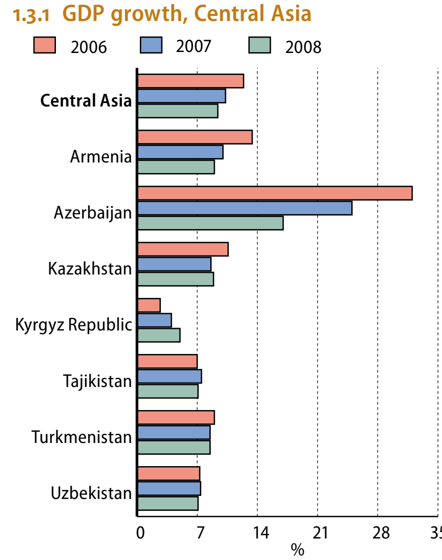
Subregional summaries

Central Asia

Subregional performance

Subregional growth in gross domestic product (GDP) was boosted by a favorable external environment as oil and non-oil commodity prices rose. GDP growth strengthened to 12.4% in 2006 (Figure 1.3.1), up from 11.2% in 2005, and from an average of 9.4% over 2000–2005. The hydrocarbon exporters—Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan—accounted for much of the growth. Most non-oil exporters also saw higher growth, benefiting from stronger non-oil commodity prices, and from workers' remittances from, primarily, Kazakhstan and the Russian Federation. Only the Kyrgyz Republic's growth was anemic.

1.3.1 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

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While vibrant external demand is the proximate cause of the growth upturn, domestic demand, in particular private consumption growth, has also been buoyant, stimulated by higher wages, remittances, and credit expansion. The rapid expansion in construction and services across the subregion is bifurcated, from the oil boom on the one hand, and from remittances on the other.

Strong domestic demand, together with rising net foreign assets, put upward pressure on prices and the money supply. Subregional average consumer price inflation rose slightly to 8% in 2006, with higher inflation reported in four countries (Tajikistan, Kyrgyz Republic, Kazakhstan, and Armenia) and a fall reported in two official estimates (Azerbaijan and Uzbekistan).

For countries that experienced higher inflation, contributory factors include wage and pension increases, higher food and fuel prices, and credit expansion. Azerbaijan's officially reported decline in inflation is at odds with alternative estimates that are more consistent with the last couple of years' surge in spending. Reflecting expansion in credit to the private sector and accelerating official reserves accumulation, broad money has grown strongly in several countries. Monetary tightening measures taken by central banks, including raising refinancing rates and reserve requirements, have not been very effective so far.

Fiscal positions showed diverging patterns as oil exporters' soaring revenues were used to ramp up public spending while the non-oil exporters' were accompanied by expenditure restraint. Azerbaijan and Kazakhstan pursued an expansionary fiscal policy, spurred by burgeoning oil revenues: Azerbaijan's non-oil fiscal deficit as a share of non-oil GDP in 2006 was estimated at an unsustainable 36%. Kazakhstan's

non-oil fiscal deficit was much lower. The saving factor (literally) was the large increases in net assets of the oil funds of the two countries. With improved tax collections and expenditure restraint, the Kyrgyz Republic and Tajikistan managed to improve their fiscal positions despite the severely constrained fiscal space they had to contend with, while Uzbekistan and Turkmenistan maintained a more or less balanced recorded budget. Of concern are the still sizable energy sector quasi-fiscal deficits in Azerbaijan, Kyrgyz Republic, and Tajikistan, that reflect weak public resource management and that narrow the fiscal space.

External performance reflected differing dynamics of trade and invisibles accounts. Large current account surpluses were recorded in Azerbaijan, Turkmenistan, and Uzbekistan, as commodity price-driven surges in export revenues outpaced imports. There was a notable slowing of import growth in Azerbaijan as hydrocarbon-related imports of machinery and equipment tapered off with the completion of a number of large projects. Kazakhstan's more modest current account surplus as a share of GDP was due to the sizable trade surplus being offset by hydrocarbon-related services and income payments.

On the capital account, hydrocarbon-related net foreign direct investment (FDI) inflows fell in Azerbaijan but picked up in Uzbekistan. Export growth recovered in the Kyrgyz Republic and accelerated in Tajikistan but slackened in Armenia. All three countries saw acceleration in import growth fueled by higher energy costs and strong remittance-driven growth in demand for consumer imports. Trade deficits were partially offset by strong remittance inflows in other accounts of the balance of payments.

On the financing side, net FDI covered around one third (Kyrgyz Republic) to one half (Armenia and Tajikistan) of the current account deficit. Gross official reserves across the subregion have grown. This has proved to be a mixed blessing in that the resulting thicker import cushion comes with pressure on money supply from surging foreign exchange inflows. This is problematic in an environment where, in many cases, sterilization options are limited. Among low income countries that depend largely on official concessional assistance, currently, external debt sustainability is a concern for the Kyrgyz Republic. Among countries with access to capital markets, Kazakhstan's external borrowing by private commercial banks has risen steeply.

The subregion has seen some headway on structural reforms in certain areas such as small-scale privatization, banking reform, and infrastructure reform but in other areas such as governance and enterprise restructuring, the reform backlog is significant. Several countries have continued to improve the private sector incentive framework by streamlining the tax regime (Kyrgyz Republic and Uzbekistan), competition law (Kazakhstan), and business registration and licensing (Armenia and Azerbaijan). Uzbekistan's slow steps in trade reform (both external and domestic) continues to be an impediment to private sector development.

