk; both downloaded 19 February 2007.

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Development challenges

The economy faces several challenges in the medium to long term. The Government obtains much of its revenues from income taxes, charges, and levies tied to property values. These are procyclical, which in an economy subject to externally driven volatility implies fiscal uncertainties. Holding excess reserves to provide assurance against such uncertainties is costly.

The Government wants to broaden the tax base, and launched public consultations in 2006 focusing on a proposal for a Goods and Services Tax (GST). A GST is economically appealing because it minimizes distortions to relative prices needed to raise revenue. However, some retailers opposed the GST, arguing that it might reduce sales and involve compliance costs. Advocates for the poor maintained that a GST would be regressive and would widen the wealth gap. The Government announced in December that while the consultation on the GST continues, it is seeking other ways to broaden the tax base.

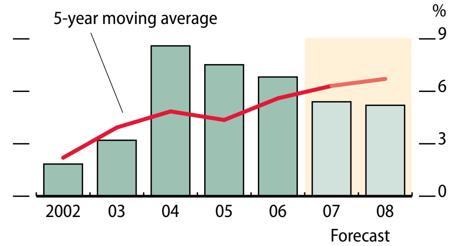
The economy stands to profit substantially from its high-quality institutions for ensuring financial stability and predictability, which facilitates the flow of capital into and out of the PRC. Hong Kong, China's capacity to minimize information asymmetries between players on financial markets is therefore vital. However, as the range of assets traded in its financial markets grows, and becomes increasingly tied to mainland companies that have historically operated to different financial standards, the difficulties associated with ensuring such transparency may increase. Thus ensuring institutional standards in the face of rapid financial development will require considerable effort.

On a related issue, several important markets, including those for basic services such as retailing leave market power concentrated in relatively few hands. Recent moves to liberalize entry into services suggest there will be new competitors from the mainland. This will be helpful, but only if it leads to more autonomous firms in the market, not just a rotation of new players into the market, and old ones out. Thus, the development of competition policies remains a challenge.

Rapid growth in the Pearl River Delta has degraded air quality, and this has led, reportedly, to difficulties in retaining internationally mobile services sector staff. Recognizing the transboundary dimension to this problem, in that many of the emitting plants are outside Hong Kong, China, the governments of Hong Kong, China and Guangdong province have developed a plan and signed agreements to substantially reduce four major air pollutants by 2010.

Finally, Hong Kong, China has an aging population, and must prepare for a surge in retirements. It has a mandatory pension fund that is well resourced and privately managed. This will help finance retirement expenses. However, health care presents concerns. The International Monetary Fund reports that 82% of in-patient and 46% of out-patient care is publicly funded. Thus fiscal pressure looms as the population ages. Discussions are under way on mechanisms to limit public health-care liabilities by encouraging potentially subsidized private insurance, especially for catastrophic incidents. Needless to say, to the extent that costs will be shifted to those about to retire, tensions will rise.

2.9.8 GDP growth



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk, downloaded 1 March 2007; staff estimates.

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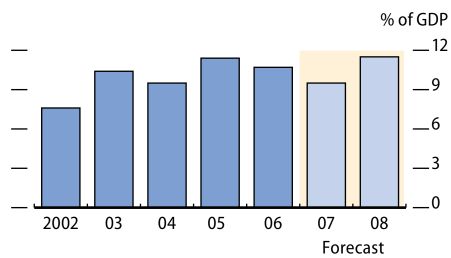
2.9.9 Current account balance



Sources: Hong Kong Monetary Authority; staff estimates.

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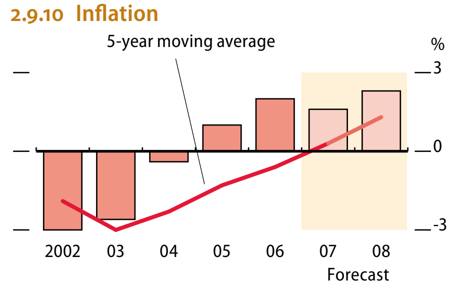
2.9.10 Inflation



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk, downloaded 8 March 2007; staff estimates.

Click here for figure data

Republic of Korea

Growth accelerated to its fastest rate in 4 years in 2006, spurred by a recovery in domestic demand and strong exports, though momentum slowed over the course of the year. In 2007, a continued expansion in investment, particularly in manufacturing, and a recovery in construction are likely to underpin a rebound in domestic demand over the year. The strength of the rebound will depend on a continued recovery in consumption. Growth in exports is likely to ease, trimming the expansion in GDP for the whole year. Structural reforms at the moment are incomplete, particularly in services, capping growth potential.

Economic performance

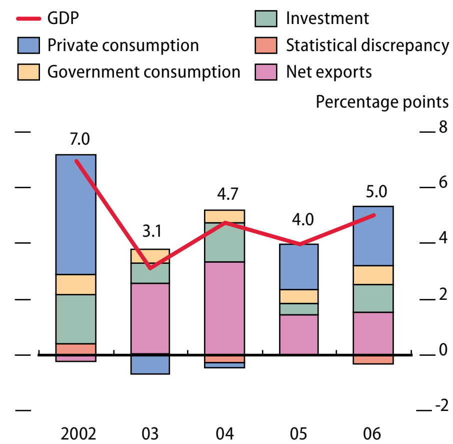
GDP grew by 5.0% in 2006 in the Republic of Korea (hereafter Korea), a marked improvement from the prior year's 4.0%. This outturn masks, though, decelerating momentum over the course of the year amid some softening in growth of both exports and domestic consumption. Quarterly GDP growth rates slid from 6.1% (year on year) in the first quarter to 4.0% in the fourth. After peaking in the first quarter, industrial production eased and inventories accumulated. A cooling in the housing market early in the year hurt construction investment and consumption spending throughout the summer months. Although buoyant exports continued to support a recovery in nonconstruction investment, domestic demand weakened over the year as a whole.

Private consumption posted healthy growth of 4.2% in 2006, the highest rate since the credit card crisis in 2003, when a sharp increase in card issuance resulted in a surge in household debt and a subsequent spending slump. Here too, quarterly growth rates slipped over the year, partly because of a renewed buildup in household debt. Despite extensive government efforts to cool a buoyant residential property market, house prices accelerated in the second half of the year. This resurgence, in an environment of relatively low interest rates and ample liquidity, prompted households to borrow more to finance home purchases. Household debt rose to nearly 67% of GDP by September 2006, from 65% in 2005, and is up sharply from about 40% a decade ago.

The economic recovery broadened with a pickup in capital investment. Capital spending increased by 3.2%, despite a shrinkage in construction investment in the first half of the year. Rising house prices lifted construction in the second half. Corporate spending on machinery and equipment made a steady recovery, increasing by 7.5% during the year. Total investment contributed 1.0 percentage point to overall GDP growth (Figure 2.10.1). Given that many large companies are export-oriented, robust export performance and strong balance sheets augur well for a continued investment recovery.

Merchandise exports rose by 14.4% in nominal US dollar terms in 2006, in the face of a strengthening won, a muted recovery in global

2.10.1 Contributions to growth (demand)



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 26 January 2007.

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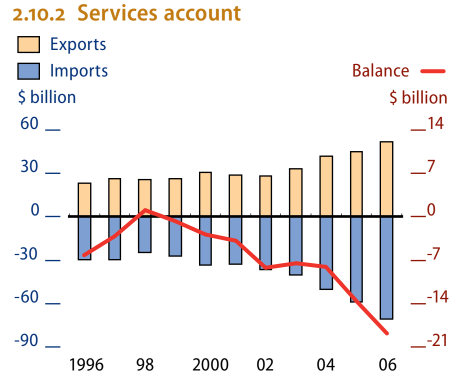
2.10.2 Services account



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 18 February 2007.

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information technology activity, and high oil prices. Automobiles, consumer electronics, semiconductors, and ships continued to lead Korea's exports. Generally benign external demand conditions and improved large-company competitiveness underpinned the robust export performance in these industries. Even faster growth in imports (up 18.4%) compressed the trade surplus. High prices for oil and raw materials lifted the import bill in most of 2006, though signs of moderation appeared in the fourth quarter. Merchandise trade still posted a significant surplus, but it was largely offset by a widening gap in services trade. The services deficit more than doubled between 2004 and 2006, to $18.8 billion, as more Koreans opted for overseas education, vacations, and other services (Figure 2.10.2). Productivity growth in a number of domestic services has stagnated (Figure 2.10.3), in part owing to a pervasive public-sector presence in the sector and also to restrictions on international firms operating in some services areas, which limits competition.

The pickup in economic growth led to some strengthening of the labor market, and for the year unemployment averaged 3.5%, down from 3.7% in 2005. Average monthly earnings rose by 2.6%. However, while 2006 saw 295,000 new jobs, the economy is generally sluggish at creating employment, even during upturns. Rising labor costs have encouraged manufacturers to relocate production overseas or to outsource parts of their production to countries with cheaper labor.

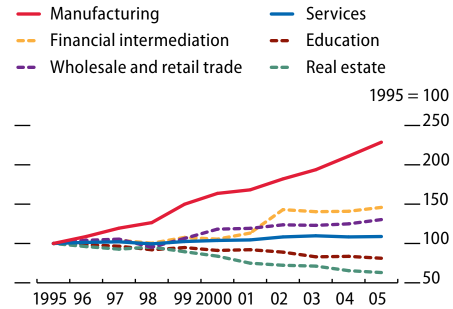
Another barrier to creating more jobs is structural rigidity in the labor market. After years of labor union action, employees in jobs classified as permanent positions have gained strong legal protection for job security, improved working conditions, and higher wages. Employers increasingly have turned to workers they can hire on fixed-term contracts, often at lower overall compensation. Government efforts to contain the trend toward fixed-term employment could result in companies being more reluctant to hire, unless permanent workers agree to give up some of their existing benefits.

Consumer price inflation decelerated by a half percentage point to 2.2% in 2006. The easing of global oil prices from their peaks in 2006 and a stabilizing of food prices helped, and monetary tightening over 2 years also took effect. The won appreciated against both the US dollar and the yen from already strong levels, also helping keep a lid on inflation (Figure 2.10.4). Surpluses in both the current and capital accounts have underpinned the currency's strength. Despite significant capital outflows of portfolio investment, the capital account posted a large surplus due to a sharp increase in short-term borrowing by banks for the purposes of export industries' currency hedging. The pressure on the currency to appreciate appears to be easing though, as export growth moderates and as Koreans are allowed to invest more overseas.

Economic prospects

Growth is expected to pick up again from late-2006 levels on the back of a steady increase in investment and continuing support from exports, as well as a gradual consumption recovery in 2007. Although annual growth is projected to slow to 4.5% (Figure 2.10.5), quarterly economic performance is likely to accelerate over the year. The recovery will

2.10.3 Labor productivity



Source: Staff estimates based on employment data from International Labour Organization and gross value added from Bank of Korea.

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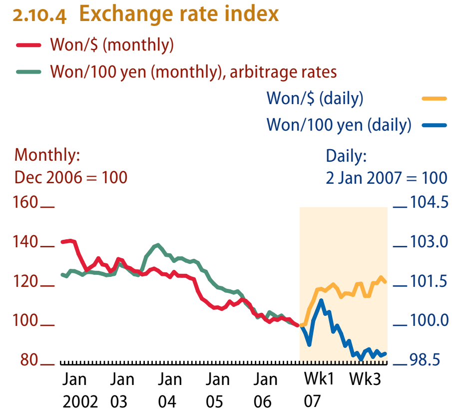
2.10.4 Exchange rate index



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 6 February 2007.

Click here for figure data

2.10.1 Selected economic indicators

	2007	2008
GDP growth	4.5	4.8
Inflation	2.4	2.6
Current account balance (% of GDP)	0.1	0.1

Source: Staff estimates.

2.10.1 Dangers of the house price boom

Surging housing prices have raised concerns in the Government that a bubble may form, which ultimately could damage the economy. At this stage, there are fundamental reasons behind the price gains: an underlying housing supply shortage and strong demand underpinned by low borrowing costs. The house price/rental value ratio—its historic average may be used as proxy for property values—also remains low for the country overall, even though home prices have been rising much faster than rental values over the past few years (Box figure 1). Nevertheless, the pace of increase in house prices in some affluent areas of Seoul has been alarming, rising by nearly 25% between September 2005 and September 2006.

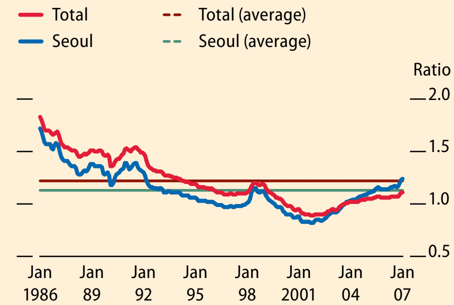
Key concerns are the rapid buildup in household debt associated with mortgage lending and its possible knock-on effects. Fast-rising house prices and expectations of further gains have encouraged households to take on more mortgage debt. For example, bank lending to households increased by 10.7% in the 12 months to September 2006, with more than 60% of this mortgage related. As household debt has grown much faster than incomes, households' ability to repay debt has deteriorated: the ratio of household debt to income has resumed its rise since 2005 (Box figure 2) and the number of personal bankruptcies has more than doubled in this period.

Heavy household debt burdens have also hurt prospects for a speedy recovery in consumer spending. A sharp downturn in house prices could push financially weak households into bankruptcy, starting another prolonged slump in private consumption, and threaten the health of the financial system by eroding loan collateral values and swelling the number of delinquent loans. For now, though, bank stability indicators show little sign of stress.

The Government introduced another set of measures in November 2006 in an effort to stabilize house prices, the eighth such package in 3 years. These latest measures include plans to increase the housing supply, which has not been a focus of previous packages. They also involve tighter financial regulations to curtail growth of household borrowing.

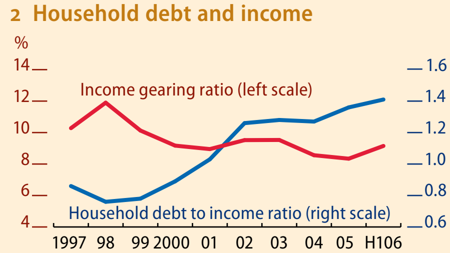
A major policy challenge is to ensure sufficient housing supply by addressing inefficiencies arising from heavy public sector involvement and regulation of the housing market, and by securing adequate public provision of housing for low-income earners, who may be bypassed in the market mechanism. But there is always a risk that measures taken to contain price rises could in themselves precipitate a sharp fall in housing prices.

1 House price/rental value ratio



Source: Staff estimates based on housing price data from Bank of Korea, Economic Statistics System.

2 Household debt and income



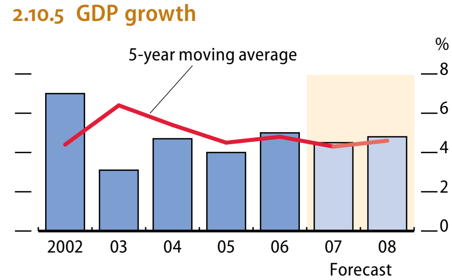
Note: Income gearing ratio refers to the share of household interest payments in household disposable income.

Sources: Household Assets and Debts: Flow of Funds Statistics, Bank of Korea; Household Disposable Income: System of National Accounts, Bank of Korea.

broaden with domestic demand strengthening. Economic indicators in late 2006 showed signs of a stabilization in industrial production, construction investment, and consumption. As 2007 progresses, the external environment could turn more favorable with the global downturn bottoming in the second half. The Korean economy is projected to continue building momentum in 2008, based largely on firming domestic demand, with growth of 4.8% that year.

Private consumption is recovering, as the improvement in the job market underpins growth in household incomes. However, household debt remains high at a time when increases in interest rates in 2005–2006 are adding pressure on consumer spending. Given the underlying weakness in household balance sheets, private consumption growth

2.10.5 GDP growth



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 26 January 2007; staff estimates.

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is expected to remain moderate. Moreover, consumer sentiment has declined (Figure 2.10.6) because of concerns about the global economic outlook, uncertainty surrounding the implementation of new tax laws targeting real estate, and political tensions involving the Democratic People's Republic of Korea.

Export-led manufacturing firms are for the most part in good shape, with strong profits, to continue an expansionary cycle in investment. Capacity utilization has edged up too, indicating a potential need for expanding production facilities (Figure 2.10.7). The upturn in house prices in the second half of 2006 is likely to be followed by a pickup in housing construction over the forecast period, helped by new measures from the Government to increase housing supply.

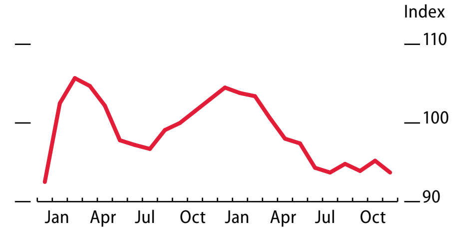
In 2007, the expected moderate slowdown in the US economy suggests there will be some easing in Korea's export growth rate. Nevertheless, a still-robust export performance will support a recovery in industrial production and business spending. However, rapidly rising imports, driven in part by demand for overseas travel and education, will cut by half the contribution of net exports to GDP growth. Although merchandise trade looks set to achieve a record surplus, based on the robust exports and declining oil and commodity prices, growth in imported services will remain high. The current account surplus, which narrowed to less than 1% of GDP last year, is projected to shrink further (Figure 2.10.8).

Monetary and fiscal policies are projected to be set in generally neutral positions. The Bank of Korea is expected to loosen the tightening bias that it maintained throughout 2006, as inflationary pressures subside in a context of softening economic growth and declining import prices. Consumer price inflation is likely to remain below the central bank's target band of 2.5–3.5% in 2007 (Figure 2.10.9). On the fiscal front, an expected increase in tax revenues, drawing on last year's stronger economic growth, should make room for some additional fiscal outlays this year. Fiscal spending will continue to focus on strengthening social infrastructure and the social safety net, on enhancing productivity in the services sector, and hence on preparing for long-term structural changes including an aging society. However, growing concerns both about long-term fiscal sustainability caused by the aging population and about the projected costs of social services will restrain the use of expansionary budgets.

New tax laws take effect in 2007 intended to streamline sources of tax revenues and restore fairness by removing some of the wide array of tax credits and deductibles. A fiscal tightening effect from efforts to broaden the tax base and to strengthen tax collection has been balanced by measures to leave in place a majority of tax credits for small and medium enterprises (SMEs) and for business investment for the time being, given that economic activity will slow in 2007 relative to 2006.

Risks to the projections would most likely originate in any sharp slump in the US economy, which would undermine Korea's export performance and reduce GDP growth. Domestically, a surge in housing prices has led to an increase in household mortgage debt. A significant downturn in the housing market could intensify financial pressures on households, which would retard the recovery in consumption spending (Box 2.10.1).

2.10.6 Consumer expectations index



Source: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 10 January 2007.

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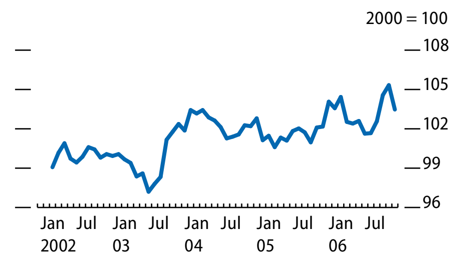
2.10.7 Manufacturing capacity utilization (3-month moving average)



Source: National Statistical Office, available: http://www.kosis.nso.go.kr, downloaded 5 February 2007.

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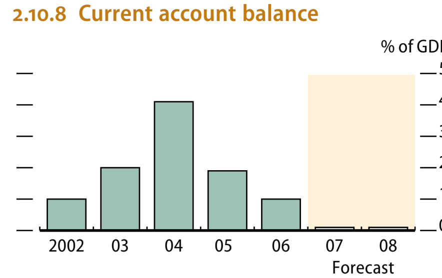
2.10.8 Current account balance



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 18 February 2007; staff estimates.

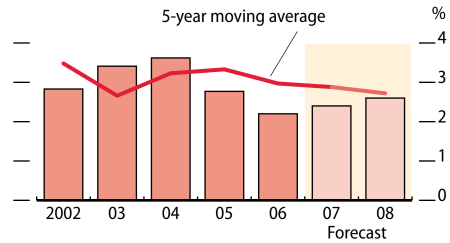
Click here for figure data

Development challenges

Korea faces important challenges resulting from intense global competition and an aging population. The recovery in GDP growth rates after the 1997–98 Asian financial crisis partly reflects successes in addressing certain structural weaknesses in the economic and financial framework. Reforms are incomplete though, as illustrated by the 2003 credit card crisis and the subsequent prolonged slump in private consumption. A more fundamental problem that is damping private consumption is lagging productivity in the services sector and among SMEs. This is holding back improvements in the labor market and in wages growth. The likely key to resuming rapid growth over the medium term is to accelerate productivity growth by continuing with structural reform, particularly in the labor market and in the services sector, including SME restructuring.

As the economy matures and as the population ages, slowing labor and capital inputs will require a more efficient and flexible economic structure that can ensure productivity gains while accommodating the necessary socioeconomic adjustments. In the medium to long term, reforms should focus on health, education, and facilities for the aged; undue regulatory burdens; and weaknesses in the services sector.

2.10.9 Inflation



Sources: Bank of Korea, Economic Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 24 January 2007; staff estimates.

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Mongolia

Buoyant commodities markets and good weather made 2006 another year of strong economic expansion. Growth is projected to step down a little in 2007, but remain brisk. The main challenges are to use the Government's revenues from mineral wealth in a manner that sets the country on a sustainable development path; and to address immediate poverty and environmental problems.

Economic performance

The economy performed well in 2006: growth in GDP picked up to 8.4%, a fourth straight year of 6%-plus expansion. Inflation moderated from high levels and both the fiscal and current accounts were in surplus. As an economy based on agriculture (which supports nearly half the population) and mining, Mongolia usually does well when the weather is favorable and commodity markets are buoyant.

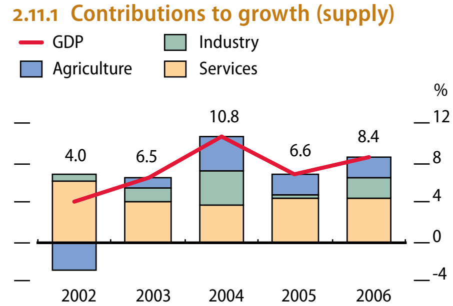
That describes 2006, when the winter was mild and copper and gold brought high prices. Livestock numbers rose by 14.5% to a record 34.8 million as herders responded to demand from the People's Republic of China (PRC). Goats and sheep make up over 80% of the total, with the remainder cattle, horses, and camels. Copper export receipts in US dollars nearly doubled, though copper export volumes increased by only 2.1%.

The clothing industry, too, was a strong performer. It contracted in 2005 after the global textile and clothing trade quota system ended, but rebounded last year as manufacturers focused on the European Union and took advantage of its tariff concessions. For mining, total mineral extraction grew marginally and reported gold production fell. The latter may have been caused by greater smuggling of gold after the Government imposed a windfall profits tax on gold and copper. Transport and telecommunications maintained robust growth, such that services contributed the most (4.4 percentage points) to total GDP growth. Agriculture and industry contributed about 2 percentage points each (Figure 2.11.1).

Broad money (M2) growth was again high in 2006 at 35% (Figure 2.11.2), but inflation slowed from an average of nearly 13% in 2005 to 5.1% last year. This deceleration reflected a much more moderate rise in food prices and a 4% appreciation of the togrog against the US dollar, which made imports less costly.

On the back of rising income from mining, the budget was in surplus in 2006 (by 3.9% of GDP; Figure 2.11.3). Revenues benefited from the Government's 51% share in the biggest copper mine, operated by Erdenet Company, and from taxes on mineral output. In 2006 the Government also imposed a 68% windfall tax on copper and gold for prices exceeding $6,500 a ton for copper and $500 an ounce for gold. This tax generated $152.4 million. Moreover, overall tax collections have been buoyed by the solid economic growth.

2.11.1 Contributions to growth (supply)



Source: National Statistics Office.

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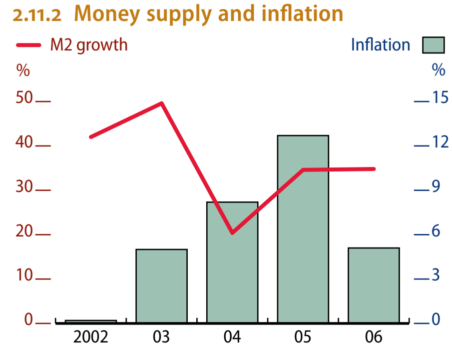
2.11.2 Money supply and inflation



Source: Bank of Mongolia.

Click here for figure data

Expenditures also rose noticeably. The Government increased salaries of public officials by 30% and started cash transfers to families with newly born children, to newly married couples, and to families for each child below the age of 18. The parliament agreed to budget those payments for years into the future, raising questions about the sustainability of public finances.

Exports soared by 44% in nominal terms, as a result of high prices for copper and gold and an increase in cashmere exports (the number of goats rose by 16.5% to 15.6 million). Textile and clothing exports to the United States continued the decline that set in when global quotas ended, but rose substantially to the European Union, which exempts certain Mongolian products from import duties. Many of Mongolia's exports have benefited in recent years from strong demand from the PRC, Mongolia's main export market.

Mongolia imports all its petroleum products, and the surge in global oil prices last year was the main reason for the strong growth in imports of 26%. The trade account produced the first surplus for many years (Figure 2.11.4) and the current account was in surplus for the third consecutive year. Foreign direct investment was $367 million in 2006, four times as high as in 2000. Most has gone into mining. Gross international reserves more than doubled to $718 million in 2006.

In the policy arena, the Government adopted a new mining law that gives it the right to acquire up to 50% stakes in "strategic" mineral deposits. As well as the imposition of the windfall profits tax, mining royalty rates were raised. Negotiations continued between the Government and Ivanhoe Mines Ltd. of Canada, which holds the license for the large Oyu Tolgoi copper and gold deposit, on an agreement concerning taxes and royalties. Companies from the PRC are negotiating to develop coal mines and build power plants, for export to their home market.

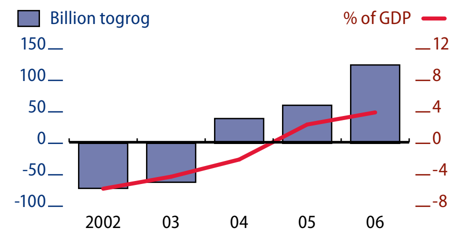
Sustained economic growth in recent years, plus inflows of foreign capital mainly into mining and a more competitive financial market, have spurred sharp increases in credit growth (by more than 40% in 2006). This rapid growth has heightened risks. Officially, the reported ratio of nonperforming loans to total loans has been fairly steady at around 9%, but actual figures are likely to be higher. Some banks do not have adequate risk management and internal control mechanisms, and their rapidly inflated lending may be at the cost of quality.

In this regard, the recent establishment of a financial regulatory commission and a stronger statement of intent by the Bank of Mongolia, the central bank, on banking supervision are encouraging.

Economic prospects

The projections assume that prices of copper and gold will be fairly stable in 2007 and that the price of cashmere will decline slightly. Government expenditures are taken to rise as elections approach in 2008. The forecasts also presuppose that policies will be implemented to maintain the confidence of international mining investors. Economic growth in the important PRC export market is forecast to ease to about 10.0% this year from 10.7% last year.

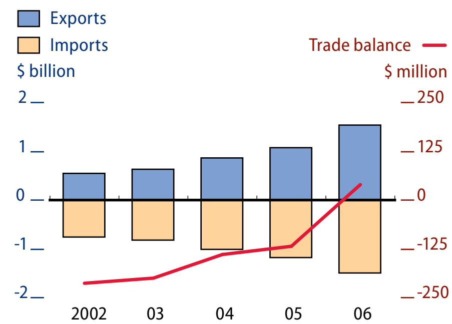
2.11.3 Budget balance



Source: National Statistics Office.

Click here for figure data

2.11.4 Trade indicators



Source: Bank of Mongolia.

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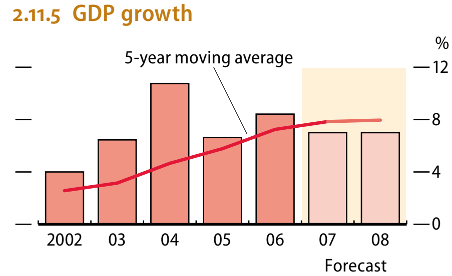
2.11.5 GDP growth



Sources: National Statistics Office; staff estimates.

Click here for figure data

2.11.1 Selected economic indicators

	2007	2008
GDP growth	7.0	7.0
Inflation	6.0	6.0
Current account balance (% of GDP)	2.0	2.0

Source: Staff estimates.

On this basis, Mongolia's GDP growth in 2007 and 2008 is projected to step down to about 7% (Figure 2.11.5), after averaging 9% for 3 years. Livestock and manufacturing growth rates have been unusually high and are projected to slow. Agriculture in particular could be bumping up against sustainability constraints in terms of herd size.

The minerals law and the tax regime for mining may well be modified to be more investor friendly, which would encourage higher mining output and attract further investment. If the Government and Ivanhoe Mines agree on terms for development of the Oyu Tolgoi deposit, Ivanhoe's investments would rise substantially over the next couple of years. In that case production could start in 2010.

Major international mining company Rio Tinto would join Ivanhoe in developing the Oyu Tolgoi deposit, which could produce an estimated 1 billion pounds of copper and 330,000 ounces of gold a year for at least 35 years. This would have a significant impact on exports and government revenues. Also, initial investment in the large Tavan Tolgoi coal deposit could start over the forecast period.

A government pledge to provide 40,000 households with improved housing should stimulate the construction industry. In addition, Mongolian banks have started to tap international financial markets, which could provide an increasing flow of longer-term funding for investment projects. The Trade and Development Bank of Mongolia issued a $75 million bond in early 2007 at a yield of 8.75%. The 3-year bond attracted strong demand from investors.

Inflation over 2007 and 2008 is projected at about 6%. The past high inflation rate (the annual average exceeded 8.0% in 3 of the past 6 years) has been driven mainly by supply shocks to food and oil prices and to exchange rate movements. Consequently, the stronger trade position is expected to support the exchange rate and so help contain price pressures. The Bank of Mongolia has found little evidence that money growth drives inflation in the economy. Continuing monetization of the economy could account for the weak link between money growth and inflation.

The current account is expected to show surpluses of about 2% of GDP in the forecast period as prices of copper and gold stabilize, but mineral export volumes rise.

The biggest risk to the economy would be a sharp drop in international metals prices. In addition to direct links to GDP, mineral exports are the major source of government revenues and affect the exchange rate, which in turn has an impact on inflation. Significant declines in prices of copper, coal, gold, and cashmere would hit the current account and, in the longer term, could lead toward debt distress. Severe winter weather can devastate agriculture in any year.

Further out, there is a threat to the sustainability of the natural-resource base. Overstocking in agriculture and lax controls over smaller mines, as well as environmental problems related to urbanization, have damaged the environment, including water resources. Unless the Government can reorient agriculture toward a sustainable growth path, this sector's growth will likely slow in the medium term and it could face longer-term contraction. Potential instability in the financial sector is a further risk, since some banks have tried to expand by offering high rates for deposits and using funds to make high-interest, high-risk loans.

2.11.1 Development challenges

Once Mongolia started its transition in 1991 from a command economy, it was quick to dismantle that system, institute legal and institutional frameworks, and adopt market-oriented policies.

Nevertheless, cumulative growth has been insufficient to resolve high levels of poverty that emerged after the initial shocks. Poverty incidence was estimated at 32.6% in 2006. The benefits from mineral wealth have not been broadly distributed.

Moreover, social services, particularly education and health, have deteriorated. Current expenditures in the budget account for an inordinately large proportion (almost 80%) of total public spending, and little public investment is directed to building infrastructure.

An important development challenge is to use government revenues from mineral resources for setting the country on a sustainable long-term development path while also addressing social and environmental problems. This will require significant investment in social and physical infrastructure, which would facilitate the development of new growth sources and an upgrading of labor productivity.

Such a plan should be linked into the budget and set out development priorities. This also will require the building of capacities in strategic planning and in project preparation and appraisal.

Among other issues the public investment plan should address the degradation of the environment. In addition to the problems outlined, the overuse and illegal trade in forest products and wildlife have inflicted heavy damage and put under threat the sustainable economic growth, primary education, and environment targets in the Millennium Development Goals.

Corruption also is a challenge to development. In 2006, Mongolia ranked 99 out of 163 countries on the Transparency International Corruption Perceptions Index.

Taipei,China

On the back of stronger exports, economic growth accelerated in 2006. Domestic demand was subdued for most of the year, weighed down by a tightening of consumer credit. This year, consumption and investment demand are projected to pick up, cushioning the economy from an expected slowdown in external demand. That would leave GDP growth slightly below last year's pace. Structurally, higher performance levels require manufacturers to move further up the value chain and services firms to become more outward oriented.

Economic performance

Supported by strength in exports, the economy grew by nearly 5.0% in the first 3 quarters of 2006, but slowed to 4.0% in the fourth when the pace of exports decelerated sharply (Figure 2.12.1). For the year as a whole, exports of goods and services measured in US dollars expanded by 12.9%, up from 7.8% in 2005, led by optical equipment, electronics, and machinery. Growth in imports accelerated to 9.9.%, from 8.2%, driven by purchases of inputs needed for the expanding export industries and by a strengthening in domestic investment. As a result, net exports in national account terms jumped by 31.3%, contributing 3.5 percentage points of total 2006 GDP growth of 4.6% (Figure 2.12.2).

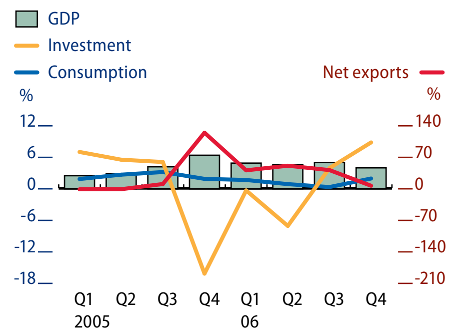
Private investment edged up by 2.1% in 2006, largely the result of a cyclical upturn in the second half, following 3 quarters of decline. The pickup was primarily seen in purchases of machinery and equipment prompted by strong exports of manufactures. Construction investment also continued to recover, as the property market strengthened. However, private investment growth was largely offset by a 4.9% contraction in public investment, due to the completion of some major projects. Overall, total fixed investment rose a paltry 0.3%, making little contribution to the overall outturn.

Private consumption decelerated to 1.5% from 2.7% a year earlier, weighed down by a tightening in consumer credit that followed the bursting of a credit-card bubble in late 2005. On a year-on-year basis, private consumption slowed to just 0.4% growth in the third quarter. It picked up in the fourth, in part because of a low-base effect from weak private consumption expansion in the last quarter of 2005. Government consumption slipped by 0.2%, reflecting efforts to tighten expenditures.

On the supply side, manufacturing grew by 7.1%, led by the subsectors of electronics components and computer and telecommunications products. Construction rose by 5.2% (from 0.5% in 2005). Services, which account for 73% of GDP, steadily progressed by 3.7% and were again the major contributor to GDP growth. Agriculture expanded by 5.4%, mostly a recovery from typhoons and floods in 2005.

Those natural disasters had hit vegetable and fruit production in 2005, pushing up the consumer price index by 2.3%. In 2006, as their

2.12.1 Growth of GDP and demand components



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 26 February 2007.

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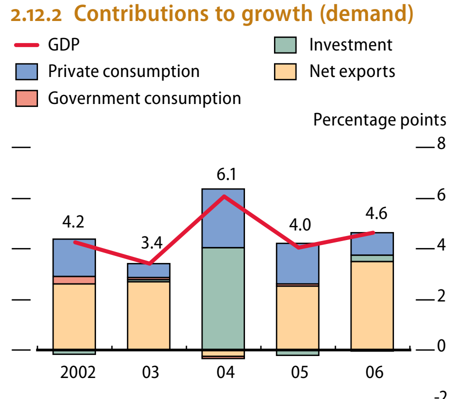
2.12.2 Contributions to growth (demand)



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 26 February 2007.

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prices fell or steadied, inflation was marked down to 0.6%. Wholesale prices, in contrast, rose steeply by 5.6%, pushed up by rising international oil and commodity prices and a weakening of the New Taiwan dollar (Figure 2.12.3). The divergent trend between consumer and wholesale prices indicates limited pass-through from increased production costs into retail inflation, partly a consequence of firms having limited pricing power.

Labor market conditions improved with the faster pace of economic growth. Total employment expanded by 1.7% and the annual average unemployment rate fell to a 6-year low of 3.9%. Job creation was broad based, with construction growing strongest, by 3.3%. The reduction in labor market slack and lower inflation lifted real wages. Real average earnings of nonagricultural workers rose by 0.5%, a switch from a 0.9% decline in 2005.

Concerned about negative real interest rates and inflationary pressures from rising prices of imported oil and commodities, the monetary authorities raised the benchmark discount rate by 12.5 basis points in each quarter of 2006, to 2.75%. The policy rate is still below those of most other regional economies, however.

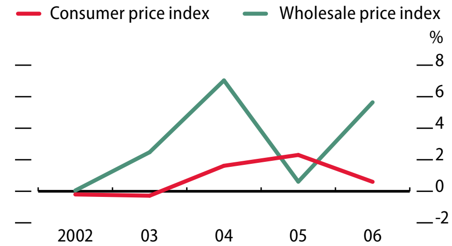
With an abundance of funds in the banking system, the cost of borrowing stayed low. The base lending rate rose by just 27 basis points over the year to 4.12%. However, the pace of domestic loan growth slowed markedly to 2.5% at end-2006 from 8.1% a year earlier, mainly due to the weakness in consumer lending. After 2 years of rising at double-digit levels, lending to consumers nudged up by 1% in 2006 as banks imposed more stringent lending standards after a surge in credit-card defaults. Banks wrote off US$5.1 billion in bad cash-card and credit-card loans last year, more than double the amount in 2005.

On the back of the property market upturn, construction lending rebounded by 26.8%, which partly offset the impact of the consumer credit crunch (Figure 2.12.4). Despite weak credit expansion, broad money (M2) grew by an average of 6.2% in 2006, similar to that recorded in 2005, as financial institutions increased their portfolio investments.

The strong rise in exports pushed the trade surplus up by 30% and this followed through into the current account surplus, which reached $25.2 billion in 2006, equivalent to 7.1% of GDP. This was partly offset by an upsurge in capital outflows channeled to overseas securities markets, and by a reduction in portfolio investment inflows. A widening gap between local interest rates and the US Federal Funds rate was the major factor driving capital outflows, though some domestic reasons apparently contributed, such as the gradual lifting of a cap on overseas investment by insurance companies. Gross international reserves rose to $266.1 billion at end-2006. The capital outflows also contributed to weakness in the currency. Over the year, the New Taiwan dollar depreciated on average by 1.1% against the US dollar, and its real effective exchange rate by 0.4%.

In fiscal matters, the faster pace of economic growth was not reflected in tax revenues, which rose modestly by 1.8%. The tax-to-GDP ratio declined to 14.3% in 2006 from 14.6% a year earlier. Corporate income tax receipts fell by 5.3%, possibly a result of tax exemptions and tax preferences for certain investment and industries. The Government trimmed spending and ended the year in the black, reversing a run of deficits. The ratio of central government outstanding debt to GDP rose

2.12.3 Inflation



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 13 March 2007.

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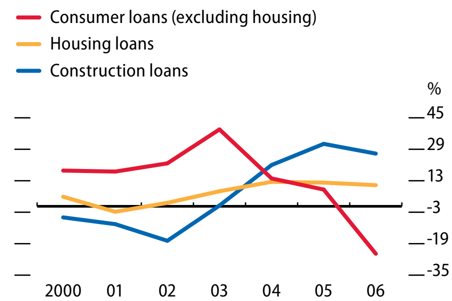
2.12.4 Loan growth



Source: Central Bank of the Republic of China, available: http://www.cbc.gov.tw, downloaded 14 March 2007.

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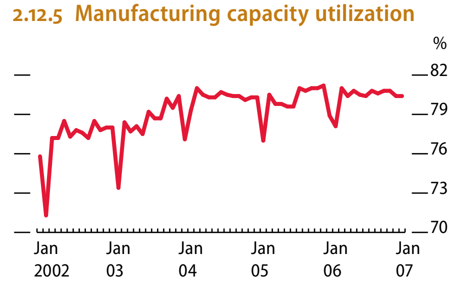
2.12.5 Manufacturing capacity utilization



Source: Business Indicators DataBase, available: http://index.cepd.gov.tw, downloaded 11 March 2007.

Click here for figure data

2.12.1 Selected economic indicators

	2007	2008
GDP growth	4.3	4.5
Inflation	1.6	1.5
Current account balance (% of GDP)	6.7	6.5

Source: Staff estimates.

slightly to 33.2% at end-2006, within a 40% ceiling stipulated by the Public Debt Law.

Economic prospects

External conditions will be benign in 2007, despite the expected deceleration in the global economy and a softening in demand for some electronics. Resilient intra-Asian trade and robust demand from the People's Republic of China (PRC) will likely provide a buffer against the slowdown in other world markets. Export growth is expected to slow by about 4 percentage points to a still-solid 8.8%. An upturn in the global electronics cycle, starting in the second half of this year, is projected to take export growth back up in 2008, to 9.4%.

Domestic demand is forecast to recover gradually, bolstered by the modest upturn in investment that started in 2006 and a strengthening in consumer spending. The cyclical rebound in machinery and equipment investment will likely be prolonged by a high manufacturing capacity utilization rate (Figure 2.12.5) and by solid exports. Construction investment growth will ease because the buoyant property market is expected to slow. Public investment will increase owing to new public infrastructure projects in energy, water supply, and railways. Private consumption is expected to accelerate back to 3.0% in 2007 as the credit-card debt problems are resolved. Also, spending is underpinned by positive wealth effects from last year's gains in housing and equity prices as well as the strengthening of the labor market.

Based on the above factors, economic growth is projected to moderate to 4.3% in 2007, then inch up to 4.5% in 2008 as the global economy gains momentum. Inflation will creep up to around 1.6% in the forecast period from last year's low levels. Low inflation, a reduced risk of imported inflation, and the expected end of US interest rate rises suggest that the monetary authorities could adopt an accommodative monetary policy stance and keep interest rates steady over this year. Import growth measured in nominal terms is projected to outpace export growth, largely because of the imports needed for investment projects. The current account surplus is forecast to decline to 6.7% of GDP in 2007 and 6.5% in 2008.

These projections are subject to both downside and upside risks. Political uncertainties ahead of legislative elections in December 2007 and presidential elections in March 2008 could unnerve investors, as would any deterioration in cross-strait relations. On the upside, a possible move to liberalize economic relations with the PRC, such as relaxing limits on investment there or restrictions on tourists visiting the island from across the strait, would boost confidence in the economy.

2.12.1 Development challenges

Two important medium-term challenges face the authorities: to nurture new sources of growth and to redress income inequalities. The growth engine of recent decades—electronics—has faced significant competition from low-cost producers. Most of its labor-intensive production has relocated to the PRC.

Firms in Taipei,China still make some high-value products and play a dominant role in regional supply-chain management, but profit margins have been squeezed and their linkages to the domestic economy weakened. This is reflected in a reduction in manufacturing to 21.4% of GDP in 2006 from 37.6 % in 1986.

Services, which accounted for 73% of GDP last year, are mainly oriented toward the domestic market and are dominated by small and medium enterprises, so are unlikely to expand at much faster rates than they do now. New growth sources would be fostered if manufacturers moved further up the value chain and services firms tapped into regional markets.

Although the economy has a relatively equal income distribution, income disparities have widened over the past decade. Only the highest-earning 20% of households enjoyed gains in income in 2001–2005, partly because corporate and investment income outpaced wage income, helped by corporate tax breaks. Incomes for other groups stagnated or declined. Unskilled workers were the major losers as manufacturers relocated abroad. Some middle-income earners also suffered because of subdued growth in real wages and a disproportionate tax burden on salaried employees.

The widening income gap will restrain expansion in consumption, make it more difficult to win public support for further economic liberalization, and could even induce social tensions.

South Asia

Afghanistan, Islamic Rep. of
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Islamic Republic of Afghanistan

In the licit economy, economic growth slowed as agriculture was hit by another drought, while reconstruction-linked construction and services continued to expand. The Government continued along its track of solid macroeconomic policy and structural reforms. Yet popular discontent with slow reconstruction, pervasive corruption, as well as sharply deteriorating security, institutional and human resource constraints, a heavy reliance on aid, and a very low domestic revenue base, all remain formidable challenges. As does the impact of opium production, which reached record levels. Since current, licit, drivers of growth cannot provide sustained growth, creating a private sector enabling environment and diversifying the economy remain crucial tasks.

Economic performance

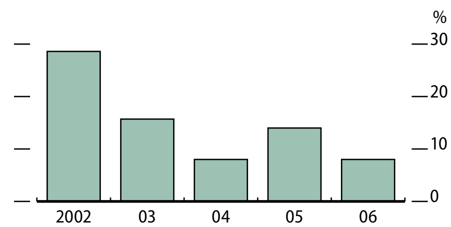
In FY2006 (ended 20 March 2007) the agricultural sector, representing about a third of licit GDP, was hit by another drought. (Box 2.13.1 on the next page discusses the non-licit economy—essentially opium.) While continued expansion in construction and services partly compensated for this decline, overall GDP growth for the year is now expected to reach only about 8% (Figure 2.13.1), or well below the 12% expected in the Poverty Reduction and Growth Facility program with the International Monetary Fund (IMF).

In December 2006, year-on-year inflation registered by the consumer price index for Kabul and five other cities declined to a little less than 4% (Figure 2.13.2), aided by a decline in energy prices and rents in the capital. Wheat imports lessened the impact of the drought on food prices.

Currency in circulation in the year to September 2006 grew less than expected with a gradual shift in money demand from cash toward deposits. Over the year, interest rates on the central bank's 30-day capital notes declined from about 8% to 5–6%. Growing competition in the banking sector is helping narrow the gap between bank deposit and lending rates. From a wider perspective though, the banking sector is still small relative to the economy, despite rapid growth in recent years, and bank assets still account for less than 9% of GDP. Commercial banks dominate the formal financial sector, with about 95% of its assets.

The Government continued to adhere to its "no overdraft" policy for bank financing of the national budget. By the end of FY2005 the execution rate of the development budget reached only 43%, reflecting low capacity, particularly in line ministries; poor prioritization of projects; unrealistic time, cost, and expenditure projections; and delays in project implementation due to a deteriorating security situation. In FY2006 the Government increased its efforts to address the poor implementation performance, such that development expenditures are likely to reach about 55–60% by the end of the fiscal year. To better reflect current spending capacities, the development budget was reduced by 5.1% at the midyear budget review.

2.13.1 GDP growth



Source: International Monetary Fund, available: www.imf.org, downloaded 9 March 2007.

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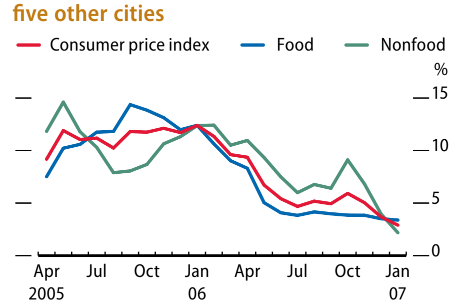
2.13.2 Monthly inflation, Kabul and five other cities



Source: Central Statistics Office, available: www.cso.gov.af, downloaded 19 February 2007.

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As spending pressures are growing, the same review increased the operating budget by 6.3% to account for expenditures that had previously been funded by donors, such as the fuel subsidy to operate several power generation plants, costs of additional teachers required, and salary arrears (mainly to teachers). The deteriorating security situation is also adding to spending pressure, and these are likely to increase in the medium term.

On the income side, domestic revenues are expected to rise by 15–20%. Since FY2003, government revenues have seen an overall increase of about 500%, yet are still very low. Customs revenues dropped in the second half of last year, most likely due to new restrictions on imports of old and right-hand vehicles, delays in the introduction of a new tariff schedule, and concessions to traders. This drop was partly offset by higher revenues from taxes on income, profits, and business receipts.

With imports of consumer and capital goods outpacing only slowly rising licit exports, the trade deficit, at $2.6 billion in FY2005, is seen rising. But with grants, the current account should remain close to balance.

The exchange rate showed continued stability, fluctuating at AF49.73–50.65/$1 over calendar year 2006. The large foreign exchange inflows have made the currency relatively strong and, given the lack of productivity improvement in the economy, has harmed external competitiveness.

Since the Paris Club rescheduling agreement of July 2006, the Government has been finalizing outstanding bilateral issues and agreements. An agreement with the United States was signed in September 2006 and agreements with the Russian Federation, the largest creditor, and Germany are expected to be signed. Afghanistan will likely benefit from the Heavily Indebted Poor Countries initiative this year.

In January 2006, the Government approved the Interim Afghanistan National Development Strategy (I-ANDS). This sets 5-year benchmarks to enhance security, governance, rule of law, human rights, economic and social development, and stimulate private trade (Box 2.13.2). The Government initiated the implementation of the I-ANDS while preparing a full strategy. The Government continues to push for more aid to be channeled through the budget (currently about three quarters of aid is off-budget) as a further impetus to better align development projects with priorities identified in the I-ANDS. It would also enhance the Government's capacity and, by demonstrating its ability to deliver services to the people, help bolster its legitimacy.

In June 2006, IMF approved a 3-year arrangement worth SDR81.0 million (about $119 million) under the Poverty Reduction and Growth Facility, building on advances made under its Staff Monitored Program. Progress under the Program and the first review of the Facility has been good, with the authorities meeting most benchmarks.

Revenue administration continued to make progress: tax receipts, particularly from large businesses, increased almost 10-fold in FY2006; a road toll was introduced in June 2006 (though revenues fell far short of initial forecasts); a draft proposal to simplify the tax system and to abolish "nuisance taxes" is expected to be submitted for parliamentary approval by end-FY2006; and reform of the mustoufiats—provincial units of the Ministry of Finance—continued. Strengthening the capacity of these units—responsible for revenue collection, payment processing, and accounting functions at the provincial and district level—is vital.

2.13.1 Opium harvest at record in 2006

According to estimates of the United Nations Office on Drugs and Crime (UNODC), total opium cultivation in 2006 increased by 59% and production by 49%. Afghanistan now produces 6,100 tons, equivalent to 92% of total global supply. Most of the production increase was from volatile, conflict-ridden southern provinces.

With the expansion of the licit economy, the share of the total export value of opium to licit GDP is gradually decreasing: from 61.7% in FY2002 to 36.3% in FY2005.

The macroeconomic effects of opium are huge: it generates large aggregate demand, boosts the balance of payments and, through customs duties on drug-financed imports, supports government revenues. However, as much of the income from opium accrues to traffickers, is invested abroad, or is used on imported goods, the overall positive macroeconomic impact is limited.

In rural areas, opium production remains one of the leading sources of employment (it is more labor intensive and more profitable than the production of other crops). In 2006, the share of households involved in opium poppy cultivation rose by nearly half to about 13% of the population.

Responding to changes in economic and enforcement situations, the opium economy has proven to be extremely flexible. Reduction in cultivation in one province often results in production shifting elsewhere.

A study by UNODC and the World Bank has highlighted that eradication efforts tend to most affect poor farmers and rural wage laborers, those who lack political support, or those who cannot pay bribes. Considering the size of the opium economy, phasing out drug production will require significant and sustained effort.

Sources: UNODC. 2006. *Afghanistan Opium Survey 2006*. September; UNODC/World Bank. 2006. *Afghanistan's Drug Industry—Structure, Functioning, Dynamics, and Implications for Counter-Narcotics Policy*.

Reforms in customs focused on the introduction of the Automated System for Customs Data, attention to compliance, training, and expansion and upgrading of customs offices. The customs tariff structure was further rationalized, customs duties for all raw materials were reduced to 1% and customs duty for all imported machinery waived.

With only about 1.3% of the total population employed by the Government, the size of the Afghan civil service is low in both Asian and global terms. The public sector continues to suffer from lack of institutional and human capacity, impacting on the delivery of basic services, causing implementation delays of development projects, and fueling corruption, though in September 2006 a higher salary structure for many "nonuniformed" civil servants, including teachers, was brought in. In 2006 progress in reforming public administration remained slow.

Economic prospects

Assuming that the agriculture sector rebounds from the most recent drought, growth for FY2007 and FY2008 is expected to reach double digits again. Inflation is forecast to stay largely unchanged.

Growth prospects for the medium term hinge on the security situation. Overall physical security has deteriorated significantly over the past year, with antigovernment and anti-Coalition forces stepping up attacks, particularly in the south and east. Suicide attacks increased many-fold. Army and police forces, government employees, and aid workers have all been targeted. Less bloody, but still important for the long-term socioeconomic development of the country, are insecurity of contract, property, and land-tenure rights.

The substantial security costs, now largely paid for by other nations, will remain outside the Government's capacity for a long while. The authorities will also have to deal with uncertainties about nonmilitary donor commitments, including the funding of development projects' operating expenditures (currently covered by donors), and salary pressures.

Development challenges

Despite impressive growth and a solid track record of macroeconomic policy and structural reforms, the country still faces substantial challenges. The current reconstruction-related drivers of growth will neither sustain growth, create employment, nor reduce poverty over the medium term.

One of the Government's main priorities, emphasized in the I-ANDS, is to improve the enabling environment for the private sector and to encourage trade (Box 2.13.2 discusses why). An estimated 80–90% of economic activity is in the informal sector because of political uncertainty, the lack of the rule of law, inefficient business registration procedures, and the tax regime. Entrepreneurs in the informal sector typically remain small, avoiding investments in productive assets or technology that would enable them to achieve economies of scale or to move into higher value-added activities.

(A fuller discussion—still relevant—of the constraints and potential drivers of growth can be found in *ADO 2006*, pp. 145–146.)

2.13.1 Selected economic indicators

	2007	2008
GDP growth	10.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-4.8	-5.7

Source: Staff estimates.

2.13.2 Private sector collapse

Prior to 1979, Afghanistan had a vibrant private sector with a long tradition of entrepreneurship, engaged in the production of agricultural products, small-scale industrial activities, and trade.

During the 1980s, most industries were nationalized, traditional manufacturing industries such as carpet weaving moved to neighboring countries, and many businesses were forced to close down due to lack of inputs.

Industrial production fell by 95% between 1979 and 2002, with private output hardest hit, falling from 60% of the total to 21% in this time, recovering to a modest 26% in 2005.

Private sector activity is concentrated in construction and services, both fueled largely by the influx of international donor assistance and opium-related funds. In services, trade and transport dominate. Private sector activity has increased in relatively new services sectors such as telecommunications and banking. Manufacturing is limited to traditional products and small-scale activities such as carpet weaving and dried fruit production.

The private sector cites a lack of adequate infrastructure (especially power), and poor access to land and finance as key impediments. A recent investment climate survey identified corruption as one of the main obstacles for doing business in the country—yet government efforts to combat corruption lack the strong political leadership required for focus and coordination.

Bangladesh

At 6% over the past 4 years, strong GDP growth has been underpinned by more market-oriented economic policies, a dynamic garment sector, and substantial inflows of overseas workers' remittances. The lead-up to the parliamentary elections was generally expected to be a rough patch given the country's contentious political environment; the constitutional mechanism of a neutral caretaker government was expected to help smooth the way. Deepening political deadlock culminated with the president in January declaring a state of emergency and calling off the elections. But the new caretaker Government has continued with established economic policies and expedited structural and sector reforms. It has taken a broad agenda of activity, including an extensive anticorruption drive that it sees necessary to establish better foundations for holding the elections. GDP is forecast to maintain its recent momentum over the medium term.

Economic performance

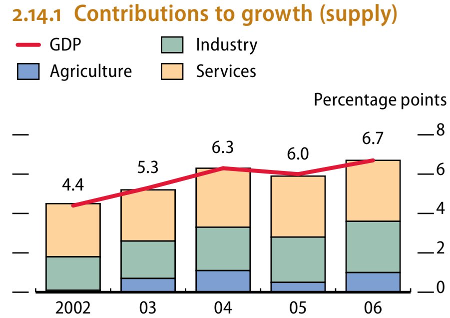
Growth in GDP has trended up in recent years, reaching 6.7% in FY2006 (ended 30 June 2006), driven by improved domestic and external demand. This performance was reflected in a steady expansion in industry, lifted by export-oriented manufacturing, and in continued services buoyancy (Figure 2.14.1). A marked reduction in poverty accompanied growth: the headcount poverty rate declined by about 1.8 percentage points a year between 2000 and 2005 to 40%, compared with a decline of only about 1 percentage point a year in the preceding decade (Figure 2.14.2). The improvement was somewhat faster in rural than urban areas. Rising access of the poor to microcredit, a rapid expansion in overseas workers' remittances, and improvements in physical and social infrastructure all contributed to the sharp drop in poverty.

In FY2006 on the expenditure side, private consumption propelled growth. Investment rose by 0.5 percentage points to 25.0% of GDP, bolstered by a rise in private investment. Gross national savings increased by 0.8 percentage points to 26.6% of GDP, lifted by a rise in workers' remittances. Net exports of goods and services remained negative.

Inflation moved up steadily to average 7.2% (Figure 2.14.3). This exceeded the 7.0% limit set by Bangladesh Bank, the central bank, in its first Monetary Policy Statement (MPS) issued in January 2006. Demand pressures generated by excess money, a sharp depreciation in the taka (Tk) against the US dollar (of 8.5% in FY2006), and a rise in global commodity prices (including oil), all heightened inflationary pressures. Rising exports of some consumer items, pulling their domestic prices to higher global levels, also added to price pressures.

Despite attempts to tighten monetary policy, both money and credit aggregates expanded rapidly in FY2006 (Figure 2.14.4). Broad money grew by 19.5%, as against the MPS program target of 14.3% and prior-year actual growth of 16.8%. Private sector credit grew sharply because of rising credit demand in support of domestic economic activity, while the public sector borrowed in excess of the credit target, mainly to

2.14.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006.

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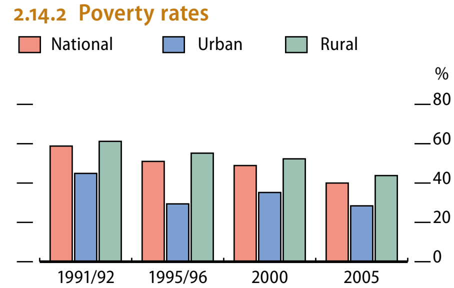
2.14.2 Poverty rates



Source: Bangladesh Bureau of Statistics, *Preliminary Report on Household Income and Expenditure Survey 2005*.

Click here for figure data

finance the high cost of imports by state-owned Bangladesh Petroleum Corporation (BPC). To tighten credit, Bangladesh Bank raised key policy rates over the course of the year: the 28-day treasury bill rate from 6.6% in the last quarter of FY2005 to 7.1% in the last quarter of FY2006, and the reverse repo rate from 4.5% in June 2005 to 6.0% in June 2006. Yet because of excess liquidity in the system, these measures failed to fully restrain credit growth.

The second MPS, announced in mid-July 2006, again aimed to tighten monetary policy, both to control inflation and to ease pressures on the exchange rate, at the same time sustaining domestic output growth. The introduction of the MPS is a welcome development as it seeks to bring greater predictability to the policy regime and to avoid policy surprises, which should aid the private sector in making its investment decisions. However, to derive greater benefit from the MPS, the Government needs to allow Bangladesh Bank greater operational autonomy and to establish greater coordination between monetary and fiscal policies.

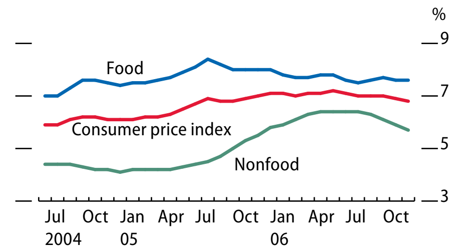
At 3.3% of GDP, the central government deficit in FY2006 came in below the budgeted 4.5%. This was because of lower than planned growth in both current and development expenditures, and in spite of underperformance in revenue collection. Current expenditures were lower as a result of tighter budgetary discipline and reductions in unproductive outlays through austerity measures. Development spending was kept at a lower than projected level by large cost reductions in nonpriority projects, fewer unproductive expenditures, and slow project implementation.

Revenues fell short of target because expected increases in collection arising from reforms and administrative improvements failed to materialize. So while tax-reform efforts yielded some gain in domestic value-added tax and income tax collection, overall targets were missed in part because of lower customs receipts stemming from tariff cuts. Domestic financing (borrowing from bank and nonbank sources) of the budget deficit amounted to 2.1% of GDP, while foreign assistance (both loans and grants) financed the remaining 1.2%.

The exchange rate came under increasing pressure during much of FY2006, because of slowing financial account inflows and higher import prices for oil and some other products. The currency stabilized in the last quarter of the fiscal year, as the tighter monetary policy started to have an effect, and the current account strengthened notably. The exchange rate stood at Tk69.7/$1 in June 2006, representing an 8.5% depreciation against the US dollar in FY2006 (Figure 2.14.5). The marked depreciation in the nominal rate offset Bangladesh's higher inflation relative to its trading partners, and the real effective exchange rate of the taka depreciated by 5.3% in FY2006, boosting the country's external competitiveness.

Import growth fell sharply to 12.1% in FY2006 from 20.6% (Figure 2.14.6) in FY2005 as administrative controls on letters of credit were imposed and unproductive imports discouraged. In addition, lower imports of foodgrains and most other edible products offset higher imports of oil, industrial raw materials, and capital machinery. Export growth surged to 21.6% from 14.0%, reflecting robust performance of knitwear and woven garments. A decline in the trade deficit and a steep rise in remittances (24.8%) turned the current account balance from a deficit of 0.9% of GDP to a surplus of 0.9%. Foreign exchange reserves

2.14.3 Inflation, 12-month moving average



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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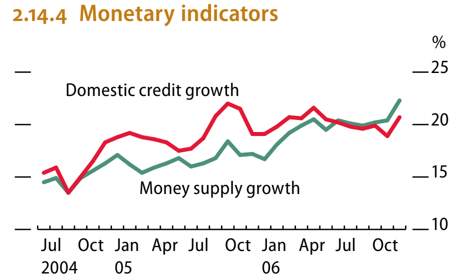
2.14.4 Monetary indicators



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

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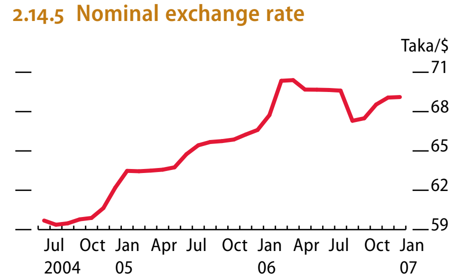
2.14.5 Nominal exchange rate



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

rose to $3.5 billion at end-June 2006 from $2.9 billion a year earlier (Figure 2.14.7).

In the FY2007 budget (announced in June 2006), the Government shaved duties on intermediate goods from 13% to 12% and on raw materials from 6% to 5%, as part of trade reforms agreed with the World Bank. It also cut supplementary duties. These measures should improve profitability and competitiveness of domestic industries, though they add to the effort needed to raise the budget's low revenue ratio.

Financial sector reforms to strengthen the regulatory and supervisory framework for banks made headway in 2006, though at a slower than expected pace. The health of the banking system has improved since 2002, as seen in the declines in gross nonperforming loans (NPLs) from 28% to 14% and in net NPLs (i.e., less provisions) from 21% to 8% (Figure 2.14.8). This led to significant rises in profitability ratios. Although the private commercial banks improved to record low NPLs of 6%, the four nationalized commercial banks (NCBs) are still weak and show very high NPLs of 25%. The NCBs have large capital shortfalls with a risk-weighted capital asset ratio of just 0.5% in June 2006 (as against the required 9%), compared with 10% for the private banks.

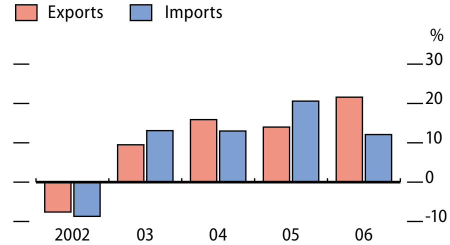
The performance of the four NCBs is monitored under memorandums of understanding signed by each of them and the central bank, in relation to tightened prudential norms and lending limits. It has been mixed, though, in part because of government-directed extensions of credit, particularly to BPC to finance its higher import costs.

The divestment of Rupali Bank, an NCB, moved forward and the sales and purchase agreements are expected to be signed. The Government has taken steps to corporatize the remaining NCBs and make them more autonomous while keeping them under the regulatory purview of the central bank, with an eye on their eventual privatization.

Other areas have shown progress. Bangladesh Bank has completed a comprehensive plan to switch over to the new international standard framework for assessing banks' capital adequacy under Basel II, which the Government intends to implement from early 2009. It established a settlement system for secondary bond trading in May 2005 and introduced mark-to-market valuation guidelines for treasury securities effective February 2006, which have improved operations of the interbank and treasury bill markets. It also introduced market-based auctions of treasury bills in September 2006 to bring greater flexibility to liquidity management.

Unlike many other bourses in Asia, the Dhaka Stock Exchange has not recorded significant gains, though January 2007 (Figure 2.14.9) saw a rise in response to prospects of an improved political situation. Still, as indicated by the low 7.5% market capitalization-to-GDP ratio, the equity market remains underdeveloped, largely because of weak corporate governance, lack of high-quality share listings, and a dearth of large institutional investors. While governance issues need to be tackled, increasing the supply of listed shares by privatizing state enterprises through public share offerings would help boost market capitalization and trading activity. Two major power sector entities—Dhaka Electric Supply Company and the Power Grid Company of Bangladesh—have already

2.14.6 Export and import growth



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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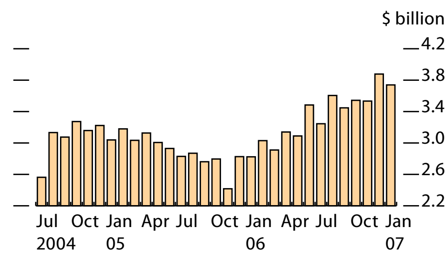
2.14.7 Gross international reserves



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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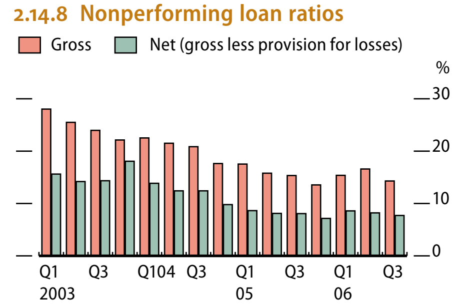
2.14.8 Nonperforming loan ratios



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

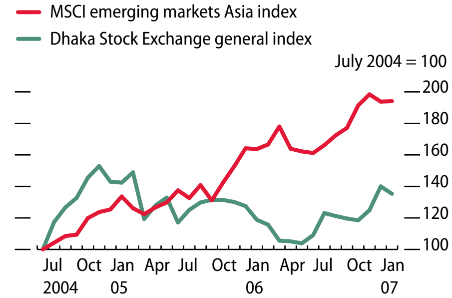
Click here for figure data

set an example by selling shares in the equity market in 2006, under the Government's broader goal of privatizing state enterprises.

Modernization of the National Board of Revenue gathered pace. Large taxpayers' units for value-added tax and income tax have already been established in Dhaka, and branches of these units are being set up in Chittagong (the second biggest city and main port). The board is being reorganized along functional lines and an audit cell has been set up. The central intelligence cell has detected several tax evasion cases and secured unpaid taxes. These actions are expected to strengthen the tax machinery and raise revenues over the medium term. In an attempt to curb corruption among tax officials and redress taxpayers' grievances, the country's first tax ombudsperson was appointed in July 2006.

The Customs House in Chittagong is being split into two entities to strengthen customs administration: one for imports and one for exports. Computerization of customs administration has improved tax assessment and appraisal functions.

2.14.9 Stock market indicators



Sources: Bloomberg, downloaded 7 March 2007; Dhaka Stock Exchange, *Monthly Review.*

Click here for figure data

Economic prospects

The economic forecasts for FY2007 and FY2008 are based on several policy assumptions. The most important is that the new caretaker Government will maintain its resolve to preserve macroeconomic stability. Continuing the reforms agreed with the International Monetary Fund under the ongoing Poverty Reduction and Growth Facility, the central bank will retain its tightened monetary policy stance to control inflationary pressures. At the same time, it will aim to support economic growth of around 7% by ensuring adequate credit to the private sector but restraining credit to the public sector.

The inflationary consequences of monetary policy will depend both on how political events unfold and on stability in labor and financial markets. At 10.7% of GDP (Figure 2.14.10), weak revenues hamper government efforts to provide resources for physical and social infrastructure development and for poverty reduction.

The second assumption is that, as agreed under the current Poverty Reduction and Growth Facility, the Government will attempt to lift revenues by 0.5 percentage points of GDP this fiscal year by adopting many tax and nontax measures, and by streamlining tax machinery, to offset reductions in customs duties. The authorities are expected to continue reorienting spending to support growth. They are also likely to strengthen institutional capacity for project formulation and administration, and to improve fund-release procedures for programs on infrastructure development and poverty reduction. In FY2007, domestic financing of the fiscal deficit will be capped at 2.5% of GDP.

A third assumption is that the Government will further rationalize energy prices to improve the financial position of state enterprises. In addition to the 5% increase in urban power tariffs of March 2007, it is likely to raise diesel and kerosene prices to bring them more into line with international prices and to reduce BPC's losses, at the same time attempting to address equity concerns.

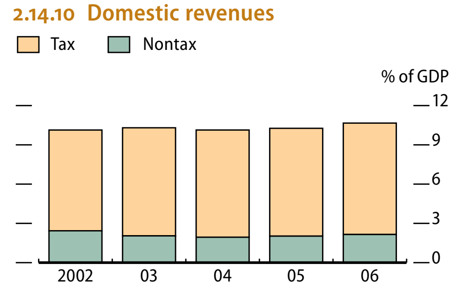
Fourth, it is assumed that the Government will continue in its efforts to shore up foreign exchange reserves. It will encourage remittances and

2.14.1 Selected economic indicators

	2007	2008
GDP growth	6.5	7.0
Inflation	7.0	6.0
Current account balance (% of GDP)	1.0	0.2

Source: Staff estimates.

2.14.10 Domestic revenues



Source: Asian Development Outlook database.

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exports by measures such as allowing the exchange rate greater flexibility and further improving banking services.

On the above basis, GDP growth is forecast at 6.5% in FY2007 and 7.0% in FY2008, driven by a robust performance in industry and services (Figure 2.14.11). Trends in the first half of FY2007 point to a significant pickup in economic activity. Although agricultural growth in FY2007 is likely to moderate from the postflood recovery in FY2006, it is still expected to be above trend. The harvest of the major summer crop—*aman*—has been good, though slightly below that of a year ago. The production of the major winter crop—*boro*—will depend on weather conditions and availability of inputs, though developments to date suggest that it—and the output of other crops including wheat, maize, pulses, and spices, as well as fisheries—is on track for an above-average outturn.

The conditions for expansion in industry (supported by new capacity in garments and textiles, chemicals, cement, and engineering) are favorable, though infrastructure constraints may pose problems. Manufacturing has shown a strong performance, as suggested by healthy growth in manufactured exports, imports of industrial raw materials, and private sector credit. Services output appears to be expanding impressively, in line with industry.

In the first quarter of FY2007, output of medium and large manufacturing, driven by export-oriented industry, rose by 14%, and that of small-scale industry by 11%, year on year (Figure 2.14.12). Uptrends were also noted in the production of nonmanufacturing items, namely gas (9.3%) and electricity (5.1%).

The garment industry grew rapidly, with 28% growth in its exports in the first half of FY2007. Successful diversification of products and markets, increased backward linkages, and a supportive policy regime are among the forces driving the industry. Yet sustaining such growth needs improved infrastructure to help producers cut the present excessive lead times, while more investment in design, equipment, training, and marketing is required if the industry wants to move from producing low- or medium-priced products to high-value-added items.

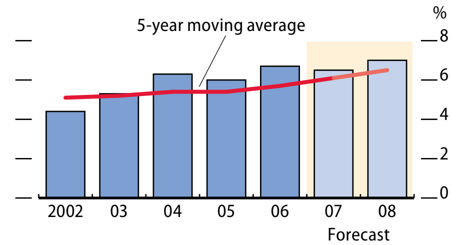
Entering and keeping its place in the market for these items, offering competitive prices and quality, and addressing social compliance issues are crucial if the garment industry is both to remain competitive internationally and to continue generating high employment and income growth for the country.

The pickup in external trade, bank advances to transport and trade, and mobile phone subscribers implies that high growth in services will continue.

In FY2007, inflation is projected to decline slightly to 7.0% and to 6.0% in FY2008 (Figure 2.14.13). After the heightened price pressures of FY2006, inflation has trended down in the early months of FY2007; on an annual point-to-point basis the national consumer price index fell from 7.5% in June 2006 to 6.1% in December 2006, with declines in both food and nonfood prices. The anticipated sustained moderation in price trends is based on a continued tight monetary policy, an easing in international oil prices, a softening of nonfuel commodity prices, and a continued buildup in foreign exchange reserves.

The authorities have announced a broad money growth target of 14.7%

2.14.11 GDP growth



Sources: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006; staff estimates.

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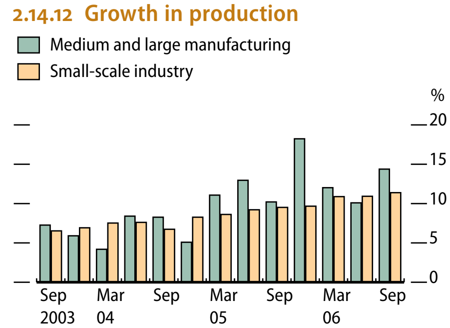
2.14.12 Growth in production



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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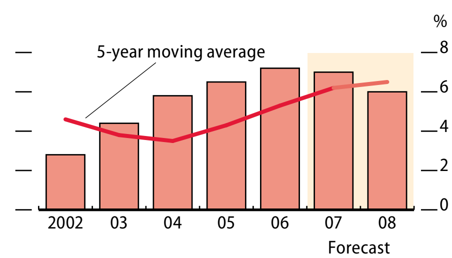
2.14.13 Annual inflation



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 2 February 2007; staff estimates.

Click here for figure data

and a domestic credit growth target of 14.1% in FY2007. Reflecting its restrained monetary policy stance, the central bank raised policy interest rates between June and December 2006: the 28-day treasury bill rate from 7.1% to 7.3%, and the reverse repo rate from 5.5% to 6.5% (Figure 2.14.14). Commercial banks' lending and deposit rates also rose over the same period, from 12.1% to 12.4% and 6.7% to 7.0%. Even with this cautious policy, a healthy flow of credit to the private sector was sustained with growth of 19.4% year on year in December 2006.

The current account balance in FY2007 is expected to record a surplus of 1.0% of GDP and moderate to 0.2% of GDP in FY2008 (Figure 2.14.15). The outcome will be aided by a continued reduction in the trade deficit and robust growth in remittances. Exports are projected to grow at 20% and 18% in FY2007 and FY2008. In the first half of FY2007 they were up by 26% from a year ago, buoyed by high growth in knitwear (32%) and woven garments (24%) (Figure 2.14.16). Import growth in FY2007 and FY2008 is forecast at 15% and 14%. In the first 6 months of FY2007, imports grew by 20%. Workers' remittances rose by 31.3% in the same period (Figure 2.14.17). Foreign exchange reserves strengthened by $0.4 billion in the same period, touching $3.9 billion at end-December 2006.

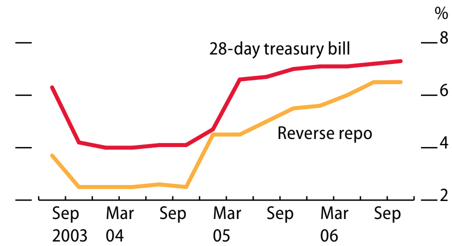
The taka/dollar exchange rate was little changed between June 2006 and February 2007. Bangladesh Bank limits its market interventions to countering disorderly movements and to building a more comfortable reserves position consistent with the macroeconomic program agreed with the International Monetary Fund. A managed floating exchange rate system in force since May 2003 has served the economy well, enabling it to adjust relatively smoothly to the changing external environment, especially in absorbing the oil price shock, supporting export growth, and protecting reserves.

BPC's large losses continue to mount. The Government has not granted any upward adjustments to domestic fuel tariffs since June 2006, when diesel and kerosene (together making up 75% of domestic consumption) were put up by 10% and gasoline by 30%. Even after the fall in prices in the international market, the prices of diesel and kerosene were about 80% of the breakeven level as of mid-January 2007, with a loss of $0.11 a liter for diesel and $0.12 a liter for kerosene (Figure 2.14.18). BPC sells other products at a profit.

Driven by growing economic activity, the demand for various fuel products is projected to rise to 4.0 million tons in FY2007, up by 5.3% from the preceding year. In FY2006, BPC incurred losses estimated at $474 million; this fiscal year losses are projected at $340 million. BPC's losses, which have been financed mainly by NCB credits, will eventually become government obligations. In a policy shift, the FY2007 budget includes an allocation equivalent of $86 million, which though inadequate, could cover part of the oil company's losses. The urgently needed policy change, however, is to implement automatic pricing formulas (on the line of those adopted in 2003 but largely ignored) to recover BPC's full costs while providing for social safety net measures to mitigate the impact on society's most vulnerable groups.

From a longer-term perspective, the economy has gently picked up its rate of growth, from 3.7% in 1981–1990, to 4.8% in 1991–2000, and to 5.7%

2.14.14 Interest rates



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 7 March 2007.

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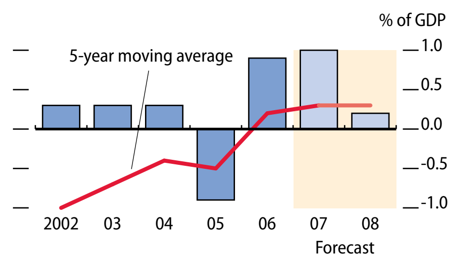
2.14.15 Current account balance



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007; staff estimates.

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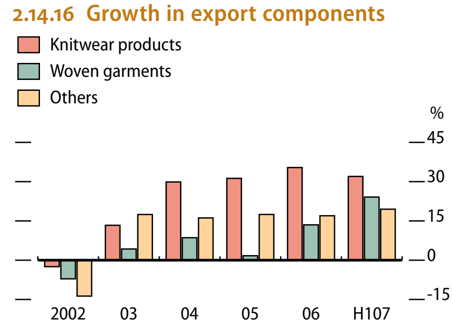
2.14.16 Growth in export components



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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in 2001–2006 (Figure 2.14.19). Savings and investment played their part, rising from 11.6% and 17.5%, respectively, in 1981–1983 to 19.9% and 24.5% in 2004–2006. Greater openness, with exports aided by the dynamic garments industry, also provided stimulus to growth. All sectors, especially industry and services, contributed. Factor productivity also increased sharply, reflecting sounder policies and a higher rate of capital accumulation. The Government stepped up policy and sector reforms to create a more market-oriented economy, paving the way for faster private sector-led growth. Significant reductions in tariff and nontariff barriers and deregulation fostered competition in the economy.

The steady growth record, despite internal and external shocks, provides a sound basis for Bangladesh's medium-term growth prospects of 8% GDP growth. However, for this to be achieved, investment needs to be augmented and economic and structural reforms accelerated to improve productivity and competitiveness in the economy.

Several downside risks to medium-term growth prospects could derail projections, implying slower growth, a weaker balance of payments, and higher inflation. An upsurge in political conflict and associated disturbances would clearly affect economic activity. Growing infrastructure constraints, particularly worsening power shortages, could deter new investments and hold back growth. Externally, stiff competition in garments and textiles in the wake of the end of the quota system poses significant risks. The competition in the world textile market will be further intensified after 2008, when temporary quotas imposed by the European Union and United States on the People's Republic of China expire.

Development challenges

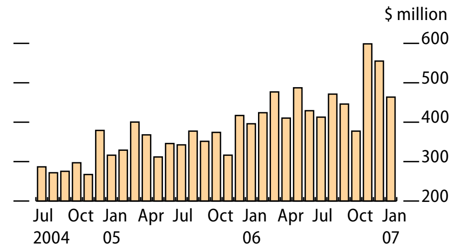
Key development challenges facing Bangladesh include upgrading the physical infrastructure, augmenting efficiency in the financial sector, stimulating greater foreign direct investment (FDI), and strengthening governance. Deficiencies in key infrastructure, such as power (Box 2.14.1), ports, railways, and roads, seriously hamper export growth, investment, and opportunities for transport integration with neighbors.

In the ports segment, Chittagong port, which handles nearly 85% of imports and 80% of exports, suffers from low productivity, labor problems, and weak management, exacerbated by the practice of stuffing and unstuffing containers in the port (because of limited off-dock facilities and costly railway services to move containers). Chittagong port is below the UNCTAD productivity standard of 230 lifts per berth a day.

Bangladesh Railway is unable to carry containers efficiently and on time because of limited locomotive and freight-car availability, congested network on major corridors such as Dhaka–Chittagong and the corridor to India, lack of operational efficiency, and infrastructure constraints. The main constraints facing the road sector are inadequate maintenance funding and weak management.

As a result of weaknesses in transport operations, the country is tardy in exporting and importing, requiring 35 and 57 days, respectively, measured from start to completion of export/import procedures and shipment. This compares ill with neighboring countries such as India

2.14.17 Workers' remittances



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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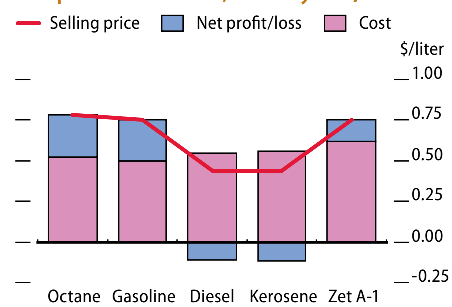
2.14.18 Bangladesh Petroleum Corporation fuel price breakdown, January 2007



Note: Figures are based on average fuel price in the international market as of 12 January 2007.

Source: Ministry of Energy and Mineral Resources.

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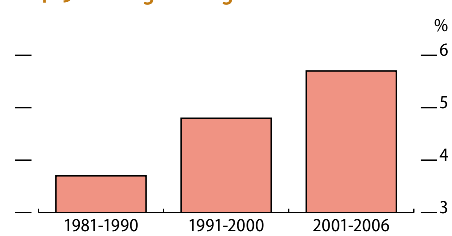
2.14.19 Average GDP growth



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, various years.

Click here for figure data

(27/41 days export/import, respectively), Pakistan (24/19 days), and Sri Lanka (25/27 days). Similarly, costs are high. For example, the cost of export for each container in Bangladesh is $902, compared with $864 in India, $797 in Sri Lanka, $481 in Malaysia, and $335 in the People's Republic of China.

For Chittagong port, the focus should remain on contracting out operations to the private sector, on allowing private operators to invest in port infrastructure, and on restructuring its management. The caretaker Government has, in fact, transferred the operations of Chittagong container terminal to the private sector, and has also signaled its intention to do the same for the new mooring container terminal.

For Bangladesh Railway, the emphasis should be on ensuring greater commercial orientation, outsourcing some business to private companies, and introducing modern management and financial systems. In roads, the priority should be on approving an integrated multimodal transport policy and creating a road maintenance fund.

Despite some progress, Bangladesh is yet to establish a healthy and efficient financial system. Ongoing banking sector restructuring must be strengthened. In the capital market, the thrust should be on improving financial reporting and corporate governance, and strengthening monitoring and enforcement by the Securities and Exchange Commission. Many government-owned enterprises, including the petroleum distribution companies and Biman Bangladesh Airlines, as well as major private companies such as mobile phone companies with huge annual turnover, could be prime candidates for selling shares, stimulating the equity market.

From already low levels, FDI inflows further declined in FY2006, depriving the country of much-needed capital resources along with the associated transfer of technology, skills, and access to new export markets. Despite the seriousness of the position, the country is yet to accord political decisions on several large FDI proposals.

Corruption is an important factor that prevents Bangladesh from achieving its potential for higher economic growth and faster poverty reduction. The caretaker Government has taken an extensive anticorruption stance, and as part of this will need to address the shortcomings of the Anticorruption Commission, giving it greater independence, scope, and resources.

2.14.1 Power problems

Power is the biggest logjam in physical infrastructure. Per capita power generation is only about 158 kilowatt-hours a year, among the world's lowest.

Only a third of the population has access to electricity, and even they have a poor, unreliable service suffering from frequent power outages and low voltage.

This stems from inadequate power generation capacity and poor transmission and distribution systems. In FY2006, maximum served generation was only 3,812 megawatts (MW) as against peak demand of 4,693 MW, resulting in up to 1,312 MW load shedding on 347 days. Most industrial manufacturers have to rely on costly generators, and small enterprises that cannot afford backups have no alternative but to shut down during prolonged power outages.

Over the last decade, net energy demand has grown by 8.1% a year. Yet for an expected average annual GDP growth rate of 8% over the next two decades, the needed average annual energy growth rate is 12%.

Bangladesh faces a momentous task meeting this burgeoning energy demand, which will need substantial investment with reforms in various areas, including introducing an energy pricing policy to recover operating costs, reducing the Government's outstanding dues to power entities, further corporatizing power entities, and making the Bangladesh Energy Regulatory Commission fully operational.

Bhutan

The huge Tala hydropower project started commercial production in July 2006. In the medium term, Tala is forecast to double electricity export capacity, boosting GDP and government revenues significantly. Yet it makes Bhutan even more reliant on export of one commodity to India. Also, hydropower employment elasticity is low, and cannot cope with the many tens of thousands of young people entering the labor market or migrating to urban areas. The Government needs to stimulate greater private sector activity and to diversify the economy.

Economic performance

Economic growth is estimated to have accelerated to 9.0% in 2006 from 6.5% in 2005 (Figure 2.15.1). The pickup in growth was largely due to commissioning of the 1,020 megawatt (MW) Tala project in July, with the commercial operation of the first of six turbines in July and the second in October. Nearly all output is exported to India. Production of power from all the four power projects (Basochu, Chukha, Kurichhu, and Tala) increased by 30% year on year, and Tala was responsible for all this rise. Total export sales of power grew by 54% to Nu4.9 billion (about $109 million).

In other sectors, agriculture is estimated to have grown by 1.5% and services 10.4%. Construction, which declined by about 3% in 2005, recovered on the back of increased private residential and commercial property building.

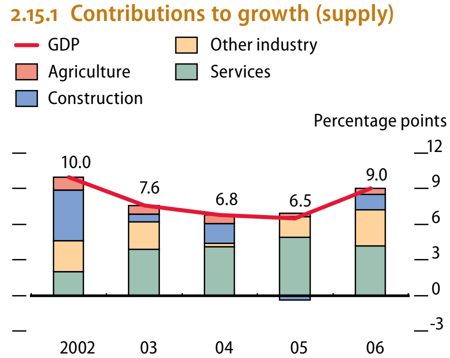
Revised budget estimates for FY2006 (ended 30 June 2006) indicate that the Government's fiscal position improved, with the overall budget deficit narrowing to Nu2.6 billion (or 7.1% of GDP) from 11.0% the previous year (Figure 2.15.2). A small decline in capital spending and an increase in foreign grants were largely responsible.

Capital spending was shaved by 2%, mostly reflecting the high FY2005 base when the Government purchased two Airbus aircraft. Current spending rose by 11%, which included outlays for draft constitution meetings and establishment costs for new institutions, such as the anticorruption and election commissions. Total expenditures, including capital spending of 24% of GDP, came to 44% of GDP.

Revenues and grants increased by 12%, with a robust increase in tax revenues and disbursement of project-tied grants as a result of faster implementation. Total budget receipts depend heavily on grants, and the tax-to-GDP ratio is low at 10.2% of GDP. Of the overall fiscal deficit, about two thirds was financed from domestic sources.

The budget for FY2007 anticipates a further reduction of the deficit to Nu1.5 billion (3.3% of estimated GDP), largely on account of much stronger domestic revenues (up 42%) associated with Tala. With grants estimated at a similar large amount as in the previous fiscal year, total receipts are projected to increase by 21%. Expenditures—both current

2.15.1 Contributions to growth (supply)



Sources: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007; staff estimates.

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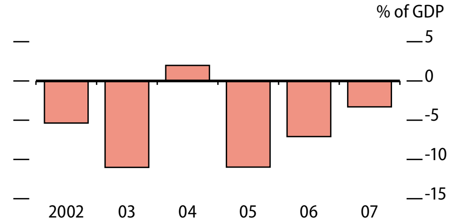
2.15.2 Budget balance



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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and capital—are each budgeted to increase by about 11%, due to a higher salaries and wages bill, preparations for the introduction of a constitution in 2008, construction of a Supreme Court building, road projects, hospital construction, and preconstruction work for Punatsangchu I and Dagachhu hydropower projects.

Broad money (M2) grew by 25% in FY2006, more than doubling from 11% in FY2005 (Figure 2.15.3). This was entirely due to an increase in the net foreign assets in the banking system. Credit to the private sector rose by 33%, but a very large build up in net deposits of the government more than offset this, and total domestic credit declined over the year. The bulk of the increase in private sector credit was for building and construction, manufacturing, and trade and commerce.

As the ngultrum is pegged to the Indian rupee, monetary developments have limited impact on prices, and inflation in Bhutan is heavily influenced by price developments in India. Consumer price inflation peaked at 6.2% in the second quarter of calendar 2006 (Figure 2.15.4). This gave an average of 4.9% for FY2006, slightly higher than India's 4.3% for the period.

The current account improved markedly, as the deficit narrowed (Figure 2.15.5) to $30 million (3.6% of GDP) from $211 million (29.7%). This is mainly attributable to tremendous growth in exports (up $114 million), small reductions (of about $15 million each) in both imports and the combined services and income accounts deficit, as well as somewhat larger net transfers receipts (up $37 million). The 61% expansion in export earnings was about equally split between India (largely electricity) and other countries (mainly fruit and manufactured commodities).

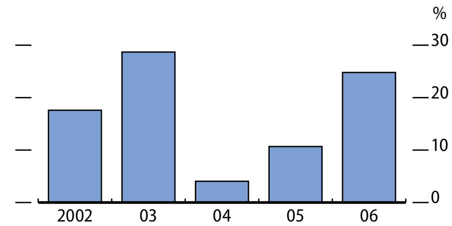
Since imports in FY2005 were buoyed by the purchase of two Airbus aircraft, the relatively small size of their drop in FY2006 of only 3.5% may be partly explained by imports for the Tala project. However, there appears to have been brisk demand for imported goods from both India and other countries. Tourism also continued strong, near-40% growth, with revenues estimated at $21 million.

As the inflows in the capital account (including grants for Tala) and the financial account (mainly foreign aid loans) together amounted to $144 million and were much greater than the current account deficit, the overall balance of payments registered a large surplus. Gross international reserves increased to $479 million at end-FY2006, a very comfortable level equivalent to about 14 months of imports. External debt outstanding at end-FY2006 was $681 million, or 82.5% of GDP. The debt service ratio for the year was only 5.3%, as almost all debt has been contracted on concessional terms.

Economic prospects

With the start of commercial operations, Tala will be the main driver of economic expansion in the next 2 years, with growth expected to accelerate further to 18% in 2007 and then moderate to 10% in 2008. Growth in other sectors together is expected to average 6–8%, while inflation should stay around 5%. Tala is expected to generate Nu40 million (approximately $1 million) in daily revenues, and raise hydropower's share of total government revenues from 45% to about 60%.

2.15.3 Money supply growth



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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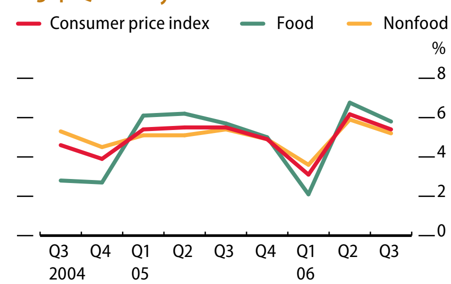
2.15.4 Quarterly inflation



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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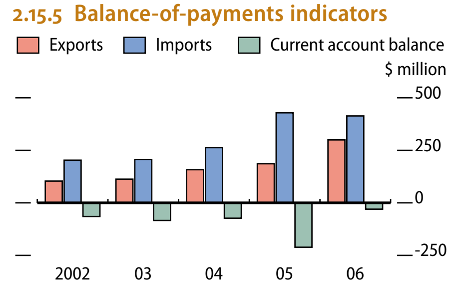
2.15.5 Balance-of-payments indicators



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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Export income from the additional power sales is expected to turn the trade balance to a surplus, and with current transfers likely maintained at about the present level, the current account balance is also projected to switch to a surplus, of 3% of GDP.

Further growth in the medium term will benefit from continued international cooperation in the hydropower sector. Memorandums of understanding have been signed between Bhutan and India for preparing detailed project reports on the 1,095 MW Punatsangchu I, the 992 MW Punatsangchu II, and the 670 MW Mangdechu hydropower projects. The full feasibility report of the Punatsangchu I project is complete and India has agreed to finance it with 60% loan and 40% grant components. Construction is expected to start this year.

2.15.1 Selected economic indicators

	2007	2008
GDP growth	18.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	3.0	3.0

Source: Staff estimates.

Development challenges

The main challenge is that hydropower employment elasticity is low. With more people entering the labor market each year, the Government must stimulate greater private sector activity and diversify the economy to boost employment, in line with the Government's poverty reduction strategy. The Government might aim to do this by improving transportation and communications infrastructure for better integration of the national economy, strengthening the private sector enabling environment (particularly for tourism and high-value agriculture), and enhancing the efficiency of the financial sector.

In preparation for its planned transition from a monarchy to a two-party democratic system in 2008, the Government has established institutions to ensure high standards of governance and transparency. An autonomous Anticorruption Commission has been established, and autonomous status is envisaged for the existing Auditor General's Office. The National Assembly has set up a public accounts committee, and a fiscal responsibility bill is expected to be presented for passing. The actual transformation and workings of a two-party democracy may lead to some initial uncertainty, but the transition is unlikely to result in any significant economic policy changes.

Bhutan is trying to integrate itself with regional and international economic groupings. It is currently negotiating to become a member of the World Trade Organization; the third meeting of the working party was held in October 2006.

India

Two years of above-trend growth are causing inflation. Optimism over growth prospects has brought high capital inflows and currency appreciation pressure. Manufacturing and construction growth have stimulated a voracious appetite for credit, which in turn complicates attempts to control the money supply.

Agricultural stagnation is the key structural challenge. Rising food prices contribute to inflation. Stagnation also widens inequality, as industry accelerates and services pull on robustly. It also raises pressures to transfer land out of agriculture into industry, and highlights the importance of industrial job creation for growth, labor absorption, and poverty reduction. Yet land transfer from agriculture to industry implies significant worker displacement, and has caused serious social unrest.

With inflation high, and serious structural hurdles for the economy to overcome, the Reserve Bank of India finds itself in a precarious position. It must damp expenditures in the short run, while also ensuring adequate credit supply to promote manufacturing and agricultural investments in the medium term.

However, interest rates have risen, construction growth has already tapered, and the rupee is appreciating slightly. Agricultural planting has responded to rising prices. These trends will help moderate inflation. A soft landing therefore appears likely.

Economic performance

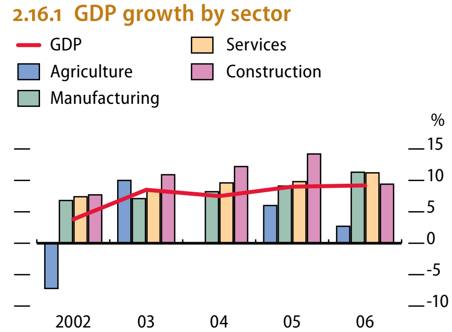
Robust growth momentum continued in FY2006 (April 2006–March 2007). After rising by 9.0% in FY2005, GDP is set to grow by 9.2% in FY2006. India's trend growth rate is estimated at 8–8.5% (see *Asian Development Outlook 2006*).

Four important characteristics emerge from the growth episode of recent years (Figure 2.16.1). First, growth is accelerating. Second, over the past few years, the manufacturing growth rate has caught up with that of services. Despite this, the services sector, given its 55% share of value added (compared to industry's 26%) continues to push up the aggregate pace. Third, construction—whose performance we report separately, given its important role in the Indian story today—has been through a boom that now appears to be ending. Indeed, construction in 2004 employed roughly 6% of the labor force, up from a more typical 3% in 1993. Fourth, agricultural performance remains subdued, with growth declining in the first half of FY2006.

Construction and home sales have soared since 2002, and demand for capital and consumer goods—especially consumer durables (Figure 2.16.2)—has followed. Demand for basic and intermediate goods has also grown with construction. Each of these developments has increased pressure to expand industrial capacity. The National Council of Applied Economic Research's October business confidence survey reveals particularly high levels of capacity utilization in the capital goods sector (Figure 2.16.3). These high levels feed back into capital goods demand.

Booming industry and construction raised gross domestic investment to 33.8% of GDP in FY2005 (Figure 2.16.4), an upward trend that appears

2.16.1 GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 2 March 2007.

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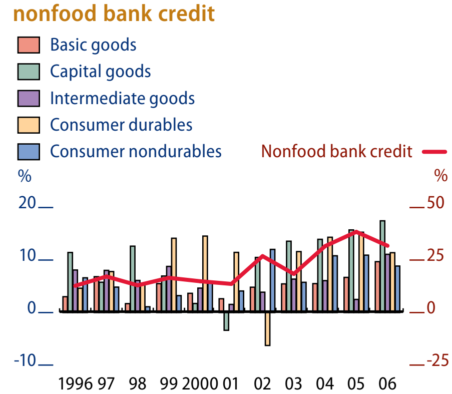
2.16.2 Growth in industrial output and nonfood bank credit



Note: 2006 data are for the first 3 quarters only.

Source: CEIC Data Company Ltd., downloaded 10 March 2007.

Click here for figure data

to be continuing despite slowing construction. This investment surge has been met by a simultaneous expansion in bank credit. Figure 2.16.2 (above) shows that India's manufacturing take-off coincided with a positive turnaround in the growth of bank credit. Table 2.16.1 demonstrates the extraordinary rate of credit expansion, which has gone into real estate (commercial and residential), infrastructure, and export industries—engineering products, textiles, and chemicals (Figure 2.16.5). An expansion in retail credit has been pushing up consumption as well.

Given the importance of high investment for continued manufacturing growth, provision of liquidity therefore remains a monetary policy priority. However, the high rate of credit growth is causing problems. First, frenetic lending by banks has, at least until recently, confounded attempts to rein in the money supply. Second, excessive lending for long-term real estate transactions appears to have led to maturity mismatches between banks' assets and liabilities. Specifically, according to some estimates, bank deposits have an average maturity of 2–3 years, while rapidly growing housing loans mature in 7–8 years. Some banks seem to feel that they are overinvested in real estate.

The impact of monetary growth and excess demand for nontradable goods and assets (especially real estate) is already being felt. Wholesale price inflation began rising in May 2006, reaching an annualized rate of 6.0% in the third week of January 2007. Consumer price inflation is higher still. While this was initially driven by booming international energy prices, and by still-ascendant food price inflation, recent figures show that burgeoning manufactured goods price inflation is now contributing as much as food and fuel prices combined (Figure 2.16.6). Given tight manufacturing and supporting infrastructure capacity, and the significant time lags involved in augmenting it to meet rising demand, manufacturing is overheating.

Prices of wheat, pulses, milk, and condiments and spices—supply has been tight for all of them—are the chief culprits of food price inflation (Figure 2.16.7). In response to these and other inflationary trends, the federal Government introduced a raft of measures including the elimination of duties on imports of wheat, pulses, edible oils, and sugar; a ban on wheat exports; modifications in the management of public food-stocks including suspension of the futures market; and reductions in regulated retail prices of gasoline and diesel charged by the government-owned oil-marketing companies.

Unfortunately, these measures have met with limited success, as some key global commodity prices have risen on adverse agro-climatic conditions. Prices in the world wheat market have risen faster than domestic prices. Nevertheless, help may be on the way, with rising prices prompting increases in the area under cultivation for wheat, pulses, and coarse cereals.

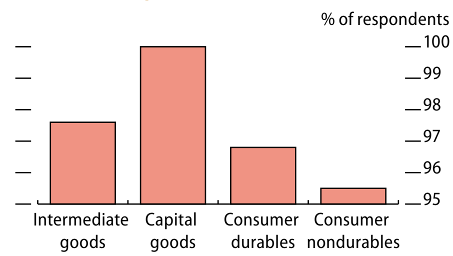
Faced with demand-led inflation, the Reserve Bank of India (RBI) needs to damp expenditures. However, in doing so, it will be important not to reduce the credit available for expanding manufacturing capacity more than is necessary to contain inflation. These capacity expansions are vital for enhancing growth potential in the medium to long term. Thus, credit provision needs to be curtailed, but also redirected away from overactive real estate markets. RBI is pursuing this redirection by

2.16.1 Credit growth rate by sector, October 2006, %, year on year

Retail	34.3
Housing	32.3
Commercial real estate	83.9
Industry, including	24.8
Infrastructure	23.2
Metals	34.6
Textiles	34.2
Engineering	15.3
Chemicals	26.9
Food processing	23.6
Construction	49.5
Agriculture	30.8

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

2.16.3 Views on capacity utilization: close to or above optimal level, October 2006



Note: Data refer to share of respondents viewing capacity utilization as close to or above the optimal level.

Source: National Council of Applied Economic Research, *Business Expectations Survey*, October 2006.

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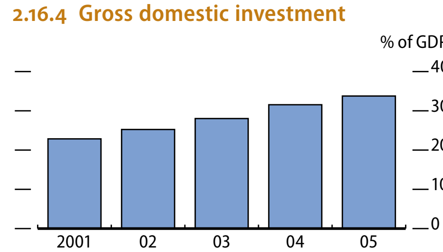
2.16.4 Gross domestic investment



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 7 February 2007.

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requiring banks to hold additional reserves equal to 2% of the value of their outstanding commercial real estate loans. This figure used to be 1%. Such adjustments are an important form of prudential regulation.

Continued high growth in money supply driven by commercial credit during FY2006 prompted RBI to raise policy rates (Figure 2.16.8). However, these rate changes proved inadequate, perhaps because inflation rose faster than some nominal interest rates, leading to a fall in real interest rates. Alternatively, the failure of rate increases to quickly curb credit growth could simply reflect long lags in responses to monetary policy changes. In any event, high growth in bank credit and money supply continued unabated.

Figure 2.16.9 shows stock prices on a tear, which began in 2002 and accelerated further from 2004. Other asset classes, especially property, display similar trends. In the context of corrections in asset prices in most Asian economies in early March, and the reassessment of risk that appears to be driving it, these trends are a source of concern.

Against this background, RBI has expressed serious concerns that the economy is overheating. Consequently, and triggered by the need to sterilize exchange rate interventions in response to a further surge in foreign capital inflows in October–November 2006, the central bank raised the cash-reserve ratio by 100 basis points between December and March. Even these measures appear to have been inadequate, and money supply grew at 20.4% year on year to the first week of January. Thus RBI raised the short-term policy rate again by 25 basis points, and has not ruled out further monetary tightening in the coming months.

Robust demand for credit, higher policy rates, and a rising credit-to-deposit ratio have driven up interest rates, on both deposits and lending. Anticipating tighter liquidity conditions, commercial banks lifted deposit rates by 25–125 basis points and prime lending rates by 75–150 basis points between April 2006 and January 2007.

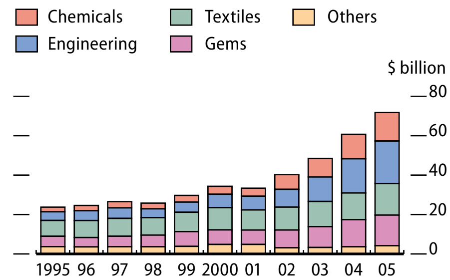
With the loanable funds market tightening, fiscal discipline matters greatly for ensuring that firms seeking to expand industrial bottlenecks are not crowded out.

In this context, it is helpful that rapid growth has boosted revenues greatly, providing ample fiscal space for large increases in expenditures while sustaining fiscal consolidation. The federal budget for FY2007 has been prepared against a background of high inflation and a comfortable foreign exchange reserves position. It also marks the beginning of the 11th Five-Year Plan.

Despite additional expenditure commitments for various social sector programs and rural infrastructure, the federal Government could sustain the momentum of fiscal consolidation. Both the current (revenue) and gross (overall) fiscal deficits as shares of GDP are marginally lower than the targets in FY2006, and the Government expects them to decline further in FY2007. The fiscal deficit is projected to fall to 3.3% of GDP, from 3.7% in FY2006.

Reviving agricultural productivity and output remains a priority area in the budget. A raft of measures has been introduced for strengthening irrigation and facilitating financial inclusion of farmers. On the revenue front, rationalization of indirect taxes continues, with the budget bringing down peak customs duties from 12.5% to 10.0%.

2.16.5 Manufactured goods exports



Source: CEIC Data Company Ltd., downloaded 1 March 2007.

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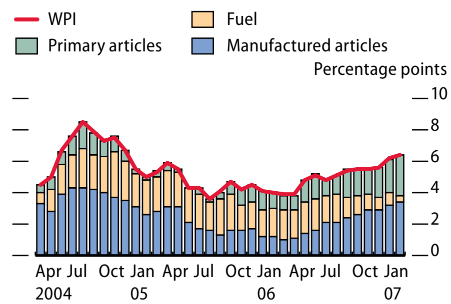
2.16.6 Contributions to wholesale price inflation



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007.

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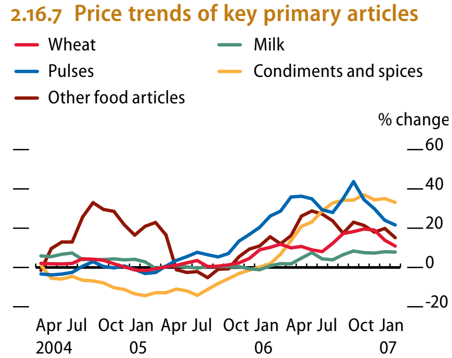
2.16.7 Price trends of key primary articles



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007.

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The budget also presents two sets of options for using India's growing foreign exchange reserves (Figure 2.16.10) to finance improvements in infrastructure. Whether and how to reinvest reserves has been widely debated. The immediate difficulty with actually doing so is that, in most cases, rupees would have to be released against foreign currency being returned to the country to purchase domestic inputs. So RBI, already running out of options for controlling money supply and inflation, would have even more liquidity to mop up. Further, demand for rupees by infrastructure investment firms would contribute to rupee appreciation.

The first option presented in the budget neatly sidesteps these complications by requiring foreign exchange reserves, borrowed by foreign subsidiaries of the publicly owned Indian Infrastructure Finance Corporation Limited (IIFCL), to be applied only to expenditures on *imported* inputs for infrastructure projects. Thus the reserves would never be converted into rupees or stimulate local demand. The key limitation of this approach is that most infrastructure inputs are not imported.

The second option would essentially permit foreign IIFCL subsidiaries to borrow RBI's foreign exchange reserves and use them as collateral for larger international loans. These loans could then be applied to domestic infrastructure investments denominated in rupees. Clearly, this option runs into the above monetary problems head on, as would any large foreign direct investment inflows.

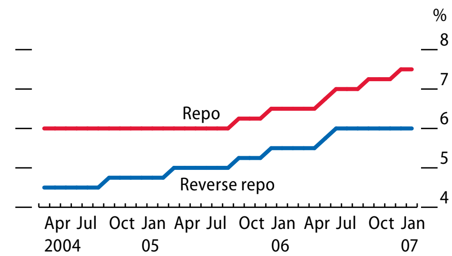
The schemes raise other concerns. IIFCL is a government-owned company, so its borrowings add to the liabilities of the Government. In the context of consolidating the budget, it must therefore be recognized that the Government is borrowing from RBI through the IIFCL. The advisability of such schemes depends on the view taken of the role of foreign exchange reserves accumulation. There are two main perspectives on this.

First, foreign exchange may be accrued for prudential reasons. If this is what reserves are for—and this is clearly RBI's position—then it is institutionally appropriate that RBI, which has been appointed to manage India's overall monetary risks, should be the arbiter of how much accumulation of reserves is "adequate." It is particularly important not to undermine RBI's autonomy as it attempts to navigate the economy toward fuller capital account convertibility.

Second, foreign exchange may be accruing as part of an effort to use exchange rates to maintain the competitiveness of exports. This is consistent with the fact that RBI has had to actively build up reserves, while remaining active in the foreign exchange market. If this is the case, then foreign exchange accumulation involves a tax on imports. Therefore this plan is tantamount to using a tax on imports to finance infrastructure. This is a policy whose relative merits the Government could debate, but it is not clear why RBI should be involved.

States' finances have improved significantly, after worsening during the second half of the 1990s (Table 2.16.2). This deterioration led to growing recognition of an urgent need to improve their finances. State governments adopted specific expenditure and revenue reform measures, and set aside funds to cover their contingent liabilities. These steps have been institutionally enshrined in fiscal responsibility legislation. The states are also undertaking measures to control rising pension liabilities.

2.16.8 Policy rates



Source: CEIC Data Company Ltd., downloaded 8 March 2007.
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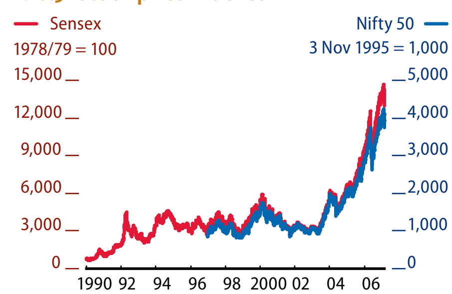
2.16.9 Stock price indexes



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 10 March 2007.
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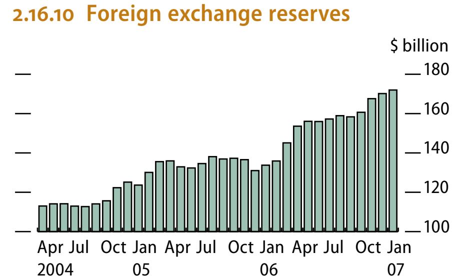
2.16.10 Foreign exchange reserves



Source: CEIC Data Company Ltd., downloaded 1 March 2007.

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2.16.2 Major indicators of state finances (% of GDP)

	1995–1997	1998–2003	2004–2006
Gross fiscal deficit	2.8	4.3	3.0
Revenue deficit	1.0	2.5	0.5
Capital outlay	1.4	1.5	3.7
Revenue expenditure	12.3	13.5	13.0
Debt	21.4	29.1	32.7

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

Yet these improvements are threatened by several forces. The first is impending public pay increases. The federal Government has appointed a Pay Commission to review public salaries, and states are likely to follow suit. Some already have (Karnataka and Punjab). The second is that the era of easy borrowing seems to be over. Although existing debts have been restructured, bringing down the interest rates assessed on them, new debts will incur higher interest. The federal Government therefore needs to keep a strict vigil on states' borrowing programs. Finally, the pressure to generate larger resources for India's 11th Five-Year Plan, coupled with complacency facilitated by strong recent growth, is reducing the constituency for fiscal discipline.

Domestic overheating has been forcing RBI to raise interest rates. As a consequence, surges in capital inflows are leading to rupee appreciation pressure. Indeed, the real effective exchange rate has risen in recent months (Figure 2.16.11). Export growth has declined, and the current account deficit is rising. The balance-of-payments data presented below reflect these forces.

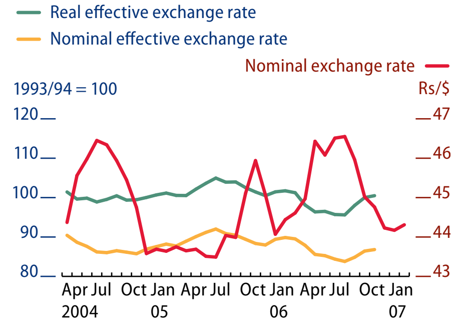
While goods exports grew 23% in the first half of FY2006, imports grew by 25%, widening the merchandise trade deficit to $35 billion (Figure 2.16.12). This deficit was significantly offset by robust inflows from invisibles, which included earnings from services such as software exports and business services (Figure 2.16.13), as well as transfers from nonresident Indians. The combined current account deficit therefore rose to $11.7 billion from $7.2 billion in the first half of FY2005. India ran a current account surplus in FY2003, when the latest growth acceleration began.

Pursuing growth opportunities, net foreign direct investment (at $4.2 billion) exceeded net portfolio capital inflows in the first half of FY2006 for the first time in several years. Net capital inflows were $19.3 billion during the same period. The surplus in the capital account is mainly attributable to foreign (direct and portfolio) investment ($5.8 billion), commercial borrowing ($5.1 billion), deposits by nonresident Indians ($2.0 billion), banking capital ($1.1 billion), and short-term credit and other capital ($4.9 billion). Thus, even with a large current account deficit, sizable capital inflows led to foreign exchange reserves accumulation of $8.6 billion.

Economic prospects

The performance described above highlights a fairly broad and overactive domestic demand base for the economy in FY2006, with public expenditures, investment, and household spending all contributing. RBI

2.16.11 Exchange rates



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 5 March 2007.

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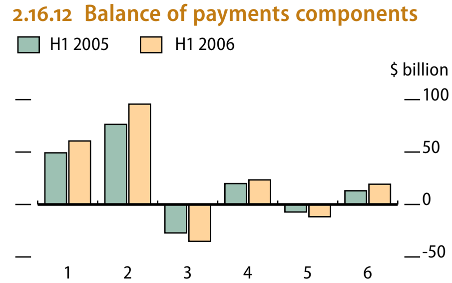
2.16.12 Balance of payments components



Note: 1 = exports; 2 = imports; 3 = trade balance; 4 = net invisibles; 5 = current account balance; 6 = capital account.

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

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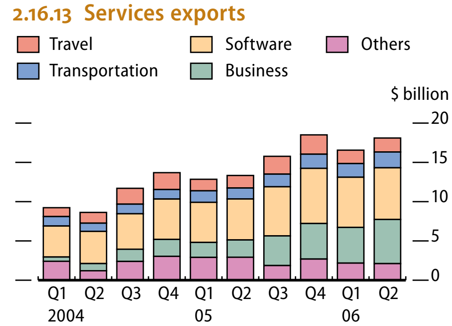
2.16.13 Services exports



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 1 March 2007.

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has responded with policies intended to slow demand growth, and has indicated a willingness to tighten further.

The following forecasts rest on five major assumptions. First, there is no sudden decline in fiscal discipline. Second, monetary conditions tighten further. Third, agricultural productivity proceeds at its usual, plodding pace. Fourth, with the softening of international oil prices, the Government does not pursue further increases in diesel, kerosene, and cooking-gas prices. Fifth, RBI permits a modest appreciation of the rupee in real effective exchange rate terms.

Rising interest rates in FY2007 will have subtle and wide-ranging consequences, mediated, most importantly, through property development. As liquidity becomes scarce, banks are beginning to reexamine lending practices, which will lead to scaled-back lending for construction and housing loans to allow them to deal with the emerging maturity mismatch. Construction has already decelerated significantly in FY2006. Consumer credit should also come under pressure as banks reallocate loanable funds.

This loss of construction momentum is likely to persist through early FY2007, with knock-on effects for other components of demand. Spending on consumer durables, which has benefited from the construction and sale of new homes, will continue to slow in FY2007. Interest rate rises will also induce consumers to delay consumption, further reducing consumer durables demand. Manufacturing investment will be slightly restrained as falling demand for durables and new homes eases pressure to add industrial capacity. Rising costs of borrowing will also have a direct effect on manufacturing investment, despite good corporate earnings in the current year.

These restraints on demand growth from home buyers, manufacturing investors, and consumers will be accompanied by fiscal discipline, so domestic demand growth will be limited overall. Modest rupee appreciation will contain export growth. However, import growth will remain moderate as well, due to easing demand growth.

These forces are expected to moderate growth rates, bringing aggregate growth down to 8.0% in FY2007, closer to potential (Figure 2.16.14). The correction will not be sharp, in large measure because several drivers will continue to hold sway: industrial capacity remains tight, militating for high investment; key consumption goods markets are expanding, independent of new homes sales—including the sale of consumer durables for homes already built or construction under way; and demand for exports remains healthy, though with some deceleration. Thus despite a firm monetary position, momentum should ensure a soft landing.

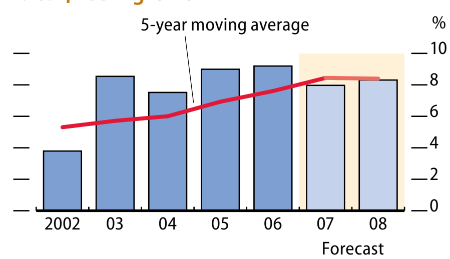
With aggregate demand back in control, interest rates are likely to stabilize and turn down slightly by FY2008. Growth that year should return to around 8.3%, as interim relief offered by the Federal Pay Commission is expected to buoy consumer spending, and as spending strengthens in the new interest rate environment. Specifically, construction is likely to pick up slightly. A large portion of the huge rise in bank lending to real estate in FY2006 was used to finance land acquisition. Future demand for commercial real estate is currently unpredictable, reflecting the uncertain future trajectory of interest rates

2.16.3 Selected economic indicators

	2007	2008
GDP growth	8.0	8.3
Wholesale price inflation	5.0	5.0
Current account balance (% of GDP)	-2.2	-2.2

Source: Staff estimates.

2.16.14 GDP growth



Sources: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 2 March 2007; staff estimates.

Click here for figure data

and inflation. Therefore, while construction on some lands has been put on hold, it is likely to restart as the cost of funds becomes more conducive to long-term investments.

Against this background, wholesale price inflation is expected to soften and then remain steady at 5.0% in FY2007 and FY2008 (Figure 2.16.15). Inflationary pressures are seen weakening on four factors. First, and most important, the tighter monetary position will limit demand expansion. Second, as a result of rising agricultural prices, the acreage under cultivation has increased, and good *rabi* (spring) harvests are expected. Third, already-high agricultural prices in FY2006 will sap some of their upward momentum in FY2007. And finally, cuts in import duties on key commodities, including edible oils, will help.

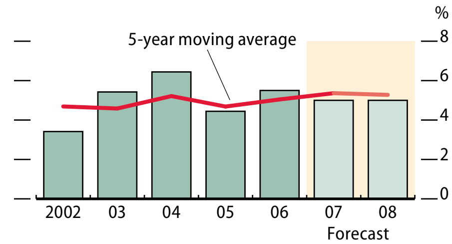
Realized performance may depart from this outlook for four key reasons. The first is the potential for an excessive contraction of credit availability. This could be due to unexpected fiscal laxity, particularly in noninvestment expenditures, or an overly severe monetary response, which would beat back investment, lowering growth.

Second, with food stocks still low, the possibility of further supply shocks in the 2007 *kharif* (autumn) harvest, or beyond, present important risks. Food supply management policies therefore need to be urgently improved to reduce price volatility. Minimum support prices are too low, buffer stock targets are not being filled, and measures to augment food stocks through imports have failed. A purely monetary solution to price increases will not work if food prices resume their acceleration.

Third, export growth has started to decline (Figure 2.16.16). This is especially true of manufactured exports, and could reflect real exchange rate appreciation. Declining exports in the short run, however, are not an economic risk—simply a potential deviation from forecast. Given excess demand in the economy, some real appreciation is expected, and a little less exuberance on the external account will help the economy to rebalance. With foreign investors confident in India's growth prospects and a solid stock of currency reserves, balance-of-payments reversals are unlikely. Active management of real exchange rates is therefore unnecessary. RBI should therefore focus on limiting short-term exchange rate volatility.

Fourth, inflated asset prices—both for real estate and equities—might fall rapidly. This would suck the air out of hot consumer spending, as wealth falls. It would also make it more difficult to raise funds for new investment on the equity market. And this would also create significant uncertainty regarding the forward path of interest rates, investment, and ultimately growth.

2.16.15 Wholesale price inflation



Sources: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007; staff estimates.

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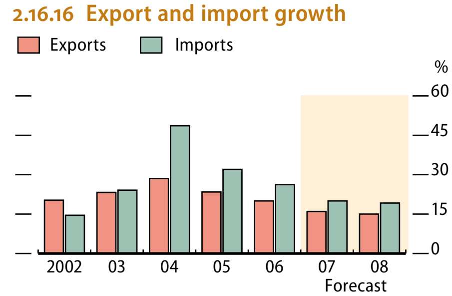
2.16.16 Export and import growth



Sources: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007; staff estimates.

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Development challenges

The Government envisages growth rates of 8.5% over the next 5 years with little inflation. Agriculture provides only 18.5% of GDP, and agrarian growth has slipped to 3.0% over the last 6 years. With industry and services, which make up 81.5% of output, growing fast at anywhere between 7% and 11%, the performance of agriculture is not arithmetically important for aggregate growth. For example, if agricultural growth rates doubled, GDP growth would edge up by a mere 0.5%. It is therefore tempting to focus on industry, and less capital-intensive services, when seeking growth.

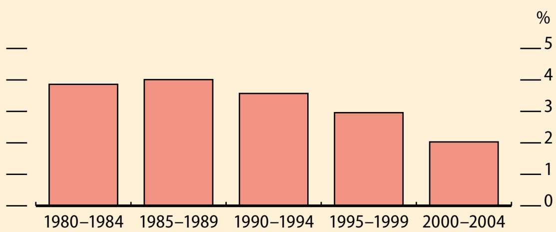
However, the arithmetic belies far more serious matters. Agriculture and related activities employ around 60% of India's labor force (or 115 million farming families), so stagnation in agricultural productivity will put poverty reduction on hold. India's food security situation is also deteriorating alongside farmers' incomes. What is to be done?

Box 2.16.1 delineates the key forces stifling agriculture, and argues that diversifying products into cash crops, improving foodgrain yields in lagging states, and scaling up agriculture a little will help. The last will probably accelerate the rate of labor displacement out of agriculture. Substantial job creation, particularly in India's infrastructure-scarce factories, is therefore urgent. But unfortunately, meager farm incomes leave little by way of profits to invest in rural industry. This helps to

2.16.1 Agriculture in transition

Agricultural performance in the past decade has been erratic, while growth in agriculture and allied activities has been slowing since the mid-1980s (box figure).

Average growth of agriculture and allied activities



Source: Mathur, A., S. Das, and S. Sircar, "Status of Agriculture in India: Trends and Prospects." *Economic and Political Weekly*, 30 December 2006–5 January 2007, pp. 5327–36.

Three primary reasons for the agricultural slowdown have been falling levels of public investment, especially in irrigation; steady deterioration of the public institutions that provide credit, inputs, and research and extension services to farmers; and environmentally unsustainable production practices (aggravated by subsidies, output pricing, and marketing policies). For example, while 39% of central Punjab enjoyed water table depths of less than 5 meters in 1973, none does today. Each of these factors adversely impacted yields of principal crops. Rice yields in 2002 were 2,915 kg/hectare compared with 3,448 in Bangladesh, 9,135 in Egypt, and 7,372 in the United States. Wheat yields, at 2,770 kg/hectare, compare poorly with 3,885 in the People's Republic of China, 7,449 in France, and 8,043 in the United Kingdom.

Reviving the performance of agriculture is therefore the major challenge of the 11th Five-Year Plan. The strategy rests on two pillars: increased public investment in rural infrastructure, and reforms and incentives facilitating diversification into high-value crops.

However, agricultural diversification is held back by structural rigidities.

- Marketing arrangements need to be revamped to deal with monopsony, rent seeking, and waste. Private sector competition can help in this regard. Private investment is also crucial for stimulating downstream food processing and extension research to support horticultural growth.
- The absence or poor condition of supporting infrastructure, such as cold storage, hampers the process of diversification. Moreover, the shift to animal husbandry and dairy is constrained by, for example, lack of green fodder, grazing land, and proper supply-chain facilities.
- Better extension and research services are required to adapt new agricultural activities to regional conditions, and help farmers connect to domestic and foreign markets.

Corporate contract farming is often an effective facilitator of agricultural diversification. However, land consolidation is inexorable under contract farming, and distressed farmers, many of whom are heavily indebted, may sell out despite having no alternative livelihood. Notwithstanding the obvious merits of freedom of choice, landlessness in the context of high underemployment can put serious strains on the social fabric.

Agricultural diversification carries significant productivity benefits, but it may have implications for food security. The Government faces a choice: either procure food for national buffer stocks on international markets while providing farmers with decent income alternatives; or, in the name of food security, do not assist farmers in diversifying into higher value-added cash crops when profitable. The latter, through neglect, would implicitly require farmers, among India's poorest people, to bear the burden of providing national food security.

Certainly, interventions that would increase productivity in both cash crops and foodgrains, and enhance farmers' ability to choose between the two in response to market conditions, would be the preferred outcome.

explain why large orchestrated industrialization is being attempted, with state involvement, in rural areas through the development of special economic zones (SEZs).

Such industrial developments demand more agricultural land and even greater labor displacement. Unsurprisingly, these prospects are raising tensions, particularly among landless agricultural laborers who fear a loss of livelihood and expect little by way of compensation. The challenge, therefore, is to simultaneously boost agricultural productivity, while creating enough manufacturing and other nonagricultural employment opportunities that are suited to those pushed out of agriculture.

While India's agrarian crisis has unfolded slowly but relentlessly, the dynamics of employment have shifted recently. Table 2.16.4 shows that employment growth has quickened over the last 5 years. It has done so among both men and women, and those living in rural and urban areas. Further, the data show that casual labor, with its attendant risks (food insecurity for one) is stagnant. Rather, the new jobs have gone to the self-employed and regular employees.

Moreover, employment growth has picked up in most activities. The only two activities identified in Table 2.16.4 where it has slowed ("Trade, hotels, and restaurants," and "Transport, storage, and communications"), have nevertheless grown robustly. The data appear to reveal a rebalancing of employment growth, with industrial employment growing faster, and growth rates in services regressing toward the mean. Indeed, in the last 5 years, industry overtook services in terms of employment growth.

However, those aggregate calculations neglect important details regarding the types of jobs, the locations of those jobs, and the education levels of prospective employees. A large proportion of Indians are illiterate (24.7% of men and 46.3% of women, according to the 2001 census), and many of them are older and supporting families, so educating them belatedly may be difficult. Therefore, a particularly serious concern is whether the economy can generate the types of jobs that would hire the educationally disadvantaged.

The following analysis uses numbers calculated from the National Sample Survey's employment datasets drawn in 1993/94 and a somewhat thinner sample drawn in 2004. At least in so far as the *quantity* of jobs created is concerned, the analysis indicates that these concerns regarding the less educated are somewhat misplaced.

Table 2.16.5 presents the estimated number of new employees in manufacturing and services, by education level. It shows that manufacturing has created more employment for the less educated than has services. Of new manufacturing jobs, 69.6% went to workers without secondary degrees, compared with only 45.6% in services. The four most prolific job creators, which account for 74% of new manufacturing jobs created between 1999 and 2004 are textile products (including apparel);

2.16.4 Overall employment growth rates, %

	1993/94–1999/2000	1999/2000–2004
Rural male	1.0	1.9
Rural female	0.2	3.2
Rural persons	0.7	2.4
Urban male	2.6	3.7
Urban female	1.0	6.2
Urban persons	2.3	4.2
Total male	1.4	2.4
Total female	0.3	3.7
Total persons	1.0	2.8
Nature of employment		
Self employed	0.4	4.3
Regular employed	2.3	3.6
Casual labor	1.5	-0.1
All	1.0	2.8
Sector employment		
Agriculture	0.1	1.5
Mining and quarrying	-2.8	2.4
Manufacturing	1.6	5.0
Electricity, water, etc.	-4.7	3.1
Construction	6.4	8.2
Industry	2.4	5.8
Trade, hotels, and restaurants	6.3	3.9
Transport, storage, and communications	5.3	4.9
Other services	-0.7	3.5
Services	2.9	3.9
All sectors	1.0	2.8

Source: National Sample Survey reports of 1993/94, 1999/2000, and 2004.

2.16.5 Net new job creation in manufacturing and services, 1993/94–2004

Education level of new employees	Manufacturing: Total new jobs	Manufacturing: % of new jobs	Services: Total new jobs	Services: % of new jobs	All new employment: Total new jobs	All new employment: % of new jobs
Less than primary	826,767	6.15	1,301,377	4.52	-7,225,836	-10.32
Primary	3,003,227	22.34	3,716,948	12.90	18,020,414	25.74
Middle	5,523,520	41.08	8,103,174	28.13	29,331,773	41.90
Secondary	1,750,110	13.02	4,019,009	13.95	11,042,178	15.77
Higher secondary	718,377	5.34	3,384,852	11.75	6,668,285	9.52
Postsecondary	1,624,252	12.08	8,277,945	28.74	12,171,631	17.39
Total	13,446,253	100	28,803,305	100	70,008,445	100

Note: Figures were calculated from National Sample Survey raw data, which were scaled to accurately reflect the size of the Indian population, per the central statistical organization. Scaling factors were 14.6% in 1993/94 and 14.0% in 2004.

Source of raw data: National Sample Surveys 1993/94 and 2004 employment rounds.

nonmetallic mineral products; wood, wood products, furniture, and fixtures; and beverages, tobacco, and related products. Fewer than 20% of workers in each of these sectors have completed secondary school.

The upshot is that as the less educated are squeezed out of agriculture, generating jobs for them will be significantly easier if these education-unintensive manufacturing subsectors continue to grow well.

The analysis so far does not reveal whether the low-skill jobs are being generated in the formal or informal sector. It is likely that much of the manufacturing in the four subsectors identified above is carried out by small enterprises in the informal sector. It follows that the new less-educated manufacturing workers might not enjoy the high levels of labor productivity that come with organizational scale. This is consistent with a study by IMF researchers, who have noted low rates of less-educated job creation in the *formal* manufacturing sector, which implies that these jobs must be predominantly in the informal sector.

In this environment, where farm incomes are falling; where the bulk of job creation is in self-employment and traditional services; and where those low-skill workers able to find manufacturing jobs are in the informal sector, provision of social safety nets becomes a major challenge. Workers without medical insurance, reliable savings mechanisms, and limited access to credit to finance investments and smooth consumption are particularly vulnerable to adverse economic shocks.

This challenge is magnified by the large disparities between agricultural and industrial land productivity, which are creating pressure in land markets. Governments have begun promoting the redevelopment of farmland with the aim of creating SEZs which are intended to assist industrial developers seeking to bypass infrastructure and administrative bottlenecks. As detailed in Box 2.16.2, the creation of SEZs involves a series of measures that are fiscally costly, potentially diverting industry away from other areas, and bring states' land-acquisition powers to bear in markets where land ownership is either poorly defined, or carries significant external effects. Given that large numbers of agricultural laborers who have no title to these lands nevertheless depend upon them for sustenance, the issue is exceptionally emotive.

However, manufacturing is not the only activity placing demands on land. As argued in Box 2.16.1 above, farmers face strong incentives to move land into the production of cash crops. However, agricultural diversification has obvious implications, as diversification may exacerbate India's deteriorating food self-sufficiency situation, as well as inflation.

Well-targeted interventions are required that seek to identify and remove the very distinct barriers to agricultural productivity growth in different states. Foodgrain yields can be increased significantly in agriculturally lagging states, whereas diversification is required to enhance farm income in more agriculturally advanced regions. As the Government has chosen to pursue self-sufficiency in foodgrains as a way of ensuring food security, it must strive to ensure that farmers receive adequate support for their role in making the policy work. While the budget has set aside funds for this, improving systems for delivering services to farmers remains the bottleneck.

Each of these trends shows clearly that as India's modern sectors steam ahead of the traditional sectors, social tensions are brewing,

2.16.2 Special economic zones

A special economic zone (SEZ) permits a set of units to operate in a well-defined area where policy measures (which are not generally applicable to the rest of India) promote certain economic activities.

These zones offer high-quality infrastructure facilities and support services, and allow duty-free imports of capital goods and raw materials. In addition, they offer attractive fiscal incentives and investor-friendly institutional services such as simpler customs, banking, and other procedures.

The SEZ Act of 2005 provides a raft of incentives to attract firms. These include: fiscal incentives; tax concessions; establishment of free trade and warehousing zones; reliable infrastructure services, including power, warehousing, and transport; establishment of a single-window authority for each SEZ to impart greater administrative autonomy and reduce bureaucratic costs; and designation of special courts and a single enforcement agency to ensure speedy trials.

Fifteen SEZs were already operational prior to the SEZ Act. The central Government had given formal or in principle approval to 403 applications for setting up new SEZs as of 20 October 2006. Investments of about Rs1 trillon with an employment potential of over 500,000 are expected from the new SEZs over the next 3 years. The central Government has, however, put all new SEZ approvals on hold until the following issues are resolved.

The pros and cons of SEZs are very difficult to weigh. Nothing of this scale and with this particular set of administrative arrangements and subsidies has been attempted before in India. Clearly, SEZs present an opportunity to provide potential investors with better infrastructure and greater bureaucratic efficiency. Nevertheless, valid criticisms of subsidies to SEZs deserve consideration.

First, with firms already eager to invest (but for the infrastructure and bureaucratic problems), providing enclaves that meet these needs might be enough to stimulate investment. Tax breaks may therefore be unnecessary. Second, SEZ tax inducements are expensive, and come at a time when government is struggling to provide adequate infrastructure in the wider economy.

Third, special tax exemptions always risk opening up loopholes for tax evasion. And fourth, subsidies can undermine both investment and existing firms located outside the SEZs. These firms suffer two disadvantages—worse infrastructure and higher taxes.

Serious concerns have also been expressed with regard to the people displaced by land acquisition. Important issues include: the kind of land to acquire for SEZs; the extent of state involvement in selecting and taking land; how to provide land losers with financial stakes in SEZs; and how to retrain economically displaced people, especially landless agricultural workers for jobs in SEZs.

Indeed, some of the loudest political opposition to SEZ projects comes from the landless, who may not receive lasting compensation for land conversion and who lack the capital to become self-employed.

mediated as ever through tight markets for land and food, and slack markets for labor.

The Government is in a position to play a crucial role in alleviating these tensions. It can do so by assuring appropriate compensation packages for displaced workers; retraining schemes to permit displaced workers to qualify for jobs on SEZs; and most important, infrastructure support for creating and locating manufacturing jobs more organically. More directly, it can help tackle the tensions through well-targeted investments to improve agricultural productivity.

This pursuit of geographically distributed industrialization and agricultural productivity growth requires significant resources to expand infrastructure. For this reason, some economists have urged the Government to suspend its fiscal discipline targets. Yet the historical data suggest that fiscal laxity is at least weakly associated with slower growth in India. Given high capacity utilization and the rising costs of borrowing today, it would be unfortunate if government borrowing crowded out private investment. Therefore, the Government must continue its fiscal consolidation efforts to create fiscal space for infrastructure financing, and continue to explore alternative mechanisms for such financing.

Maldives

The economy strongly rebounded in 2006, after the downturn in 2005 that stemmed from the impact of the December 2004 tsunami. The Government's expansionary fiscal policy adopted in response to the disaster, building on long-standing structural issues, such as expansion of the civil service and continued heavy subsidies for some social services, worsened the fiscal indicators. This deterioration presents a potentially serious threat to prospects of further recovery.

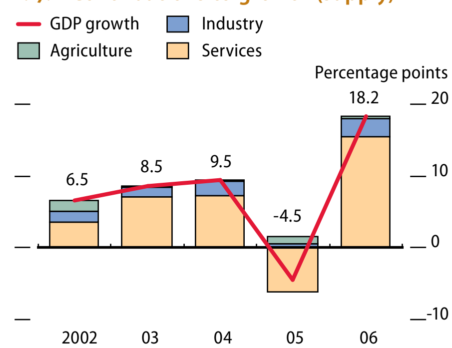
Economic performance

After 2005's contraction—essentially caused by the December 2004 tsunami—2006 saw an economic upswing, with GDP growth estimated at 18.2% (Figure 2.17.1). Tourism, traditionally accounting for about one third of GDP, grew by nearly half and its contribution to GDP rebounded to its former share as tourist arrivals recovered to close to pre-tsunami levels (Figure 2.17.2). Transport and communications recorded 12% growth. Growth in fisheries (accounting for 7% of GDP, though more important in terms of exports and employment) increased by 3.7% from its robust expansion of 17% in 2005.

Inflation measured by the consumer price index is volatile, as the heavily weighted food component fluctuates significantly. In 2006, inflation picked up slightly to 3.7% from 3.3% a year earlier. This was largely driven by price rises in transport and communications, and in housing, water, fuel, and power, in the main reflecting global oil price rises. The Maldives Monetary Authority tightened monetary policy in 2006 to address inflationary pressures, raising the interest rate on certificate of deposits from 4% to 5% in January. Broad money, however, accelerated to 21% growth from 12% in 2005, driven by a large expansion (50%) in private sector credit, mainly to the tourism and wholesale/retail trade sectors.

The 2006 budget planned for the deficit to widen to 18.1% of GDP from 12.5% in 2005 (Figure 2.17.3). Expenditures were set to grow by 51% (74.5% of GDP) mainly due to a more than doubling in capital expenditures, including those for tsunami reconstruction projects, while current spending was slated to rise by around 18%. Total revenues, including a large increase in grants, were to grow by 44% (to 56.4% of GDP). Preliminary fiscal data through the third quarter of 2006 show strong increases in both tax and nontax revenues. Import duties (about 70% of tax revenues) rose by around 40% from the previous year, reflecting a higher level of imports (as well as the Government's decision to withdraw the 2005 duty exemption granted for tsunami-related reconstruction) and a recovery in tourism taxes (about 20% of tax revenues) from the previous year's lower base. Large nontax revenues of advance payments from newly leased resorts were also collected. However, expenditures through the third quarter of 2006 have risen

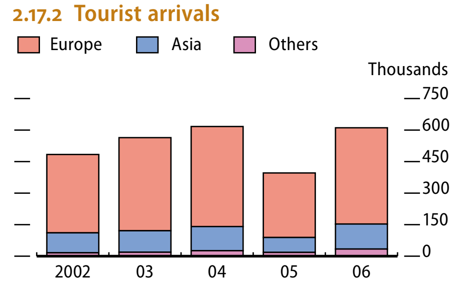
2.17.1 Contributions to growth (supply)



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

2.17.2 Tourist arrivals



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

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less than revenues, on account of lower utilization of the development (capital) budget. This result is likely to hold for full-year 2006, as monetary data show that net credit to government decreased (by 22%) and balance-of-payments estimates no substantial increase in grants.

The Maldives is an import-dependent country, bringing in everything from staple foods to resort supplies, construction materials and petroleum products. The average ratio of imports to GDP in 2000–2004 was about 60%, while that for merchandise exports was about 20%. The trade balance deteriorated significantly after 2004, leading to a deficit of $604 million in 2006 (preliminary estimate, about 67% of GDP; (Figure 2.17.4). Imports increased by 27% in 2006 as both private sector and public sector imports grew. The increase largely came from petroleum products and from construction materials and related products. Exports (domestic and reexports) recorded a strong increase of 40%, mainly due to a pick up in marine exports, which now account for nearly all domestic exports. Garment production and exports virtually disappeared in 2005 with the termination of the quota system at end-2004.

Net services and income receipts about doubled and reached $185 million in 2006. Earnings from tourism were up by 51% to $434 million for the year but still were 8% lower than the 2004 pre-tsunami level. Grant transfer receipts estimated at $122 million were somewhat less than the $152 million of grants in 2005. Taking into account payments (mainly workers' remittances), net transfers amounted to $42 million. In sum, the current account deficit widened to $376 million (42% of GDP, from 36% in 2005).

In terms of financing the current account deficit, the financial account saw an estimated large inflow of $318 million in 2006, largely private and commercial bank borrowing. Taking account of a large positive errors and omissions, the overall balance was estimated to post a surplus of $45 million in 2006 (switching from the $17.3 million deficit of the previous year). At $232 million as of end-2006, gross reserves offer 3.0 months of import cover.

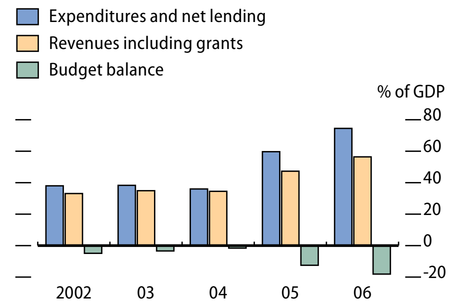
The rufiyaa's peg to the falling US dollar (Rf12.8/$1 since 2001) has contributed to tourism's sharp recovery. About three quarters of tourists in 2006 were Europeans, benefiting from a strong euro.

External debt statistics of the country cover only government and government-guaranteed borrowings, and the external debt of the banking sector. In the 2 years since the tsunami, external debt sharply increased by $250 million to reach an estimated $582 million at end-2006 (64% of GDP), about three quarters the expansion in debt was accounted for by sector short-term external borrowing of commercial banks for onlending to the private sector. At end-2006, about 63% of the outstanding debt was in medium- to long-term maturities (the bulk of which is concessional lending by official creditors), while the balance of $213 million was short debt of commercial banks. The debt service ratio at the end of 2006 was 4.6%.

Economic prospects

The Government estimates that GDP will continue its rapid growth in 2007, at 12.1%. This would appear realistic given that tsunami-related damage is being restored, tourism is rebounding strongly, and inflation

2.17.3 Fiscal indicators



Note: 2006 is budget estimate for the year.

Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

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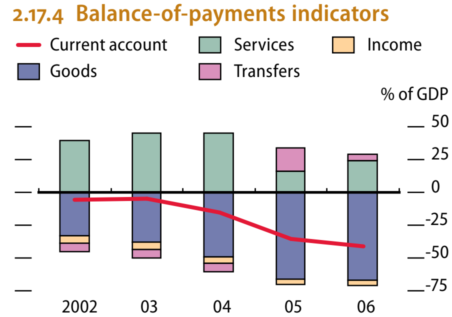
2.17.4 Balance-of-payments indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

and the balance of payments are under control. Growth would likely slow in 2008, perhaps to about 8%. The Government estimates that the current account deficit could even exceed 60% in 2007 if development plans are fully put through. Inflation should stay at around 4%.

However, the deteriorating fiscal indicators are worrying. The large budgeted deficit stems not only from reconstruction, but also from long-standing structural issues such as expansion of the civil service (and large pay rises) and subsidized social services. Unless the Government addresses these issues before its debt reaches unsustainable levels, high economic growth cannot be maintained. Increases in commercial banks' short-term external debt also need careful monitoring.

The downside risks are grounded in the narrow economic base, shallow financial sector, structural issues that have been masked by tourism-led growth, and severe human resources deficiencies. On average, some 40% of the labor force is expatriate—both at the lower and higher skills end—and a large number of secondary school graduates are absorbed by the public sector, not on account of their skills, but as a social policy objective of keeping youth unemployment down. While absolute poverty has declined and the Maldives is in compliance with the Millennium Development Goal of poverty reduction, inequities and inequalities have increased between Male' and the outer atolls.

2.17.3 Selected economic indicators

	2007	2008
GDP growth	12.1	8.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-60.9	-15.0

Sources: Government projections for 2007; staff estimates for 2008.

Development challenges

In the absence of any meaningful structural revenue-enhancement measures, there is a possibility that development expenditures will bear the brunt of the necessary fiscal adjustment. This is also evident from the Government's preliminary medium-term fiscal projections, which show development expenditures progressively declining to 9.6% of GDP by 2010, the final year of the Seventh National Development Plan.

The economy remains overdependent on a narrow and concentrated economic base with excessive reliance on tourism. Given its natural endowments, the Maldives will continue to rely on tourism to fuel its growth. However, the feasibility of expanding into business tourism (conference tourism) should be examined.

Other structural issues, such as the presence of many state-owned enterprises, coupled with the absence of a clear strategy for privatization, have flowed into the economic undercurrents that are now beginning to surface ominously in the fiscally constrained post-tsunami era. The process of political liberalization needs to be continued and higher standards of governance adopted to facilitate inclusive development.

In addition, given that the country now has middle-income country status with an average per capita income projected to increase to over $2,500 in 2006, the Government should decide whether to keep its role to providing and sustaining an enabling environment with a well-defined regulatory mechanism, including enforcement of contracts; or whether to become a more expansive provider of social goods and services.

Nepal

Economic growth remained hobbled by the long-running insurgency, political instability, and poor weather. Yet there is now guarded optimism on the political, and thus economic, front, due to major political breakthroughs starting in April 2006. These brought a comprehensive peace agreement that officially ended the 11-year armed insurgency and started a political process that holds promise of peace and a transition to a more productive economy. Nevertheless, the challenges are huge, and include widespread poverty, pervasive social inequality, low economic growth, and the legacy of a quasi-feudal political structure.

Economic performance

Political developments were the main event of the year, and moved rapidly from late-April 2006 when parliamentary government was restored following nationwide demonstrations. A few days later a cease-fire was declared by the Maoist insurgents. Subsequently in November, a comprehensive peace agreement was signed that officially ended the 11-year insurgency. Then in January this year the parliament approved an interim constitution that will be effective until a constituent assembly, scheduled to be elected by June 2007, approves a new constitution. Also in January, the Communist Party of Nepal (Maoist) joined the interim legislature.

Many difficult issues of course remain, but the current peace process holds the best promise yet of a new beginning for the country.

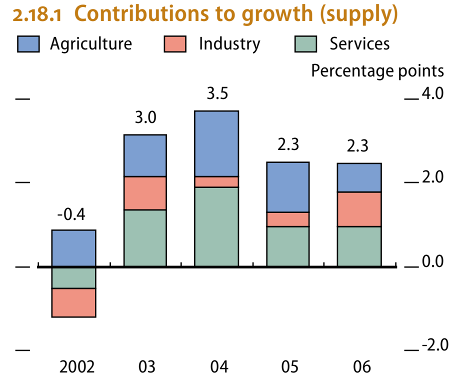
The economy continued its passage through the doldrums in FY2006 (which ended mid-July 2006), undermined by the continuing insecurity and political turmoil (the restoration of parliamentary rule and the cease-fire came late in the fiscal year). GDP grew at 2.3% (Figure 2.18.1), a rate unchanged from a year earlier. Weak conditions in agriculture largely offset industry's slight improvement.

Inclement weather hampered agriculture, damaging the production of the main food and cash crops. Agriculture, which accounts for about 40% of GDP and the livelihoods of 80% of the population, grew by 1.7% in FY2006 (contributing 0.7 percentage points of GDP growth), down from about 3.0% the previous year. Production of key agricultural crops declined by 2%, with paddy output, which accounts for one fifth of the value of food crops, falling by 1.8%.

Industry grew by 3.5% (contributing 0.8 percentage points), primarily due to a 4.2% expansion in construction after 2 years of stagnation. Utilities output was also well above the previous year's level. However, manufacturing remained weak, slipping to 2.2% growth, largely on tumbling garment production (exports slid 35%), continued supply and transport bottlenecks, and more frequent work stoppages and disruptions.

Services growth stayed at 2.4% (making a 1.0 percentage point contribution to growth). Performance was mixed as a recovery in trade, restaurants, and hotels was offset by slower growth in transport,

2.18.1 Contributions to growth (supply)



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

Click here for figure data

communications, and storage; finance and real estate; and social services. Tourist arrivals were little changed.

In terms of aggregate demand, both public and private investment stayed sluggish, reflecting the weak investment climate and security-related limitations to making development expenditures in much of the countryside. At 18.5% of GDP, the gross fixed investment rate continued its decline of recent years, moving by about 0.5 percentage points below the level of FY2005 (Figure 2.18.2). As for that year, growth in GDP was mostly driven by expansion in private consumption, which was made possible by the continued large, rapidly expanding inflows of remittances.

The budget deficit widened slightly to 1.8% of GDP, from 0.8%, indicative both of weakness in attempts to expand total revenues and of a decline in grants. Receipts (including current revenues, capital receipts, and grants) increased by 4% (compared with 16% in FY2005) due to low economic activity, poor export growth, and a shortfall in aid flows. Government spending, growing by 11%, fell substantially short (about 15%) of initial budget targets, thereby limiting the deterioration in the deficit.

Both current and capital expenditures missed budget plans, reflecting the difficulties in undertaking spending because of conflict-related disruptions. With foreign aid financing falling below both the budgeted and FY2005 levels, domestic financing of the deficit amounted to 1.4% of GDP (up from 0.2%).

Continued strong growth in remittances boosted liquidity in the banking sector. Broad money (M2) rose by 15.6%, with about two thirds of that coming from a rise in net foreign assets. Private sector credit picked up by 8.9%, in good part reflecting higher import credit, while credit to government rose by 14.5%.

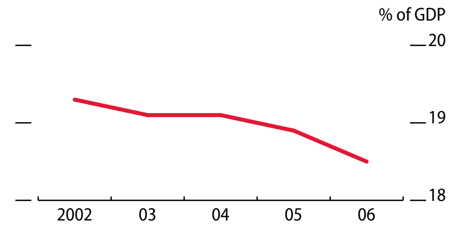
Over the year, bank lending rates rose to about 11.6%, while deposit rates declined marginally to 2.3%. Little progress was made in the effort to accelerate loan recoveries from large, willful defaulters, yet this is essential to bring down high levels of nonperforming loans and improve banks' operations.

Inflationary pressures grew in FY2006 with the consumer price index averaging 8.0%, nearly double the prior-year rate (Figure 2.18.3) and marking the largest rise in 6 years. Lower farm output drove up agricultural prices while upward adjustments to petroleum-product prices in February pushed up fuel and transport costs. The impact of the upward revision in value-added tax in May 2006 was a factor in commodity price rises.

Nepal Rastra Bank sought to tighten monetary policy through raising the discount rate by 25 basis points to 6.25% in February 2006, though this has a weak impact and reserve money still increased by 14% over the year. As the central bank has only limited means to engage in market operations to offset large inflows of remittances, monetary aggregates such as reserve money and money supply are very difficult to control. Still, given that the Nepalese rupee is pegged to the Indian currency, domestic inflation is broadly kept to India's. This link was evident in the rapid growth of imports in FY2006, which muted price pressures. In view of the rise in foreign exchange reserves and the very comfortable level of reserve holdings, this safety valve on price pressures remains securely in place.

Lackluster export growth, higher imports, and a trade deficit widening to $1.5 billion characterized the external sector. Merchandise

2.18.2 Gross fixed investment



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

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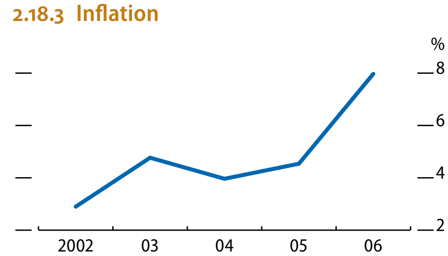
2.18.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

Click here for figure data

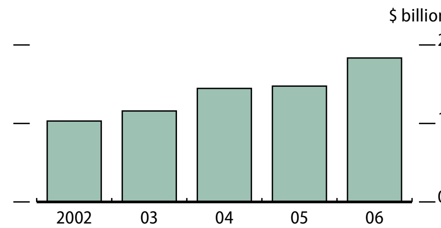
exports climbed by only 4.2%, reflecting slower growth in exports to India (accounting for nearly 70% of the total). They decelerated to 5.4% from 28.2% a year earlier. Stimulated by preferential trade arrangements, exports to India have grown rapidly in recent years, and the growth slowdown bore witness to a sharp drop in shipments of vegetable ghee, a major export that was affected by countervailing duties.

Exports to other countries improved by 1.8%, following a steep 14.5% decline in FY2005, when a sharp fall in garment sales was recorded. Performance in FY2006 underlined the facts that the country's export base is not well diversified and that traditionally large earners such as garments, as well as carpets and pashmina shawls, face stiffer competition, which has eroded sales both to India and to the rest of the world. Imports rose by 18.4%; oil-product imports accounted for about one quarter of the increase and remittance-financed consumption expenditure most of the rest.

Tourism receipts are estimated to have declined by about 10% to $132 million from a year earlier, but total net services and income receipts are small and were little changed. Nepal is increasingly dependent on remittances as a source of income and foreign exchange: they reached $1.3 billion in FY2006, an almost 50% year-on-year jump.

The remittance surge more than offset the wider trade deficit and kept the current account in surplus for the seventh consecutive year (at $191 million or 2.4% of GDP). Taking account of developments in the capital account and valuation changes, gross foreign exchange reserves rose by 24.3% to reach $1.8 billion (Figure 2.18.4)—equivalent to about 8 months of imports.

2.18.4 International reserves



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 1 February 2007.

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Economic prospects

The peace process has rekindled hopes of economic revival in Nepal (Box 2.18.1). Whether the 2.1% average growth of the past 5 years can be substantially lifted to bring the country nearer to its real potential depends crucially on sustaining peace, including timely (and nonviolent) constituent assembly elections scheduled for June this year. The transition to higher growth will also require political stability (including law and order) and better labor relations, the latter to restore business confidence and allow normal economic activities to resume.

Besides political stability and the weather, the populace's ability to cope with price rises for petroleum products (to eliminate the large operating losses sustained by the Nepal Oil Corporation) will substantially influence growth and economic developments. Renewing the bilateral trade treaty with India, which is scheduled to expire in March 2007, could provide a fillip to exports if Nepal can again achieve beneficial terms from its dominant trading partner.

Over the medium term, the economic outlook will depend on how fast the new Government can both step up the pace of structural and governance reforms, and maintain macroeconomic stability. It will concurrently need to boost investment in infrastructure and basic services, education, and health. Reviving conflict-hit industries is also important.

Major donors have already pledged to boost aid to facilitate economic recovery. Moreover, in November 2006, the Government and the International Monetary Fund agreed on a resumption of the poverty

2.18.1 Selected economic indicators

	2007	2008
GDP growth	2.8	2.8
Inflation	5.3	5.4
Current account balance (% of GDP)	1.0	1.0

Source: Staff estimates.

reduction and growth facility arrangement that defined comprehensive economic and financial policies for FY2007. To help get the economy back on track, the Government will soon unveil a 3-year interim development plan, which aims at reconstruction of infrastructure, rehabilitation for displaced people, basic service delivery, and reforms to boost investment.

GDP is seen picking up to about 2.8% in FY2007 and FY2008. Agriculture is likely to grow by the same amount, but this will depend on the weather, since irrigation is patchy. Weather conditions in the early months of FY2007 have not been the best, but expansion penciled in for the year still seems achievable. Better rural security should bring some areas back into cultivation, improve distribution of inputs and services, and generally raise farm productivity, especially after FY2008.

Industry is forecast to grow by 2.2–2.5% in the next 2 years. Increased construction expenditures and better operating conditions in manufacturing, along with continued strong, remittance-based, consumer spending, are expected to provide the stimulus. However, reviving many "sick industries" will prove difficult since this requires overcoming long-standing weaknesses, such as low labor productivity, high transport costs, and keen competition for external markets. Moreover, power outages have become a grim reality: the wider problem is that energy demand is rising by 10% annually, but supply constraints remain unaddressed.

Expansion in consumption will continue to be the main driver of aggregate demand and this, with some expansion in tourist arrivals, is expected to generate services growth of 3.3%. Investment spending is also likely to rise substantially. At first, this would largely stem from greater budget allocations for rehabilitation and investment and from the more secure countrywide conditions. Private investment in construction and equipment is expected to expand. However, for investor confidence to return, labor relations will have to improve (and the number of work stoppages fall), and the authorities will need to ensure a supportive climate for entrepreneurship.

Inflation is expected to trim to about 5.3–5.4% in the next 2 years, as supply bottlenecks ease, but two factors will have a heavy impact on this forecast: agricultural output and prices may be less than assumed because the weather in early FY2007 was unfavorable, and the magnitude and timing of upward adjustments of Nepal Oil Corporation's fuel prices cannot be predicted with certainty.

The external sector is set to remain manageable, though reflect a widening trade deficit. Merchandise exports are projected to grow by 4.7% and 6.0%, respectively, in FY2007 and FY2008. Exports to India are likely to be relatively brisk on account of the expected renewal of the existing bilateral trade treaty, but exports to other countries will be attenuated until new strategies to compete in the garment trade, as well as new products, are developed.

Imports are likely to continue growing at relatively high levels of 6.5% and 10.0% in the forecast period, in view of expected double-digit expansion in remittances from abroad as well as fiscal and monetary polices that focus on fostering economic revival. Tourism should see steady improvement, but the overall services and income net balances are unlikely to record major gains. The current account surplus is set to decline moderately to 1% of GDP.

2.18.1 A peace dividend?

Nepalis are upbeat following the formal cessation of armed hostilities and, it is hoped, an end to the devastating human cost. Economically, the insurgency has relegated Nepal to being one of the world's poorest countries. Growth in the medium term, however, clearly depends on how political events unfold in the next couple of years.

On the assumption that peace becomes embedded, a higher growth trajectory requires increased resource mobilization and productivity gains. An investor-friendly climate would create more employment, generate technological spillovers, and contribute to overall economic competitiveness, while a skilled labor force would contribute to raising domestic productivity.

As regards infrastructure—largely neglected in recent years—despite Nepal's huge reserve of water resources, the country faces scarcity in meeting its irrigation, energy, and drinking-water needs.

Agroprocessing industries and light manufacturing provide much further scope for widening the industrial base, and tourism and remittances also represent lucrative sources of income. With its unique location between the two fast-growing Asian giants, Nepal could benefit from the spillovers of their rapid growth.

But benefits will only fully materialize if peace is consolidated.

Pakistan

Buoyant growth, improved macroeconomic fundamentals, and strengthened international credit ratings have been the economy's hallmarks in recent years. In fiscal year (FY) 2006, high oil prices, a weak agricultural performance, as well as the effect of the October 2005 earthquake, trimmed the expansion, while strong demand-side pressures have exposed macroeconomic stresses. The economy is expected to pick up slightly in FY2007, reflecting some strengthening in agriculture and manufacturing. Inflation is set to moderate, after a further tightening of monetary policy, but still come in above the central bank's target. Spurred by an expansionary, pro-growth fiscal policy, the budget deficit will widen slightly, as will the current account deficit. The medium-term outlook remains positive, but macroeconomic stability has to be maintained and structural issues addressed.

Economic performance

The economy has grown strongly over the past 3 years, at an average pace of 7.5%. After expanding at high rates in the preceding 2 years, the economy slowed in FY2006 (ended 30 June 2006), but still maintained a robust outturn of 6.6% (Figure 2.19.1). On the demand side, private consumption, boosted by continued rapid expansion in consumer credit and higher workers' remittances, continued to be a lead contributor to GDP growth for the third year running (Figure 2.19.2). Private sector credit expanded by about 24%. Total investment spending (fixed and inventories) rose to 20.0% of GDP in nominal terms, mainly because of a sharp increase in private investment.

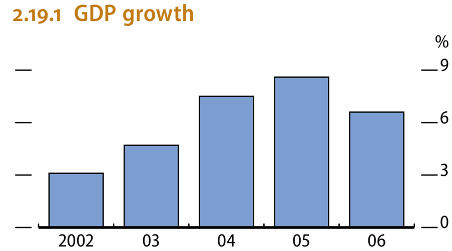
Over the last 3 years, improved business confidence and rising inflows of foreign direct investment (FDI) have buoyed private investment, but negative real interest rates on bank deposits and rising consumer demand have helped push down national savings, further widening the investment–savings gap. With a sharp rise in the current account deficit, the contribution of net exports of goods and nonfactor services became negative for the first time in 6 years.

On the supply side, GDP's deceleration in FY2006 was due to a sharp decline in agricultural growth and slower year-on-year growth in manufacturing, attributable to capacity constraints and the high-base effect. Services, in contrast, accounting for slightly more than half of GDP, gained further steam and recorded their fastest-ever growth rate of 8.8%.

In recent years, the Government's strong macroeconomic policies, high growth rates, increases in pro-poor spending, and burgeoning workers' remittances have all contributed to a steep decline in the incidence of poverty and the unemployment rate. According to official statistics, the proportion of the population living below the poverty line fell sharply from 34.5% in FY2001 to 23.9% in FY2005; in absolute terms, the number of poor people fell from 49 million to 37 million. The unemployment rate declined from 7.7% in FY2004 to 6.2% in FY2006.

Based on recent years' macroeconomic improvements and the strong

2.19.1 GDP growth



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007.

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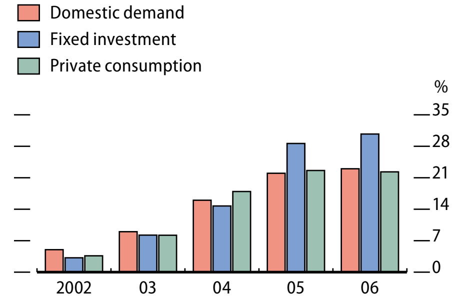
2.19.2 Growth of nominal demand components



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 6 February 2007.

Click here for figure data

growth potential of the economy, Standard and Poor's in December 2006 announced upgrades for credit ratings to B+ for foreign currency, BB for local currency long-term ratings, and B for short-term sovereign ratings.

Strong demand, catalyzed by increased investment and consumption expenditure, as well as the rise in workers' remittances, has outstripped supply and helped stoke inflationary pressures. Inflation, after peaking at 9.3% in FY2005, remained high at 7.9% in FY2006. The first half of FY2007 witnessed no change in inflation, as rising food prices offset easing oil and nonfood commodity prices. Food inflation rose to 12.7% at end-December 2006 from 7.8% at end-June (Figure 2.19.3), lifted by higher prices of milk as well as by edible oil and wheat, pulled by rising international levels.

In the context of a continuing expansionary fiscal policy, the onus of demand management rests on monetary policy. The State Bank of Pakistan, the central bank, started tightening monetary policy in the second half of FY2005 by raising the discount rate by 150 basis points to 9.0%. In FY2006, it focused on draining liquidity from the market to push up the interest rate structure and contain credit expansion.

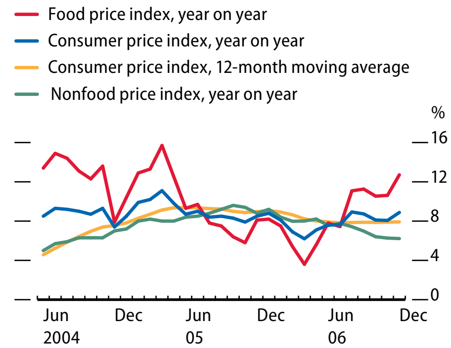
This policy succeeded in reducing growth in private sector credit and resulted in monetary growth that was below the increase in nominal GDP for the first time in 5 years. But, as high inflation persisted, the central bank further tightened monetary policy in July 2006 by raising the discount rate (by 50 basis points to 9.5%), the reserve requirement (on demand deposits by 200 basis points to 7.0%), and the liquidity requirement (by 300 basis points to 18.0% of demand and time deposits). Consequently, the average interest rate on new bank loans rose from 10.1% in June 2006 to 11.3% in December. Monetary growth declined (Figure 2.19.4) because of the decrease in domestic credit and the Government's reduced bank borrowing.

The State Bank of Pakistan continued a managed float policy and the nominal rupee/dollar parity rate remained stable in FY2006. With relatively high domestic inflation, the real effective exchange rate appreciated, which with strong domestic demand, contributed to the deterioration in the current account.

With advances in hand in structural reforms and macroeconomic fundamentals of recent years, the Government since FY2005 has pursued a pro-growth fiscal policy. Development outlays have sharply risen. Spending in the various pro-poor sectors defined in the poverty reduction strategy paper, in particular, increased from 4.8% of GDP in FY2005 to 5.6% the following year. Alongside this, unplanned spending on relief and reconstruction in areas affected by the October 2005 earthquake also contributed to a sharp increase in public expenditures in FY2006, raising the fiscal deficit to 4.2% of GDP (Figure 2.19.5). Excluding earthquake-related spending, the fiscal deficit was 3.4% of GDP, little changed from FY2005. The primary balance, however, which is a more accurate reflection of the Government's discretionary fiscal stance because it excludes the impact of interest payments, turned into a deficit in FY2006 after being in surplus the preceding 4 years.

The current account of the balance of payments has recorded increasingly wide deficits in the last 2 years, after posting large surpluses in the preceding 3 years). In FY2006, the current account deficit,

2.19.3 Inflation



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 20 January 2007.

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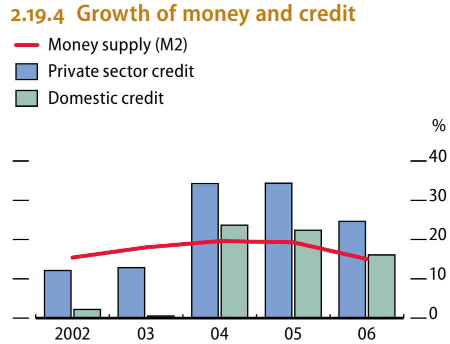
2.19.4 Growth of money and credit



Sources: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 12 March 2007; State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 29 August 2006.

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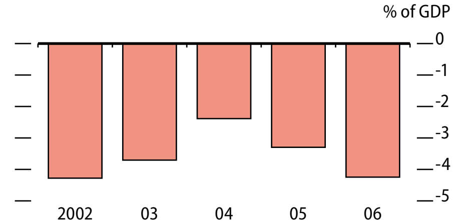
excluding official transfers, more than tripled to $5.7 billion, or 4.4% of GDP, from 1.6% of GDP in FY2005, as import growth outstripped export growth (reflecting higher oil prices and strong domestic demand; Figure 2.19.6). The deficit would have been larger still but for the very robust increase in workers' remittances to $4.6 billion.

The current account deficit was easily financed through non-debt-creating inflows and concessional loans from multilateral agencies. In fact, the overall balance of payments posted a substantial improvement in FY2006. Official foreign exchange reserves rose, and the external debt-to-GDP ratio remained on a downward trajectory, declining further to 28% in FY2006 from 31% in FY2005. However, ever-greater reliance on privatization proceeds, official grants, and portfolio investment, which together financed 45.3% of the current account deficit, raises issues of sustainability of financing large deficits over the medium and long term.

The improved policy environment has stimulated a multifold increase in FDI in recent years, which has risen from $483 million in FY2002 to $3,451 million in FY2006. The first half of FY2007 saw an inflow of $1,873 million. About 70% of total FDI is concentrated in just four sectors: telecommunications, oil and gas exploration, petroleum refineries, and financial businesses.

Privatization picked up further in FY2006 when two large entities—the Pakistan Telecommunication Company Limited and the Karachi Electric Supply Company—were privatized. A sum of $1.5 billion was raised in privatization proceeds, which represented 43% of total FDI in FY2006. In the last few years, the Government has also used the domestic stock market for selling the shares of public sector enterprises to the general public to broaden the base of share holdings. In December 2006, it ventured into the international equity market for the first time in several years, raising $731 million in global depository receipts issued by the Oil and Gas Development Corporation on the London Stock Exchange.

2.19.5 Budget balance



Source: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 9 March 2007.
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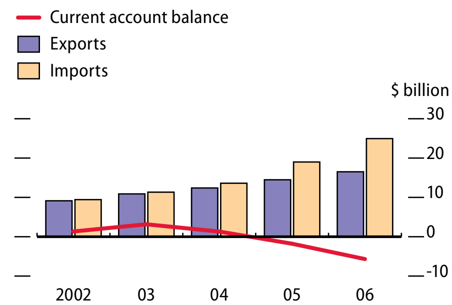
2.19.6 Balance-of-payments indicators



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 12 March 2007.
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Economic prospects

The prognosis for FY2007 and FY2008 is based on the assumptions that the authorities will continue, or perhaps strengthen, the economic reforms of recent years, and that they will press on with relieving the macroeconomic stresses that have emerged in the last couple of years. It is assumed that the central bank will continue its tight monetary policy and pursue a flexible exchange rate policy. Globally, economic growth in the United States (US) and the European Union (EU), the country's two largest trading partners, is assumed to slow somewhat, as is the growth of world trade volume.

The sharp rise in investment last year and moderation in oil prices are expected to boost growth in FY2007. However, shortages of natural gas and suspension of its supply to a number of industrial units to meet the rising demand for household consumption (because of exceptionally cold weather) will likely depress industrial growth, which along with the ongoing slowdown in exports, will dampen the expansion. Agriculture and manufacturing have improved in the first half of FY2007, and services appear to be growing robustly, but somewhat less quickly than last year.

2.19.1 Selected economic indicators

	2007	2008
GDP growth	6.8	6.5
Inflation	7.0	6.5
Current account balance (% of GDP)	-4.5	-3.9

Source: Staff estimates.

With developments to date, the economy is projected to grow by 6.8% in FY2007, a solid expansion but essentially unchanged from a year ago (Figure 2.19.7).

In agriculture, production of the major summer crops in FY2007 has shown improvement. The higher offtake of fertilizers and a substantial increase in production loans for agriculture, as well as greater availability of water, all augur well for winter crops. The new package of incentives for livestock, announced in the FY2007 budget, and high prices of livestock products throughout last year, will also boost livestock production. Agriculture is projected to grow by 4.0% in FY2007.

Large-scale manufacturing, which constitutes almost half of the value added in industry, is expected to grow by 8.6%, supported by incentives provided in this year's budget. Growth in textiles and clothing, however, is expected to soften, on lower than targeted output of cotton and weakening export demand. The significantly larger public sector development program, reconstruction of earthquake-affected areas, and greater supply of cement will all boost construction output in FY2007. Hydropower generation will be bolstered by greater rainfall and availability of water in the two main water reservoirs. In all, industrial growth should pick up to 8.6%.

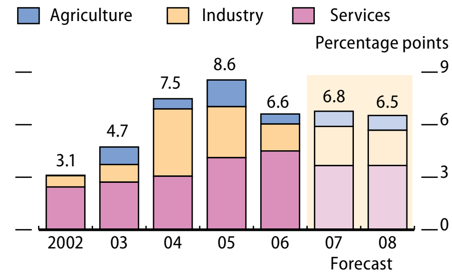
In services, rising foreign investment in telecoms and privatization of the Pakistan Telecommunication Company last year will help sustain vigorous growth. Strengthened by reforms, privatization, and ongoing mergers and acquisitions, the financial sector is expected to stay lively. It will be further spurred by the planned flotation of new global depository receipts for some financial institutions. However, the growth of wholesale and retail trade will slow because of decelerating exports and imports. Services as a whole is projected to grow by more than 7% in FY2007, somewhat off last year's fast pace.

In FY2008, on the back of the expected continuing strength in services and stable growth in manufacturing, GDP is projected to slow slightly to 6.5%. This is still solid performance but less than the projected 7.6% in the Government's Medium-Term Development Framework. The buildup of macroeconomic imbalances and the consequent tight monetary conditions, emerging capacity constraints, infrastructure bottlenecks, and issues of competitiveness in exports of textiles and clothing—on which the economy is overdependent (Box 2.19.1)—are some of the key constraints to reaching the Framework's target.

Inflation is expected to decline further in FY2007, under the weight of continued tight monetary conditions. After resisting demands for cutting domestic prices of petroleum products for 9 months, the Government finally lowered these prices in January 2007. This will have a damping effect on prices throughout the economy in the coming months, as will the slower monetary growth last year. But, because of the upsurge in food prices and higher prices of raw materials, inflation is projected at 7.0%, above the central bank's target of 6.5%. Sustained tight money is likely to take inflation down to 6.5% in FY2008 (Figure 2.19.8).

With projected strong GDP growth, ongoing tax reforms, extension of the tax net to real estate transactions, and higher tax rates on some financial services in the FY2007 budget, tax receipts are expected to maintain double-digit growth and be above the budget target. Despite a

2.19.7 Contributions to growth (supply)



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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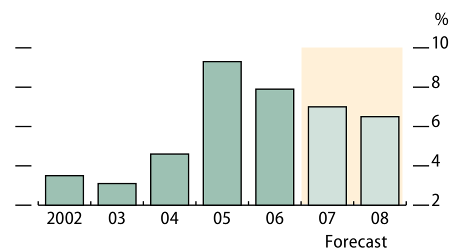
2.19.8 Inflation



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

Click here for figure data

2.19.1 Export performance

Over the past 5 years, merchandise exports have delivered over 12% average annual growth, as they have benefited from an enabling policy environment, low inflation, the low cost of credit, and general upturn in economic activity. In FY2005 and FY2006, they grew by 16.6% and 15.4%, respectively, but started decelerating in the second half of FY2006, to just over 6.5%, and to 5.0% in the first half of FY2007. Some of the deceleration stems from the high-base effect, but the underlying causes appear structural.

The main issue is exports' heavy reliance on textiles as well as limited geographic diversification. Between them, textiles and clothing, cotton, leather, rice, and sports goods account for over three quarters of total exports—textiles and clothing alone for three fifths. Thus a downturn in these segments has a significant overall impact.

Conversely, immediately after the ending of quotas, textile exports accelerated strongly, to 16.8% in FY2006 from 6.6% the year before. Increasingly, however, textile exports have come under competitive pressure from Bangladesh, People's Republic of China, and India, specifically in the higher value-added categories that have traditionally not been a strength of the Pakistani textile sector. This pressure, in turn, has led to a fall in international export prices. Consequently, Pakistani textile exports increased by only 4.3% by value in the first half of FY2007 (box table). The low expected cotton production in 2007 will further hit textile exports, as will the removal of restrictions on textile exports from the People's Republic of China in 2008.

Another issue is that the bulk of Pakistan's trade is with a handful of countries, particularly in Europe and North America. It is expected that the growth in trading volumes in those regions will decline in 2007, hitting Pakistan's exports there.

Export growth of major commodities

Commodity	FY2005	FY2006	July–Dec 2005	July–Dec 2006
Textiles and clothing	6.6	16.8	32.5	4.3
Rice	47.1	19.3	46.4	1.2
Leather and leather products	18.7	16.1	31.3	-26.3
Sports goods	-3.0	13.4	6.9	-14.4

Thus, lack of export diversification—for products and markets—is the main reason for recent sluggish performance. Trade policy should therefore focus on developing strategies for diversification and enhancing export competitiveness.

decrease in the domestic oil price, the petroleum levy will likely continue to yield significant income, as will receipts from the US for logistics support operations for Afghanistan. Current expenditures, though, are expected to exceed the budget estimate, because of expected overruns in the interest payment on domestic debt. On balance, the fiscal deficit is likely to rise to 4.5% of GDP in FY2007, coming in at the planned level.

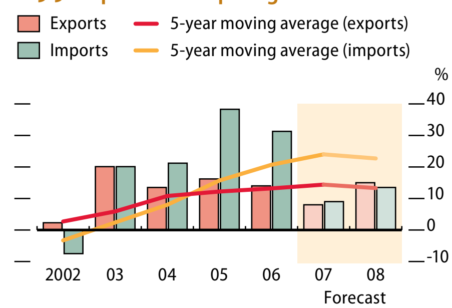
Import growth is set to decelerate in FY2007, on account of moderation in the oil import bill, weaker demand for consumer durables, and some rundown from an apparent buildup of inventories in FY2006 (Figure 2.19.9). Nevertheless, sustained growth and the forecast rise in investment are projected to keep import growth at about 9%. Exports too will rise, but the high domestic cost of production in the textile and garment sector as well as stiff competition from the People's Republic of China (PRC) and India are likely to restrict total export growth to about 8.0%. The current account deficit is projected to edge up to $6.5 billion, or 4.5% of GDP in FY2007. With the expected stabilization in GDP growth, cooling demand for consumer durables (on higher interest rates), and softening in oil prices, import growth is likely to be moderate in FY2008. As a result, the current account deficit could decline to $6.0 billion, or 3.9% of GDP (Figure 2.19.10).

In an environment of pro-growth government policies, a continuous increase in the public sector development program, and the projected rise in investment, the medium-term outlook for the economy is positive. Greater trade volumes with countries in the region, including the PRC, will also help. The boom in banking and telecoms is likely

to continue, as the policy environment for these sectors is favorable. Foreign hydrocarbons investments in recent years will have an output payoff. Finally, significantly strengthened through reforms and mergers and acquisitions, the banking system is well positioned to better channel savings to productive uses.

The growing current account deficit, continuing high inflation, and the emerging power and gas shortages are potential risks to the country's medium-term economic prospects. Any deterioration in the security environment would be another. In addition, the ending in 2008 of PRC-specific safeguards imposed by the US and EU against textile and clothing imports could further weaken Pakistan's textile export prospects.

2.19.9 Export and import growth



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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Development challenges

After the so-called lost decade of the 1990s, the strong performance in the new decade so far is attributable to sound macroeconomic management policies and pursuit of structural reforms in key areas.

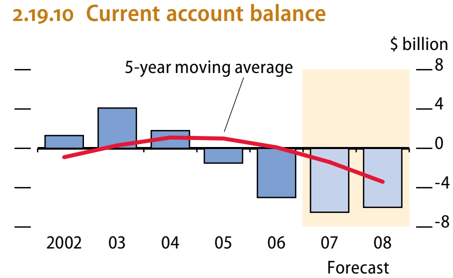
Still, important structural challenges remain and have to be tackled promptly to sustain the present growth trend. Despite healthier investment, the investment-to-GDP ratio is still low relative to countries that have experienced sustained strong growth. Even if investment in the country is underestimated, gross capital formation in 2004 was less than half of that in the PRC and about 60% of that in India or Thailand. Total factor productivity has improved, but insufficiently either to compensate for low investment or to sustain high growth.

Similarly, gross savings as a share of GDP needs to pick up substantially. In recent years, the demand-driven growth and negative real interest rates on bank deposits have contributed to low savings. Another issue is the narrow industrial base, which is linked to the lack of a diversified export base, which in turn must cope with rising international competition.

Human capital development remains a major structural challenge. Despite the recent rise in pro-poor spending, historical underinvestment in human capital has critical implications for growth and competitiveness. Public spending on education was only 2.0% of GDP in 2004, compared with 6.0% in Malaysia, 4.0% in Thailand, and 3.0% in the PRC and India. Unsurprisingly, the human development index rating was the lowest among these countries as well. The Government has, however, announced its commitment to increasing education expenditures to 4.0% of GDP. Finally, critical physical infrastructure bottlenecks impede high growth.

The Government is tackling these structural challenges over the medium term by committing to reform, by strengthening the enabling environment for investment, and by prioritizing resource allocation for infrastructure development and the social sectors.

2.19.10 Current account balance



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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Sri Lanka

Despite resurgence of the civil conflict, impact of the Asian tsunami, and doubling of oil prices since 2004, the economy grew at its fastest rate since 1978 last year. This strength was fueled by buoyant private activity and expansionary macroeconomic policies that have, though, accelerated inflation. Growth is forecast to moderate over the next 2 years, given the conflict, slow pace of structural reform, and need to cool the economy. Further out, if the fiscal consolidation and increased investment envisaged in the new 10-year development framework are achieved, growth is expected to pick up substantially.

Economic performance

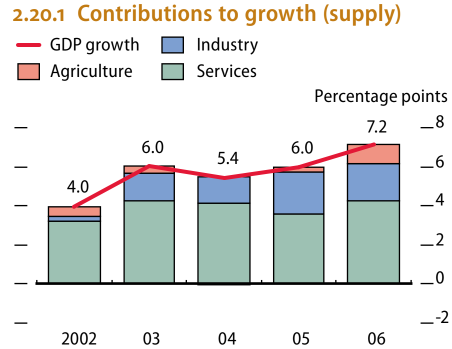
The impressive 7.2% growth in 2006 reflected continued strong performance of services of 7.7% and an unexpectedly high outturn in agriculture of 5.9% (Figure 2.20.1). (The peaceful west and south were responsible for most of the good news, since the two north and eastern provinces embroiled in the conflict contribute only about 9% of total GDP.) Aiding agriculture was fisheries' recovery from the December 2004 tsunami, as it surged by 55%. In fact, had agriculture continued its past 10-year trend of 1% growth, total GDP would have expanded by only 6.4%.

Aggregate domestic demand—buttressed by workers' remittances and rapid credit expansion—stayed high. The population continues to release its pent-up demand for consumer goods and services, especially mobile phones. Mobile and landline phone penetration has grown dramatically since 2003; as a result, mobile phone companies are thriving, with the major operators reporting revenue growth in the first half of 2006 of over 40%. These growth rates have induced many companies to reinvest their earnings to expand their networks, leading to an estimated doubling of total foreign direct investment inflows from $234 million to $480 million in 2006. Port services, cargo storage, and warehousing as well as other trade-related services also continued to boom, in line with growing international trade.

Tourism, in contrast, failed to do well in 2006 (Figure 2.20.2), with profit margins falling by up to 50% as hoteliers dropped prices to attract tourists. The subsector had picked up strongly after the signing of the cease-fire agreement between the Government and the Liberation Tigers of Tamil Eelam (LTTE) in 2002. However, it suffered in the aftermath of the tsunami and more recently has been hit by blanket travel warnings from key European markets following the sharp escalation of hostilities between the Government and the LTTE. Tourism industry sources put occupancy rates at 30–50% in January 2007, down from the 90% usually seen at that time of year. While tourism accounts for little more than 2% of GDP, the impact on employment, with about 120,000 directly and indirectly employed, is likely to have been significant.

Industry's performance was decidedly mixed. On the one hand, garments, which dominate the export and industrial base (contributing

2.20.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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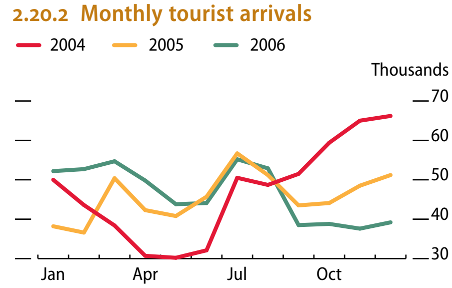
2.20.2 Monthly tourist arrivals



Source: Ministry of Finance, *Weekly Economic Position Report*, 2nd week, February 2007.

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about 40% of export earnings; Figure 2.20.3), continued to struggle following the end of the quota system on 1 January 2005, growing by little more than 5% in 2006. Structural weaknesses in garments, such as high staff turnover and levels of absenteeism, difficulties in attracting staff (over 30,000 vacancies left unfilled), problems with transport, high electricity prices, as well as the loss of price competitiveness vis-à-vis Bangladesh, People's Republic of China, and Viet Nam, caused in part by an appreciating real exchange rate, all added to the garment industry's woes. Small-scale manufacturing, too, was weak.

On the other hand, favorable weather conditions boosted hydropower generation, helping the utilities subsector expand by about 15%.

As expected, construction continued to grow, in part because of tsunami reconstruction, but also because of major housing developments in big cities, bolstered by a surge in property prices and demand for high-quality housing by Sri Lankan expatriates, and by returnees to the country.

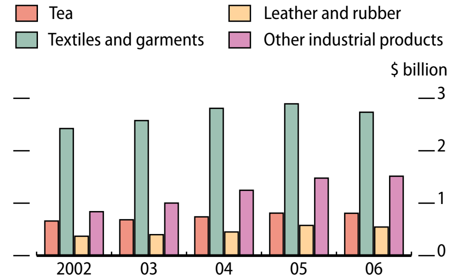
Government spending, up by 26% in 2006, imparted a strong stimulus to the economy but also drove up inflation. While the 2006 budget planned no borrowing from the banking sector, the Government ultimately borrowed 30 billion Sri Lanka rupees (SLRs), or about 1% of GDP. Fiscal consolidation has been a policy objective in recent years, though the Government has repeatedly announced that it would not cut expenditures to contain the deficit, focusing rather on improving revenue collection.

Preliminary data indicate that the 2006 budget deficit (including 0.8% of GDP for foreign-funded tsunami-related project expenditure) was 8.9% of GDP, essentially unchanged from the 2005 outturn and in line with official budget projections (Figure 2.20.4). Three elements contained the deficit: the Government lifted revenue collection substantially for the second year running (up 27.5%); it removed almost all fuel subsidies that had cost it SLRs26 billion, or about 1% of GDP, in 2005; and it offset an SLRs38 billion cost overrun on recurrent spending by means of reallocating funds previously earmarked for capital expenditures. The bulk of the revenue improvement stemmed from changes to income tax (raised tax rates and lowered taxable thresholds), improved value-added tax (VAT) collection, and increased import tariffs.

Recurrent spending rose by 22%, fueled mainly by larger defense expenditures (up by 27%); new recruits to the civil service (continued regularization of 40,000 trainees taken on earlier); additional home guards (35,000 recruits); a greater number of pensioners; and higher civil service wages (the second installment to bring the base salary to SLRs11,650) and cost-of-living allowances.

Looser fiscal policy and increased central bank financing of the budget deficit led to an escalation of demand pressures over the year. Inflation, which had subsided toward the end of 2005, reversed course and accelerated sharply after July 2006, peaking at 20.5% in January 2007 (Figure 2.20.5). This should be seen in the context of annual average inflation in 2006 of 13.6% (based on the Colombo consumer price index). While the one-time impact of rises in administered prices for fuel and electricity and in vegetable prices (due to supply shortages) were factors, the sustained large price upswing primarily reflects rapid increases in

2.20.3 Major exports



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007; Economist Intelligence Unit, *Sri Lanka Country Report*, February 2007.

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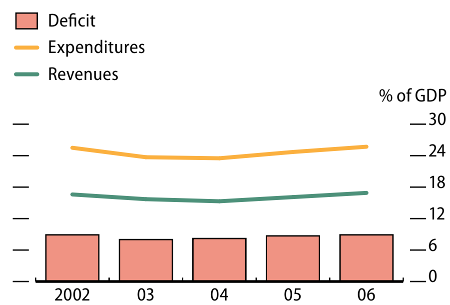
2.20.4 Fiscal indicators



Sources: Central Bank of Sri Lanka, avaliable: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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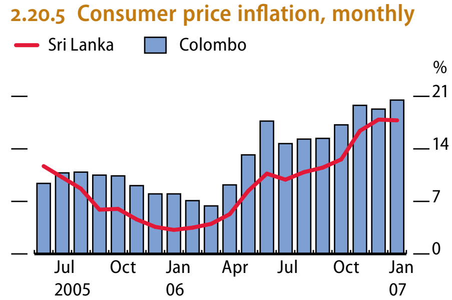
2.20.5 Consumer price inflation, monthly



Source: Department of Census and Statistics, available: http://www.statistics.gov.lk, downloaded 10 March 2007.

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money (Figure 2.20.6) and credit powered by low and at times negative real interest rates. Consumer credit jumped by 43% (October 2005–September 2006), and overall private sector credit leaped by 24% (both substantially above their respective 10-year averages of 25% and 15%); and credit to the government expanded by 20%.

From September 2006, the central bank took steps to reduce liquidity in the market by increasing its policy rates, bringing the repurchase (repo) rate to 9.625%, and reverse repo or lending rate to 11.5%, and the 91-day treasury bill rate to 12.7% by year-end (Figure 2.20.7). Since the start of this year, the central bank has restricted access to the reverse repo facility at times when the commercial banking system shows a liquidity surplus. Some commercial banks previously used this facility as their main source of credit expansion, taking advantage of the interest differential between the interbank market and (lower) policy rates. But on 30 January, the central bank acted to narrow the interest rate differential between market and policy rates.

Despite improvements in key debt indicators, the Government's debt policy has increased its exposure to foreign exchange rate fluctuations. While public debt rose in 2006 in absolute terms, it declined as a proportion of GDP because of the rapid expansion of *nominal* GDP, but it still remained quite high at about 92%. Since 2004, the Government has pursued a policy of taking on domestic short-term foreign-denominated debt to reduce interest rate costs and to retire more expensive local currency debt, increasing its exposure to foreign exchange risk.

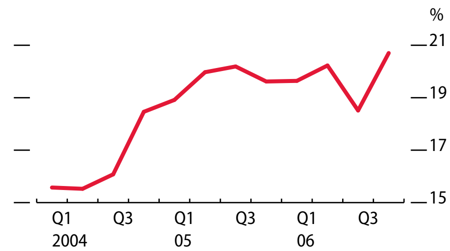
The stock of such debt increased by $520 million in 2006 to $1.65 billion at year-end, or 6% of GDP. Overall debt service (principal and interest) of the Government fell from 92% of total revenues in 2004 to 82% in 2006, but still amounted to 15.7% of GDP in 2006, edging up with the end of the tsunami-related debt moratorium in December 2006.

The balance of payments has weathered the oil price shock relatively well, even as the oil import bill (consonant with doubling oil prices) almost tripled in only 2 years to $2 billion in 2006. Nevertheless, strains are apparent, with the trade deficit remaining in double digits for the third year in a row, reaching 13% of GDP, a deficit not seen since 1994 (Figure 2.20.8). The current account deficit stabilized at 2.8% of GDP, substantially lower than projected in the Government's medium-term economic framework.

A major factor keeping the current account deficit largely in check and helping ease pressure on the balance of payments has been soaring workers' remittances, unexpectedly increasing by $400 million (or over 1% of GDP) to $2.3 billion in 2006: after the tsunami, they jumped by almost 30% a year (against 9% annual growth in the 5 years preceding the disaster).

An International Monetary Fund study finds that this jump is probably less a result of altruism than of high global oil prices, since they increased the chances of employment and higher wages for Sri Lankan migrants, over 85% of whom live in net oil-exporting countries. Even though foreign exchange reserves have been maintained at approximately $2.5 billion (Figure 2.20.9), last year's 15.7% expansion in imports reduced the import cover ratio to 2.6 months by year-end from 2.9 months at end-

2.20.6 Money supply (M2) growth



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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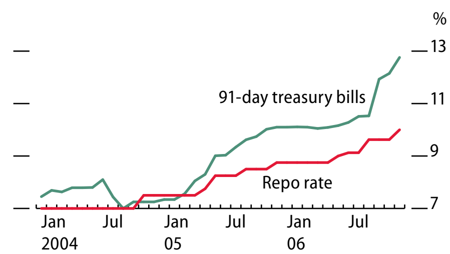
2.20.7 Interest rates



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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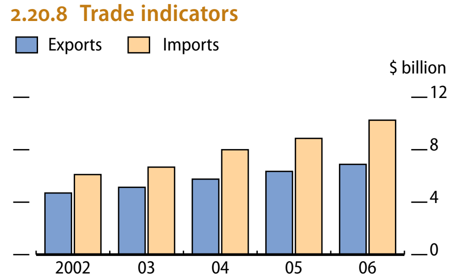
2.20.8 Trade indicators



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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2005. To safeguard reserves, the central bank imposed restrictions in late September 2006 on current payments, imposing deposit requirements of 50% on the import value of certain goods. The International Monetary Fund subsequently approved these restrictions as a temporary measure.

The nominal exchange rate has increasingly come under pressure and has depreciated substantially, especially vis-à-vis the euro and the British pound, even despite initial central bank intervention to defend the currency. Tsunami-related foreign inflows, which in 2005 led to real and nominal currency appreciation, are now moving out of the country to fund capital imports for reconstruction. These outflows, in combination with higher external debt service and oil import bills, all contributed to the substantial drop in the nominal exchange rate. The real effective exchange rate however, is trending upward because of accelerating domestic inflation (Figure 2.20.10).

Since the Government took office in November 2005, structural reform has been limited. Although the private sector accounts for over 85% of GDP, the Government owns institutions that manage about 60% of all financial assets as well as all public utilities and some smaller enterprises. In key policy statements, it has announced that it would seek alternatives to privatization for bringing greater efficiency into the state-owned sector.

Restructuring, rather than privatization, of the People's Bank, which accounts for about 20% of financial assets in the country, has made some progress. One major reform was the removal of fuel subsidies in 2006, relieving a heavy drain on the budget and moving Ceypetco, the state oil and petroleum company, to operate more on a commercial basis. However, the market for retail fuel and lubricants was liberalized in September 2006 without the regulator, the Public Utility Commission, yet receiving authority to regulate applicable retail prices, safeguard consumers' interests, and ensure fair competition.

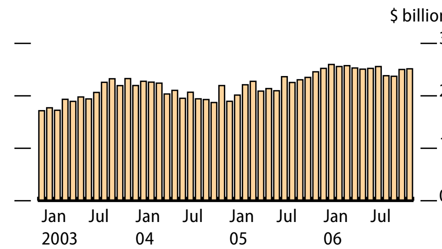
Strong opposition by labor unions has been one of the major factors holding back reforms. The long-awaited unbundling of the Ceylon Electricity Board, in the planning stage since 1997, has been put on hold. The Government is now seeking to manage the utility more efficiently by other means, and to bring more transparency into rate setting and procurement.

The power sector remains a major troublespot for the economy because its least-cost generation plans have not been implemented for the last 20 years. This has pushed electricity tariffs to among the highest in the region, despite the fact that the sector does not charge cost-recovery tariffs, leading to daily losses of SLRs50 million and an accumulation of large debts. Operational problems are exacerbated by rising power demand and high capacity utilization in the transmission and distribution system. Many lines and transformers are becoming overloaded and this will result in rising maintenance costs, deteriorating performance, and higher technical losses.

Economic prospects

Growth prospects have become, if anything, more complex: opportunities for, and risks to, economic growth have risen since last year. Factors that could potentially lay the foundation for strong economic growth

2.20.9 Gross official reserves



Source: Central Bak of Sri Lanka, available: http://www.cbsl.lk, downloaded 14 March 2007.

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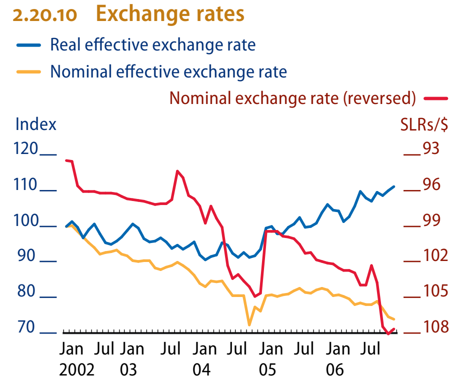
2.20.10 Exchange rates



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

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and that show a marked departure from previous approaches are, first, a powerful president whose first term will end in 2011, and who has now also succeeded in forging a parliamentary majority with crossovers of Members of Parliament from the typically more private sector-oriented United National Party. This could make implementing legislative changes easier than before, and could also be the beginning of a "southern consensus," the lack of which has been partially blamed for the slow resolution of the ethnic conflict in the country. Second, public investment is considerably higher.

Factors that have increased the risks are the falling import cover in terms of foreign exchange reserves, accelerating inflation, and the rapid buildup of domestic dollar-denominated, short-term, commercial debt, now amounting to 6% of GDP. Despite the fact that the private sector continues to be resilient, these developments are a concern, and need to be addressed through policy actions to reduce the fiscal deficit (and hence the need to borrow commercially), and to gradually tighten monetary policy so as to control inflation. There is also the risk of prolonged power cuts in 2007, a result of the delay in commissioning a new power plant, unless the government quickly introduces contingency plans.

The underlying assumptions of the following projections are: the conflict will not escalate further; the LTTE will not succeed in destroying key economic infrastructure; and 2007 will see gradual monetary tightening and a determined effort to slow inflation (as the central bank at least partially succeeds in implementing its ambitious financial and monetary policies for the year). In this it will need to be supported by the Government and the newly established National Economic Council.

The outlook for 2007–2008 is for growth of 6.1% and 6.0%, respectively (Figure 2.20.11), which is somewhat below government forecasts. It assumes that tighter fiscal and monetary policies gradually curtail aggregate demand by 2008, and that the conflict will continue to curtail tourism growth. In addition, agriculture will expand much less quickly than in 2006, in line with long-term trends, as its post-tsunami recovery is largely completed. However, except for the lackluster performance of tourism, the private sector will once again prove to be resilient, and services will remain the engine of growth. Finance, trade-related services, telecommunications, and information technology (IT) will perform robustly, buoyed by continued consumer demand and public sector expansion.

Assuming a gradual deceleration in inflation to 9% by 2008 (as the impact of tighter policy is felt with a time lag of up to 2 years), industry consolidation, and facilities upgrading, the garment sector is projected to regain some of its competitiveness by 2008, just when the People's Republic of China moves out of restraints imposed by the European Union and United States. The Government expects a breakthrough in the negotiations with the European Union on lowering the threshold of country-of-origin requirements under the "GSP Plus" scheme from 50% to 35% this year. However, hopes to conclude a free trade agreement with the United States are unlikely to be realized.

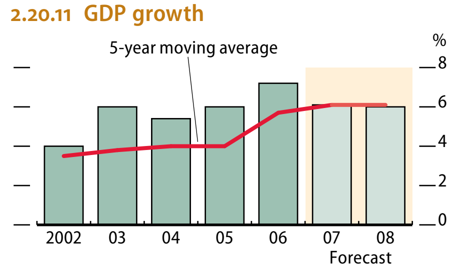
The government-projected deficit of 9.2% of GDP for 2007, including fully foreign funded projects, is likely to be met. A gradual reduction of spending as fiscal policies slowly tighten will bring the deficit—including

2.20.1 Selected economic indicators

	2007	2008
GDP growth	6.1	6.0
Inflation	10.0	9.0
Current account balance (% of GDP)	-2.5	-2.4

Source: Staff estimates.

2.20.11 GDP growth



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

Click here for figure data

fully foreign funded investment projects—to 7.7% of GDP in 2008. However, the expenditure composition is likely to change, with recurrent expenditure (such as defense, subsidies, and wages and pensions) likely to surpass budgeted estimates. The implementation of key cost-cutting exercises outlined in the budget speech, such as cutting SLRs16 billion by avoiding duplication of expenditure, would have to be tackled quickly to show results.

Revenue collection, though, is projected once again to increase substantially, despite the growing complexity of the tax regime that introduces more exemptions: higher CIF mark-up values on imports, the cascading nature of the tax regime, falling tax thresholds, and tax implementation changes that would convert VAT to a quasi-withholding tax (whereby one third of VAT payments to government contractors are withheld), will all help boost revenue collection.

The first steps taken in January 2007 to rein in growth of monetary aggregates suggest that the central bank is determined to fight inflation more aggressively than last year. Its financial and monetary policy plans of January 2007 indicate its intention to reduce growth of broad money supply to 13.2% by December 2007 (relative to estimated actual levels of 12 months earlier), a sharp drop from the 17.8% growth seen in 2006.

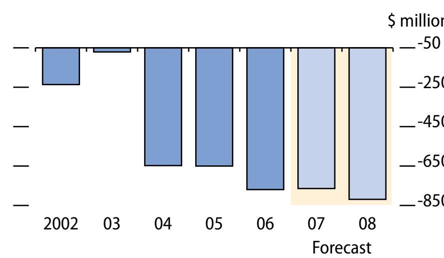
Achieving the central bank target depends crucially on the volume of government net domestic borrowing, which has to keep in line with the budget target of SLRs156 billion (out of which commercial bank borrowing should not exceed SLRs16.7 billion).

Given the Government's expenditure plans, and past delays in firming up foreign financing, it is not yet clear whether the central bank will succeed in controlling expansion of the money supply (and thereby inflationary pressure). Neither is it clear whether moves to control prices of 11 essential consumer items for 3 months from 1 March 2007, are temporary, or whether these measures will remain more permanent.

The current account deficit in 2007 will narrow slightly to $764 million (or 2.5% of GDP; Figure 2.20.12), due to substantially lower import growth following a projected stabilization of oil prices at about $57 a barrel. Export performance will stay muted, despite several expected positive developments for the garment sector. Concessional financing, tsunami-related grants (largely phased out by 2008), and commercial borrowing appear sufficient to finance this deficit. However, should oil prices be as high on average as in 2006 (about $65 per barrel), the current account deficit would increase sharply by 1.2% of GDP ($320 million) to 3.7% of GDP.

In the long term, the significantly higher public investment planned by the Government will increase economic growth. Three major investment projects, some in the pipeline for 20 years, are now finally going ahead: the Kerawalapitya Combined Cycle Power Plant ($310 million), the Norrachchalai coal power plant ($510 million), and the extension and development of the Colombo Port ($300 million, with total project costs including planned private sector investment for the terminals eventually estimated at $1.2 billion). These investments are crucial to safeguard economic growth, act as a catalyst to private sector investment, and expand the country's role as a logistics hub.

2.20.12 Current account balance



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 7 March 2007; staff estimates.

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Development challenges

The country's civil conflict is undoubtedly the main long-term challenge to development, shaving off an estimated 2% of GDP growth each year. Civil conflicts of such complexity can take decades, if not generations, to resolve. However, despite the opportunity costs of the conflict, the economy has grown at an annual average of 4.6% since the conflict started in 1983, and is a testimony to its resilience.

The current policy focus of the Government is on infrastructure development to improve electricity supply and roads. This is crucially important, but would need to go hand in hand with preparing the ground for higher productivity gains. To achieve this—and at the same time increase income equality—Sri Lanka needs a well-educated labor force and better access by the underprivileged to high-quality education (Box 2.20.1).

2.20.1 Education

Literacy indicators are high, and do not point to an immediate crisis. However, representatives of those segments that can propel the country on to a higher growth path (e.g., IT and high-value manufacturing) have repeatedly stated that they suffer from a shortage of suitably skilled labor.

Spending on private tuition among all families, including the poorest, has shot up, pointing to deficiencies in the quality of public education. In turn, sustained high economic growth has to create jobs attractive enough to retain highly skilled people who are usually among the most mobile and too often leave the country. The country reportedly has one of the highest "brain drain" ratios in the world. (This may reinforce the lack of skilled staff, identified by entrepreneurs as slowing growth in business outsourcing and IT development.)

In addition to the need to improve the skills of its students, the school and education system seems to increasingly fail the poorest. School leavers who, due to poor conditions in rural schools, often fail one or more of their O levels, stand little chance of being employed in the private sector; with very high pressure emanating from their families that hope to have at least their offspring move away from the agriculture sector, the public service (clerical jobs) or the army is often the only source of employment.

In addition, the lack of mathematical skills precludes even those who go to university from studying a non-arts degree, thereby again relegating them to arts subjects for which employers usually pay less well. The quality of schooling is highly skewed between rural and urban regions and educational outcomes between the provinces differ sharply (box table).

The quality of English language teaching and the lack of English language proficiency are other serious obstacles to social mobility. Overall, the poor see few chances of upward mobility, due to the lack of good education and—according to anecdotal evidence—a social and political network. As a result, their children drop out more often, and intergenerational education mobility is low internationally.

In contrast to Sri Lanka's earlier impressive record, education's share of GDP and expenditure started decreasing in the 1970s and is now equivalent to about 2.5% of GDP—lower than in most comparable countries.

The Government now sees education as a priority, embarking in 2006 on a reform program that includes improving English at all levels and that introduces English as a medium of instruction in state schools. This 5-year program should show some results within a few years. It is hoped that it will be able to address some of the needs of a modernizing society, of the knowledge economy, and of the poor.

Provincial education outcomes

Province	Percentage of students achieving mastery of: their first language (Sinhalese or Tamil)	mathematics	the English language
Western	51	52	20
Central	34	33	8
Southern	43	44	13
North-Eastern	23	25	5
North-Western	42	43	9
North-Central	36	41	8
Uva	34	35	8
Sabaragamuva	40	43	10
Sri Lanka	37	38	10

Source: World Bank, *Treasures of the Education System*, 2004.

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.

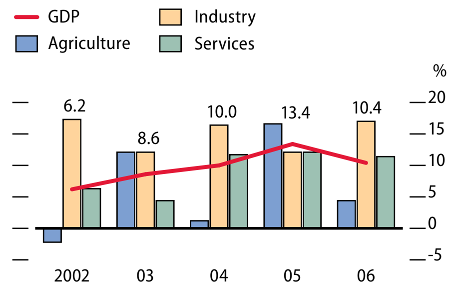
In industry, clothing exports grew by an estimated 32% in volume terms as manufacturers took advantage of temporary safeguard measures imposed against clothing exports from the People's Republic of China (PRC) by the United States (US) and the European Union (EU). Construction activity remained relatively 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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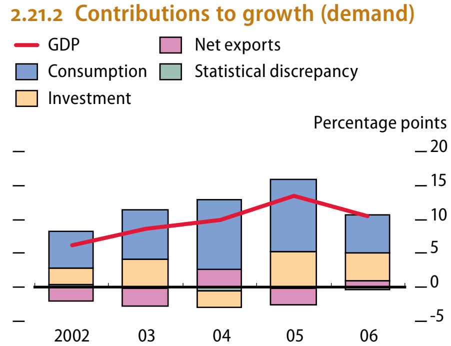
2.21.2 Contributions to growth (demand)



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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).

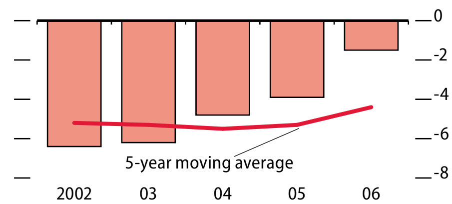
During 2006 merchandise exports expanded by an estimated 26.9%. Clothing shipments, which accounted for 72% of total exports, rose by 20.7% in value terms, despite stronger volume growth, reflecting lower unit prices as a result of stiffer global competition with the end of the Multifibre Arrangement. 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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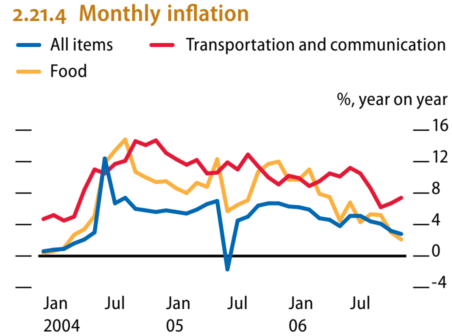
2.21.4 Monthly inflation



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

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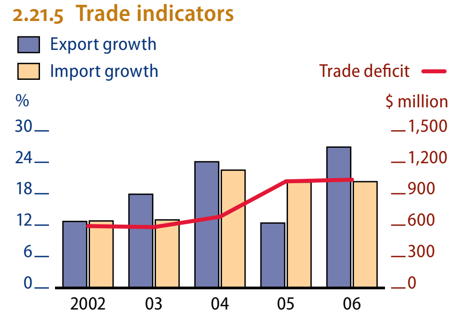
2.21.5 Trade indicators



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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).

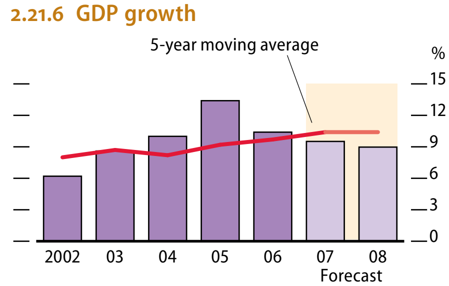
Construction activity is likely to keep expanding with planned construction of a new town, bridges across the Tonlé Sap and Mekong rivers, and a number of special economic zones. These zones will be on Cambodia's borders with Thailand and Viet Nam, where they can take advantage of lower-cost electricity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

Click here for figure data

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.

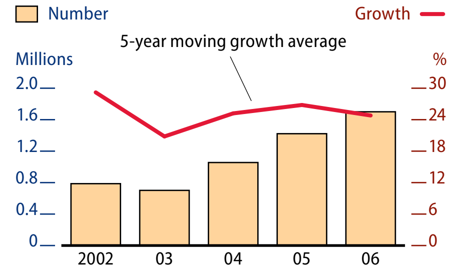
The import intensity of investment projects is likely to mean that import growth exceeds export growth, widening the trade gap and pushing the current account deficit out to 8.6% in 2007 and 10.1% in 2008 (Figure 2.21.9). Continued inflows of concessional loans and grants will partially offset the gap. 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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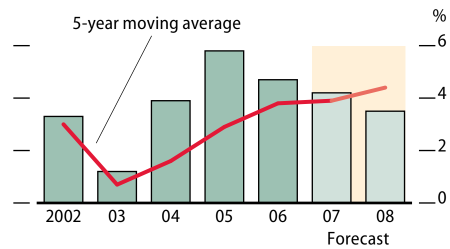
2.21.8 Annual inflation



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

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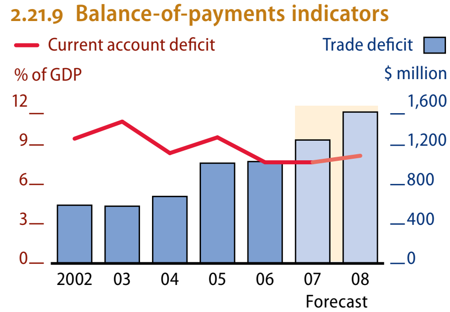
2.21.9 Balance-of-payments indicators



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

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

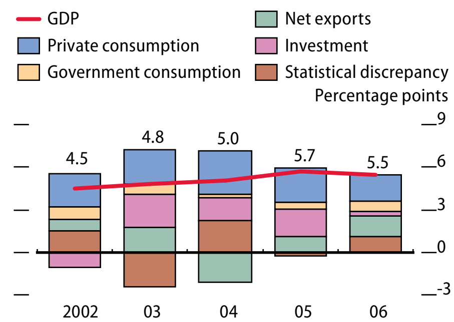
The economy grew by a modest 5.5% in 2006, slightly faster than average expansion over the previous 3 years. In line with recent trends, private consumption made the major contribution to overall GDP growth (Figure 2.22.1), even though spending slowed after the October 2005 reduction in fuel subsidies, 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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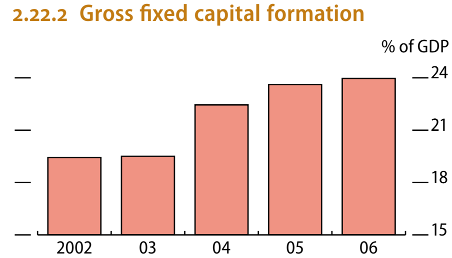
2.22.2 Gross fixed capital formation



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.

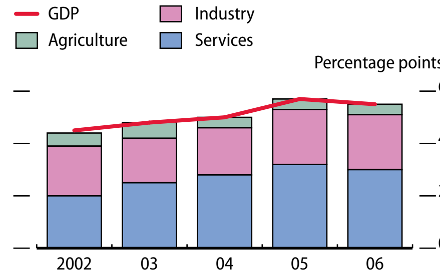
Much of the increase in nonperforming loans since 2004 has been due to operational and governance problems at state-owned banks. Consequently, the adoption in October 2006 of a regulation allowing state banks to restructure and dispose of such loans helped bring down the ratio to 7.0% by year-end. In 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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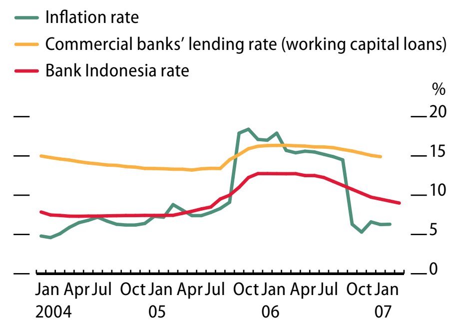
2.22.4 Interest and inflation rates



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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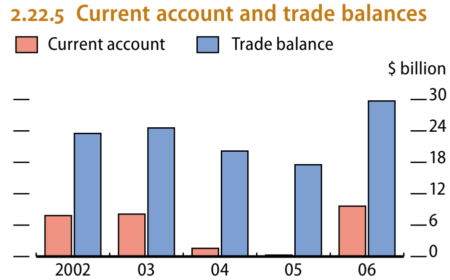
2.22.5 Current account and trade balances



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.

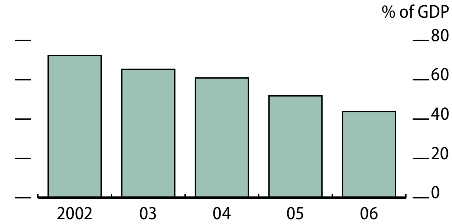
At the central government level, there is a clear effort to redirect spending. Education outlays rose by 34% in real terms last year. They accounted for 17.2% of total government spending and stood at 3.6% of GDP. However, health and infrastructure expenditures remain low, with health less than 1% of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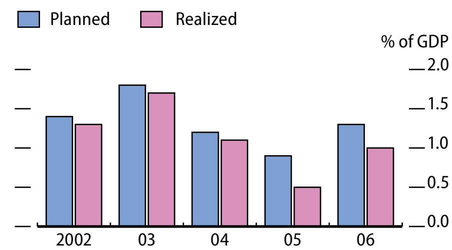
2.22.7 Fiscal deficit



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

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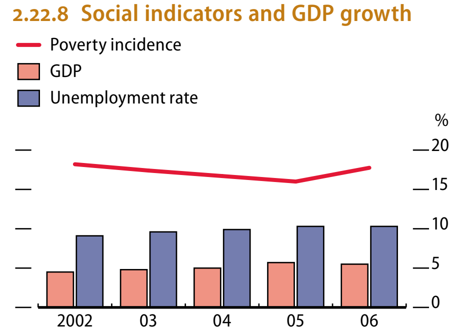
2.22.8 Social indicators and GDP growth



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.

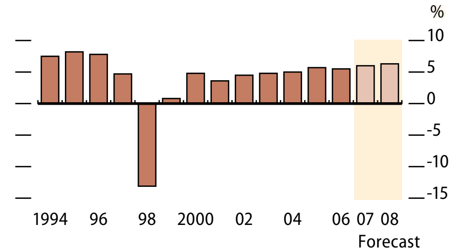
Two key domestic downside risks lurk: agricultural output and avian flu. Drought persists in parts of the country, while other areas have been flooded; and the El Niño weather phenomenon may return, which would cause drier than usual weather. Avian flu has already claimed more than 60 human lives in 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.

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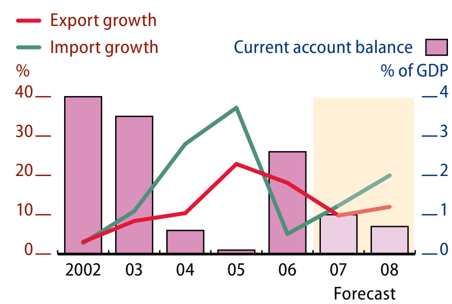
2.22.10 External indicators



Sources: Bank Indonesia; staff estimates.

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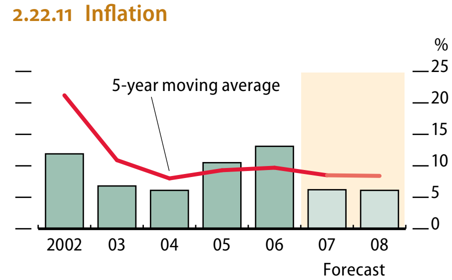
2.22.11 Inflation



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

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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.

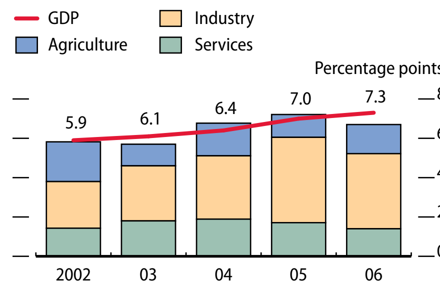
The kip appreciated against the US dollar by 5.2% using average exchange rates for 2005 and 2006, but the currency weakened slightly against the Thai baht (Figure 2.23.3). The Bank of the Lao People's Democratic Republic (Lao PDR) could be expected to take steps if needed to prevent any sharp decline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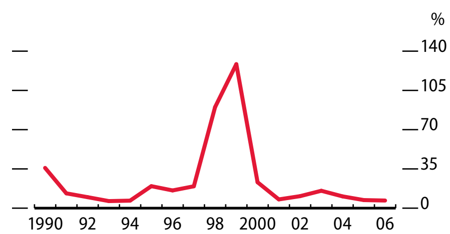
2.23.2 Annual inflation



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

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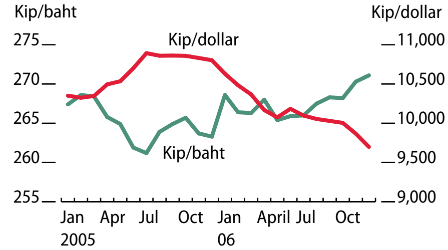
fragile. Expenditures were generally below allocations in FY2006, especially on the capital side. Overambitious revenue projections compelled the Ministry of Finance to maintain strict cash management of actual budget allocations. This approach has enabled the Government to rein in the overall budget 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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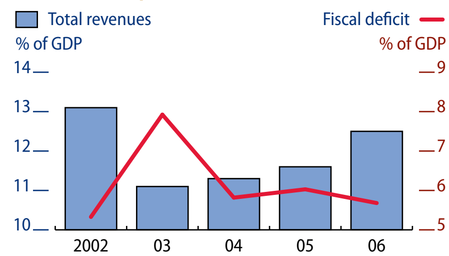
2.23.4 Fiscal performance



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.

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.

Development challenges

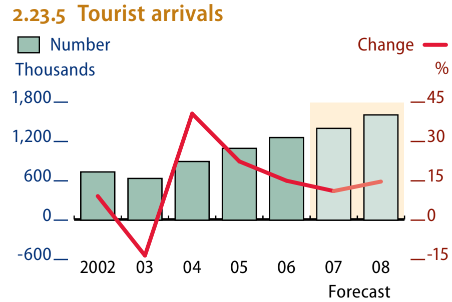
Solid rates of economic growth have reduced income poverty, though more attention is needed to ensure that growth generates the Development Plan's target of reducing the number of poor households to below 15%, and creating 652,000 additional productive jobs during 2006–2010. Exploiting hydropower (Box 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.

2.23.5 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.

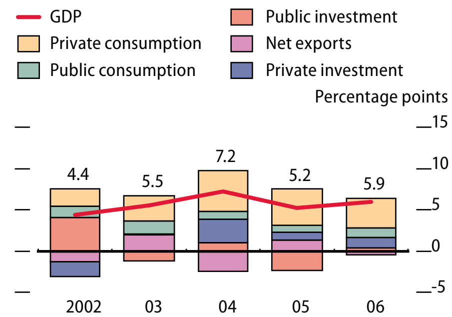
On the production side, agriculture represents less than 10% of GDP, but is important for rural incomes and for exports, and as a basis for large and growing agroindustry subsectors. Growth in 2006 of 6.4% (Figure 2.24.2) represented a longer-term supply response to high international prices for crops,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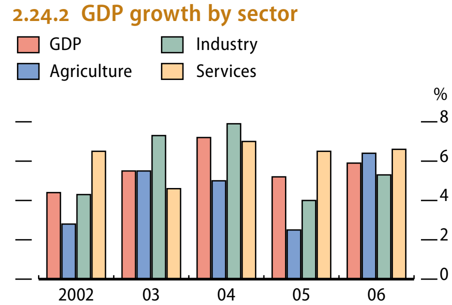
2.24.2 GDP growth by sector



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

Click here for figure data

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.

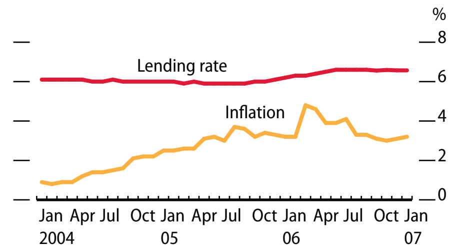
The inflationary pressures prompted increases in interest rates, although monetary policy remains broadly accommodating to growth. Bank Negara Malaysia, the central bank, raised its overnight policy rate from 2.7% to 3.5% in three separate actions between November 2005 and April 2006, and has kept it 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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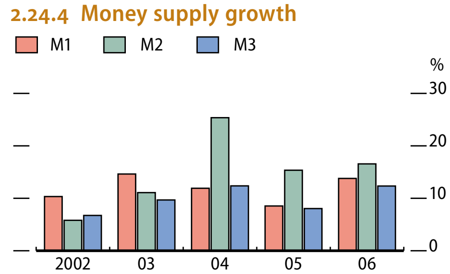
2.24.4 Money supply growth



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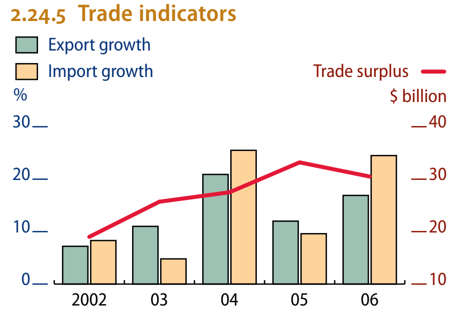
2.24.5 Trade indicators



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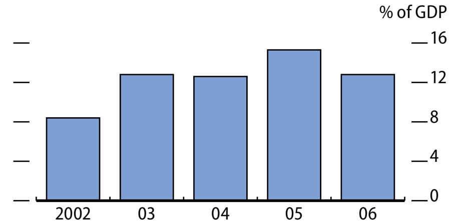
Owing to the smaller merchandise trade surplus, the current account surplus fell slightly to $19.6 billion or 12.8% of GDP (Figure 2.24.6). The deficit on net services exports widened a little. International reserves climbed to $82.2 billion, equivalent to seven times external debt falling due within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

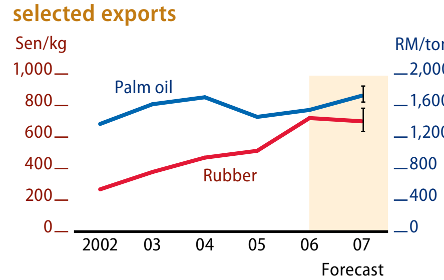
The policy of gradual fiscal consolidation is likely to be maintained, but will be balanced against the interest of ensuring that the Ninth Plan's investment programs are undertaken. Financing the Government's broader development agenda is helped by large surpluses run by

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

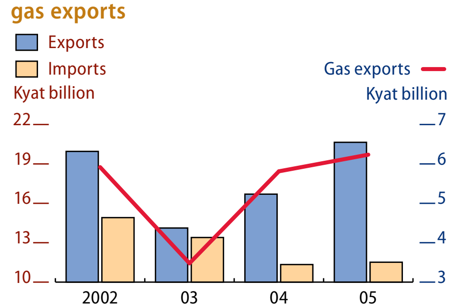
High prices for natural gas exports and a good harvest led to a modest pickup in economic activity. But macroeconomic stability remains elusive with monetized fiscal deficits feeding high inflation. The cushion provided by the gas exports makes now an opportune time to embark on structural reforms, including 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.

2.25.1 Total exports and imports, and gas exports



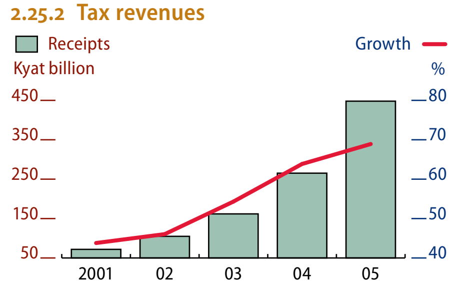
Source: Myanmar Central Statistical Organization, available: http://www.csostat.gov.mm, downloaded 2 March 2007.

Click here for figure data

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.

2.25.2 Tax revenues



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

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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.

Economic prospects

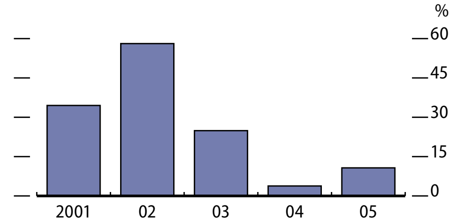
The Government's 5-year plan for 2006–2010 calls for average GDP growth rates of 10%, to be achieved through higher agricultural production, new gas fields, and increases in hydropower generation. The economy would be fortunate to achieve even half that over the medium term. In addition to the trade 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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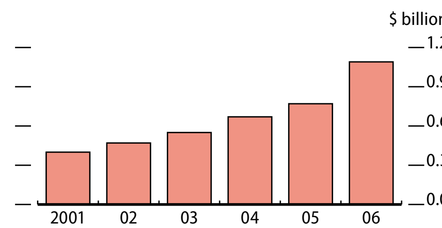
2.25.4 International reserves



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.

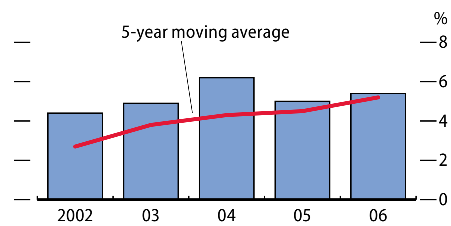
On the supply side, the pace of growth in agriculture more than doubled from 2005 to 4.1% in 2006 with more favorable weather conditions early in the year and a larger harvested area. Production of rice and corn in particular rebounded from a slump the previous year, and fisheries maintained a solid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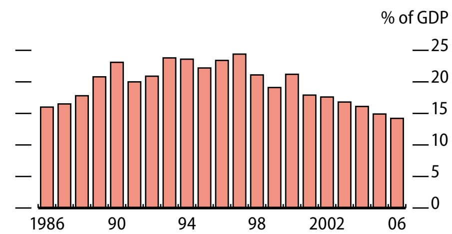
2.26.2 Gross fixed capital formation



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

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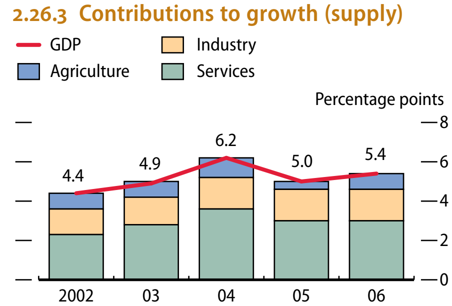
2.26.3 Contributions to growth (supply)



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

Click here for figure data

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.

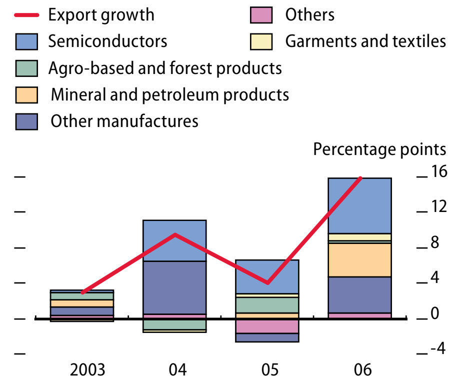
The overall balance of payments posted a hefty surplus of $2.6 billion in the first 3 quarters of 2006, similar to a year earlier. Although inflows of net portfolio investment slowed from 2005, net foreign direct investment (FDI) during the 3 quarters rose to $1.6 billion (1.4% of 2006 GDP). However, 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

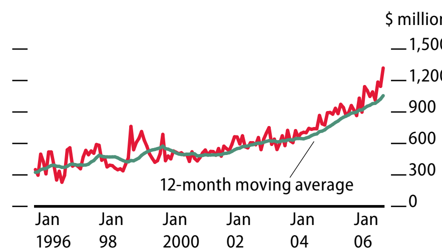
2.26.4 Contributions to export growth



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

Click here for figure data

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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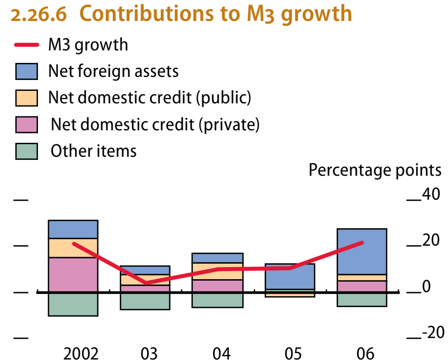
2.26.6 Contributions to M3 growth



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.

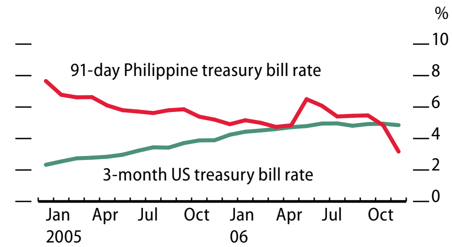
Excluding interest payments, the primary fiscal balance switched to a surplus of 4.1% of GDP in 2006, from a deficit of 0.6% of GDP in 2002. Coupled with lower interest rates, a stronger currency, and an improvement in economic growth, this contributed to a reduction in the Government's outstanding debt 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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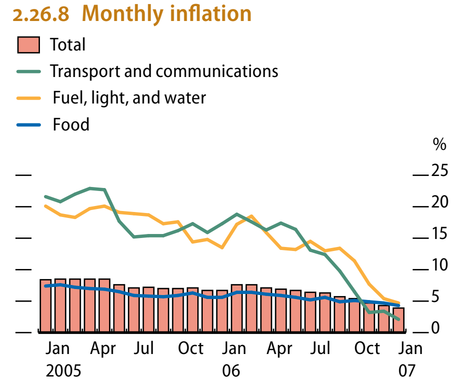
2.26.8 Monthly inflation



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

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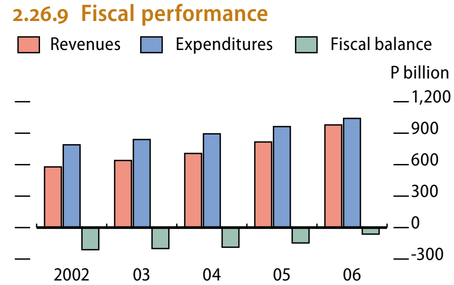
2.26.9 Fiscal performance



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.

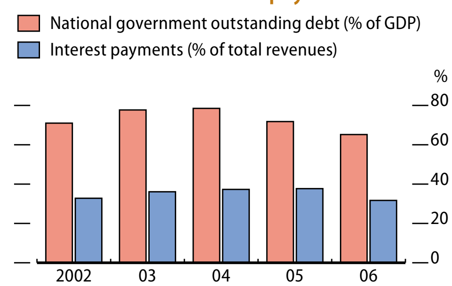
Construction will benefit from the planned upturn in public spending on infrastructure. However, the expected softening of the global electronics market and the slowdown in overall external demand will crimp manufacturing output. Industry as a whole is expected to grow by 4.8%, again underperforming 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.

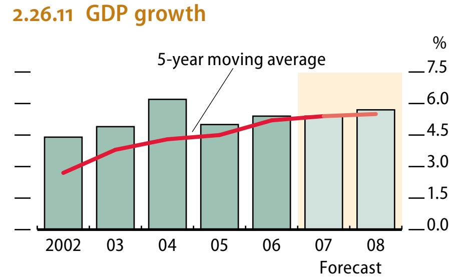
Click here for figure data

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.

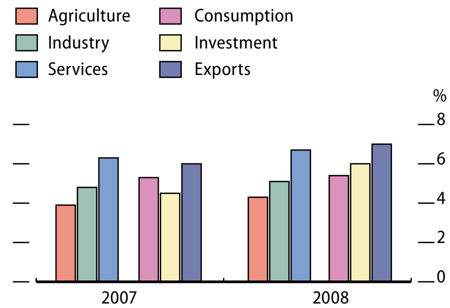
This suggests that, in the absence of new tax measures, efforts to enforce tax collection need to continue over the medium term both to finance higher expenditures on infrastructure and to reduce the deficit. For 2007, given privatization receipts from asset sales (counted as revenues, not a financing 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.

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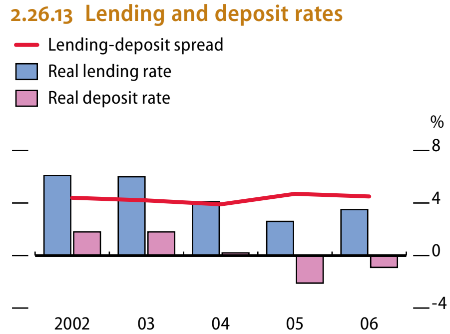
2.26.13 Lending and deposit rates



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

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

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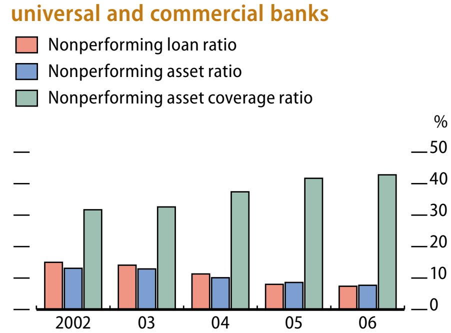
2.26.14 Banking performance indicators: universal and commercial banks



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.

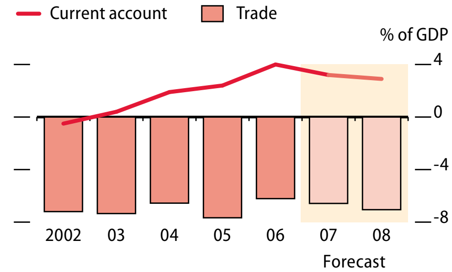
In agriculture, which accounts for 36% of employment, investment has been weak because of factors that include farmers' poor access to credit and support services, expensive inputs, high costs of transport, and the incomplete land reform program. In manufacturing, sampled firms in a 2003 survey of the 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.

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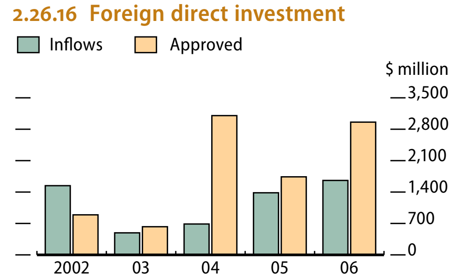
2.26.16 Foreign direct investment



Note: Data for 2006 are for January to September.

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

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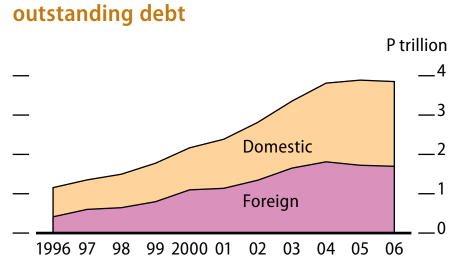
2.26.17 National government outstanding debt



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.

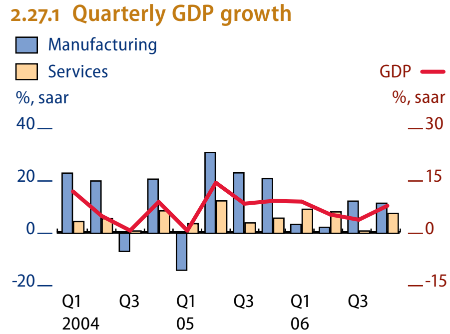
Services maintained robust growth over most of the year, providing a buffer against cyclical swings in manufacturing. Overall, quarterly growth in 2006 was less volatile than in previous years, which suggests that the economy has indeed become more diversified (Figure 2.27.1).

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.
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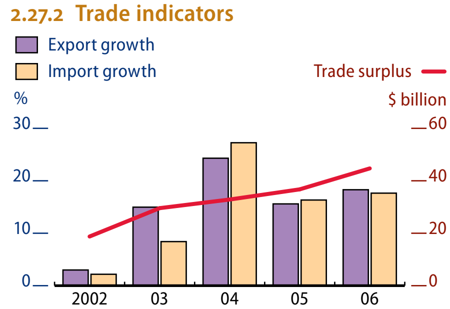
2.27.2 Trade indicators



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

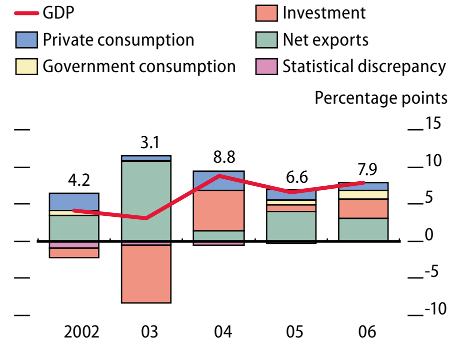
Overall, domestic demand accounted for 4.7 percentage points of total GDP growth in 2006, with a contribution of 2.5 percentage points from total investment (including inventory investment), 1.0 percentage point from private consumption, and 1.2 percentage points from public consumption.

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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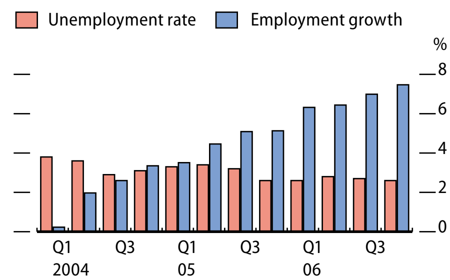
2.27.4 Labor indicators



Source: Ministry of Manpower, available: www.mom.gov.sg, downloaded 7 March 2007.
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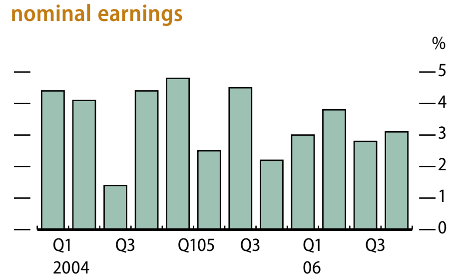
2.27.5 Growth in average monthly nominal earnings

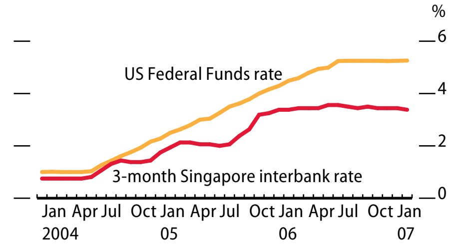


Sources: Ministry of Manpower, available: www.mom.gov.sg; Ministry of Trade and Industry, available: www.mti.gov.sg; both downloaded 7 March 2007.
Click here for figure data

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.

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.

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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.

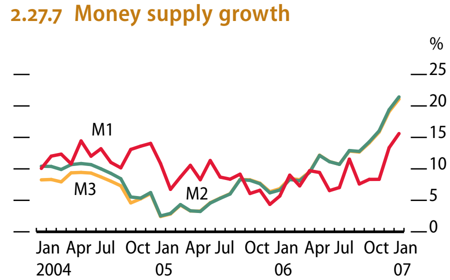
Momentum in manufacturing investment will moderate, slowed by decelerating global economic growth and softening electronics demand. However, construction investment is likely to accelerate in 2007–2008, underpinned by the two major resorts, some public infrastructure projects, and the strong residential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

2.27.1 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.

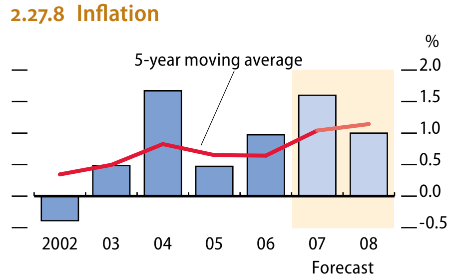
2.27.7 Money supply growth



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

Click here for figure data

2.27.8 Inflation



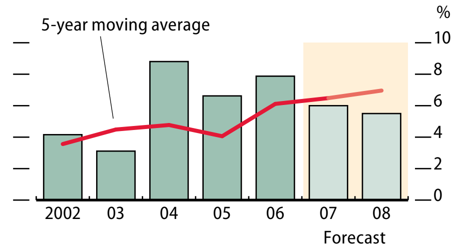
Sources: Singapore Department of Statistics, available: www.singstat.gov.sg, downloaded 1 March 2007; staff estimates.

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.

2.27.9 GDP growth



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

Click here for figure data

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.

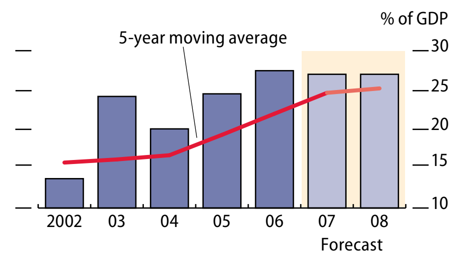
These supply-side reforms have helped make the city-state one of the world's winners in globalization, with a rising share of world trade, increased inflows of foreign capital and talent, and sustained, above-trend growth. The more flexible labor supply response and increased foreign investment have 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.

2.27.10 Current account balance



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

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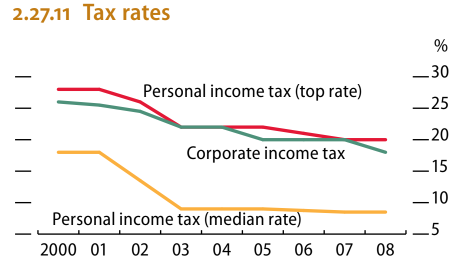
2.27.11 Tax rates



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

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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.

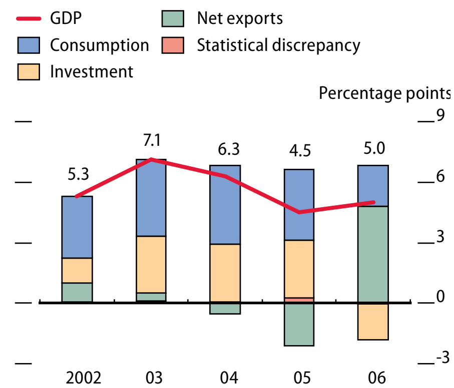
Economic performance

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.

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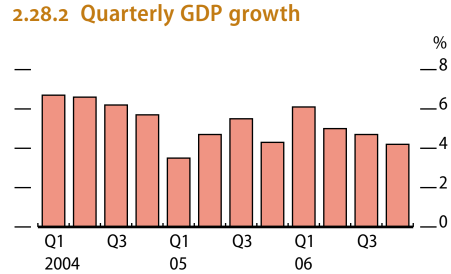
2.28.2 Quarterly GDP growth



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).

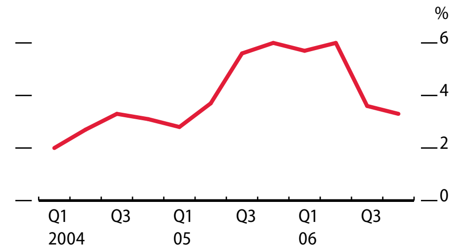
The current account surplus amounted to $3.2 billion, or 1.6% of GDP, turning around from a $7.9 billion deficit in 2005. The return to a current account surplus, together with large inflows of equity portfolio investment and a surge in foreign purchases of domestic debt securities, boosted official 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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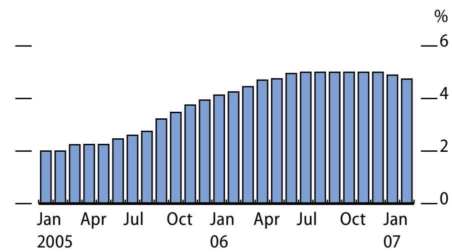
2.28.4 Policy interest rate



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

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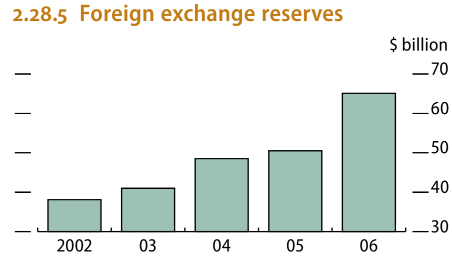
2.28.5 Foreign exchange reserves



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.

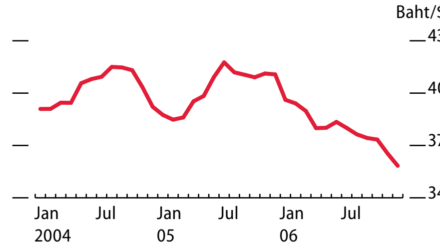
Government consumption spending in 2007 is expected to rise significantly as a result of a decision to accelerate budget disbursements and because of the elections. Hence, total consumption is projected to grow by about 4% in 2007, up slightly from 3.2% in 2006.

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.

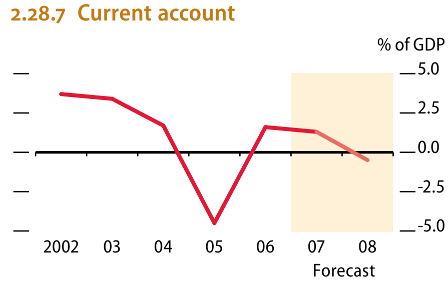
Click here for figure data

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.

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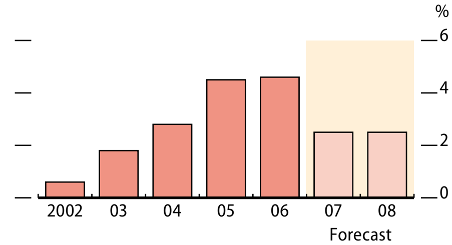
(Figure 2.28.8). This could pave the way for further reductions in the policy interest rate.

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).

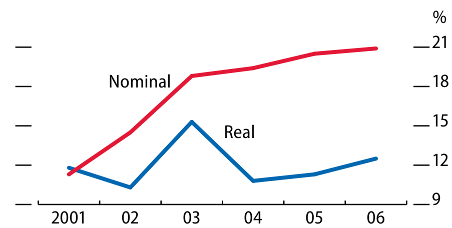
Investment levels remained high at an estimated 39.4% of GDP in 2006. Private investment was encouraged by further simplification of administrative procedures for businesses and moves toward equal treatment between state enterprises and the private sector and between domestic and foreign enterprises. 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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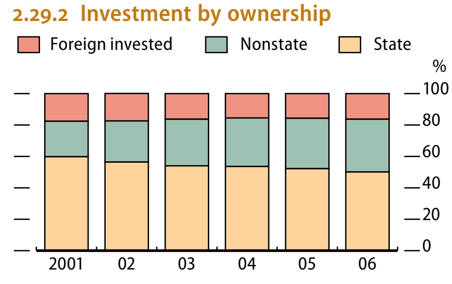
2.29.2 Investment by ownership



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

Click here for figure data

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).

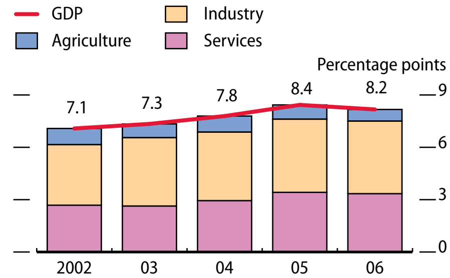
Inflation continued to run high, exceeding 7% on average during 2006 for the third year in a row (Figure 2.29.7). Rising food prices were one cause; increases in administered prices of domestic fuels and in transport charges were others. In February 2007 inflation was 6.5%, and is expected to stay around 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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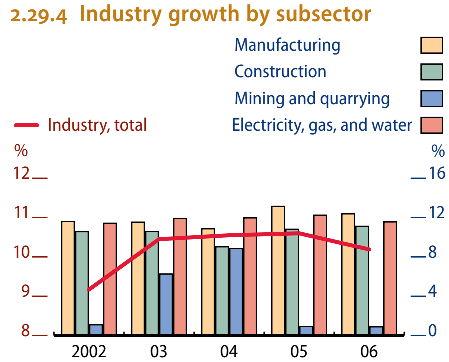
2.29.4 Industry growth by subsector



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

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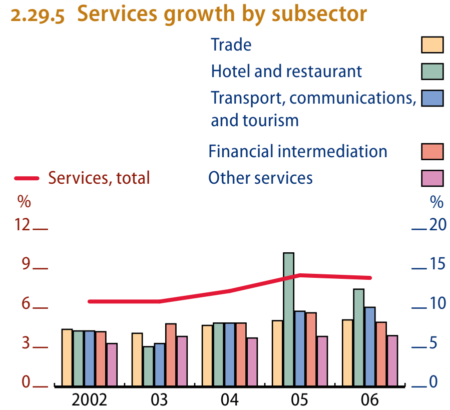
2.29.5 Services growth by subsector



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.

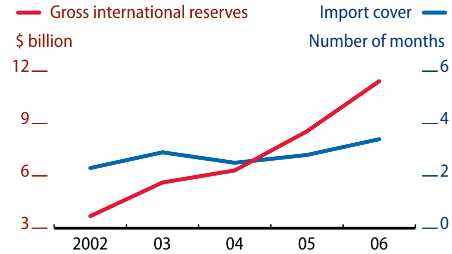
The growth of the private sector has been a significant feature of Viet Nam's economic development over the past decade. The nonstate sector accounted for more than half of GDP in 2006. Preliminary estimates show that private businesses generated almost 90% of the 7.5 million jobs created during the 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

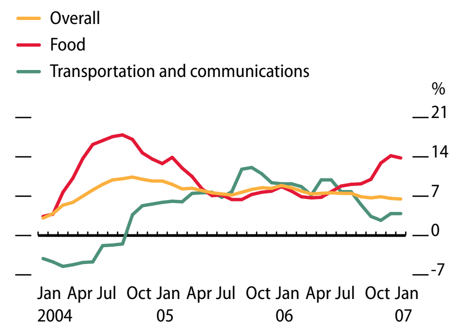
2.29.6 Reserves and import cover



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

Click here for figure data

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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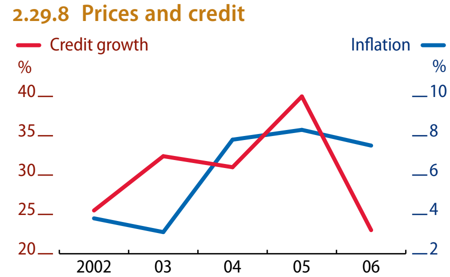
2.29.8 Prices and credit



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.

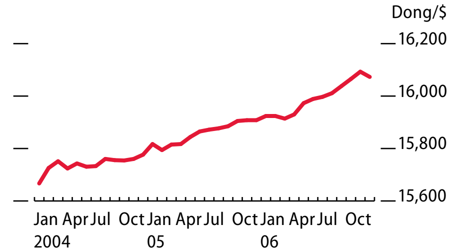
On these assumptions, the economy is predicted to grow by 8.3% in 2007 and 8.5% in 2008. Growth will be underpinned by strong private consumption, private investment, and FDI. Total investment as a share of GDP is projected to be about 40% in the next 2 years. Industry (projected to expand by 10.5%) 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.

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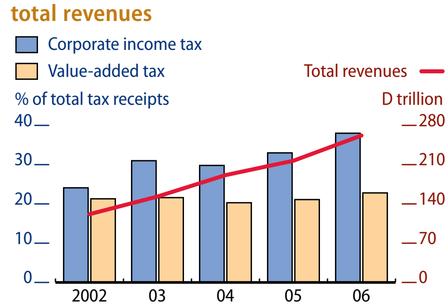
2.29.1 Selected economic indicators

	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.

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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.

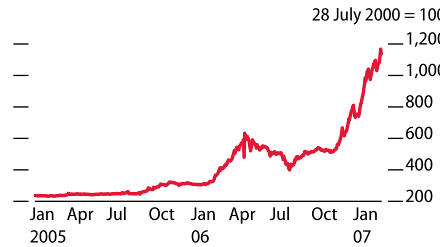
Development challenges

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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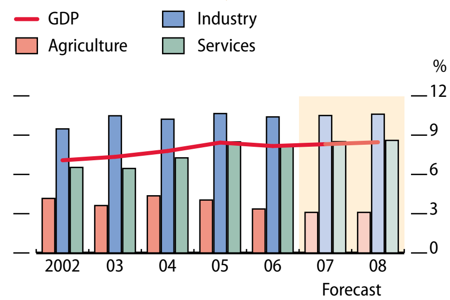
2.29.12 GDP growth by sector



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

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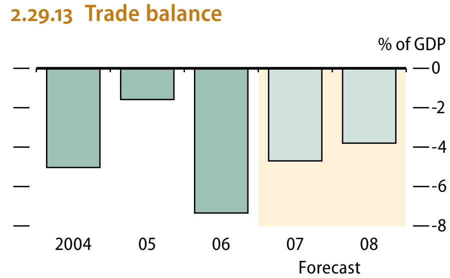
2.29.13 Trade balance



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

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