Several countries took measures to tighten bank regulation and supervision. In addition, Tajikistan made tangible progress in deregulating foreign participation in banks, strengthening minimum capital requirements, and delicensing banks. Kazakhstan continued to

develop its securities markets and nonbank financial institutions. Areas to be looked at with renewed vigor include ownership transparency and related lending (Armenia), stalled bank privatization (Azerbaijan), and performance by banks of functions inappropriate for financial intermediaries (Uzbekistan).

With regard to sector reforms, in agriculture Uzbekistan continued to transform *shirkats* (farm cooperatives) into leaseholds, a contributory factor to reported higher productivity in the cotton subsector. In energy, Tajikistan undertook corporatization of the state electricity company and the formulation of a restructuring and unbundling strategy for the sector. Progress on public sector reform was mixed. While small-scale privatization has come on well (and is largely complete in several countries), large-scale privatization has made but a few, faltering steps. Corporate governance in public enterprises is also hobbled. Recent reform of the social protection system include improved social assistance targeting and pension reform (Azerbaijan).

Subregional prospects

Subregional growth is expected to remain strong with subregional growth at about 10% in 2007 and 2008. The external environment is likely to remain favorable even though oil prices are easing and non-oil commodity prices are softening. The subregion's hydrocarbon producers are expanding capacity that will meet higher demand from the larger Asian economies, particularly the People's Republic of China (PRC). Meanwhile, the hydrocarbon-importing countries now seem likely to get a respite from high oil prices. After a pause, hydrocarbon-related FDI inflows to the subregion's two largest oil producers (Azerbaijan and Kazakhstan) are likely to resume, while Uzbekistan is set to see a further pickup in FDI, particularly from the PRC and the Russian Federation.

Although non-hydrocarbon commodity prices are now softening, growth in demand, especially from the PRC, is seen sustaining export growth rates, while import growth rates could decelerate (as easing oil prices relieve pressure on trade balances).

Private consumption in the two big oil producers could moderate if domestic credit conditions tighten and greater wage restraint is exercised to check inflationary pressures. Private consumption in remittance-generating countries could remain strong if the pace of inflows keeps up.

Some downside risks are seen in: further surges in foreign exchange inflows, so creating excess liquidity and feeding through into very high inflation; deteriorating quality of loan portfolios as credit expansion continues unabated; tighter regulation of foreign migrants in the Russian Federation adversely affecting remittance inflows; worsening current account balances among oil-importing countries; and narrowing of fiscal space in countries with external borrowing constraints.

Country highlights

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 contained. A moderate deceleration in GDP growth to 9–10% is expected in 2007–2008 as production capacity limits are reached and the pace of expansion 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 subregional conflicts need to be resolved to allow closed trade routes to open.

Azerbaijan

Phenomenal economic growth at 32% was recorded in 2006, powered by soaring production and exports of oil and gas. Very rapid expansion in government spending and the money supply are putting increasing pressures on prices and inflation in the last quarter of the year accelerated to 11%. Oil and gas production from recent investments will continue to underpin remarkable growth projected at 25% in 2007 and 17% in 2008. 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.

Kazakhstan

Strong prices for oil and gas, rapid growth of domestic consumption, and a rebound in investment continued to propel the economy. Money supply grew by 80% over the year, fueled by a huge increase in credit to the private sector. GDP growth in 2006 was 10.6% and is projected to stay high at nearly 9% in 2007 and 2008. 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.

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, kept growth slow at 2.7% in 2006. The medium-term outlook, though positive, is clouded by governance concerns, a poor business climate, and political uncertainty.

Tajikistan

The economy expanded at 7% in 2006, despite higher costs of oil and gas. Burgeoning remittances spurred demand, as supply shocks from higher

oil, utility, and food prices pushed inflation back into two-digit territory. Implementation of large infrastructure projects and a favorable outlook for aluminum production (the dominant industry) should propel growth to 7.5% in 2007. Medium-term economic prospects are promising, if the expansion in externally financed infrastructure projects is supported by the broad development reforms.

Turkmenistan

The economy continued to grow rapidly in 2006, but the exact figure 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 unlikely to change soon. Growth in 2007 is seen coming in at 8.5%, little changed from a year earlier. The key development challenges are to effectively channel oil and gas revenues toward productive investment, implement market-oriented reforms, and rebuild human capital.

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 subregion, advance structural reforms in banking, restructure state enterprises, and remove state controls hindering private development. Economic growth in 2007 is projected at somewhat higher than 7%, a rate maintained for the past 3 years. Further diversification from commodities and energy would also help sustain growth.

Development challenges

Despite differences in resource endowments, in sources of growth, and in the pace of structural reforms, the countries of Central Asia face three main common challenges. First, all of them are undergoing transition-induced structural change. From overindustrialization before transition (as measured by industry's disproportionate share in employment), these economies are undergoing industrial restructuring that has entailed job destruction in old, inefficient state enterprises, and resource reallocation and job creation in new private firms. Some countries (e.g., Armenia) are quite advanced in the process of industrial restructuring, while others are still lagging. In the latter, a weak business environment is delaying the exit of inefficient state enterprises and new entry by private firms.

Second, much of the new industrial activity in the subregion involves the natural resource industries: energy (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan), gold (Kyrgyz Republic and Uzbekistan), aluminum (Tajikistan), and copper and other base metals (Armenia). On the positive side, the subregion's natural resource wealth has attracted FDI and spurred growth of related construction and services industries. The downside is that the subregion's share of skilled labor-intensive and capital-intensive manufacturing exports is on the decline. The subregion's policy makers recognize the inherent risks in being overly

dependent on natural resource-based industries, not the least of which is heightened vulnerability to price shocks. Economic diversification is therefore high on their agendas. The challenge is to pursue this within an industrial policy framework based on a level playing field, and on transparency and accountability.

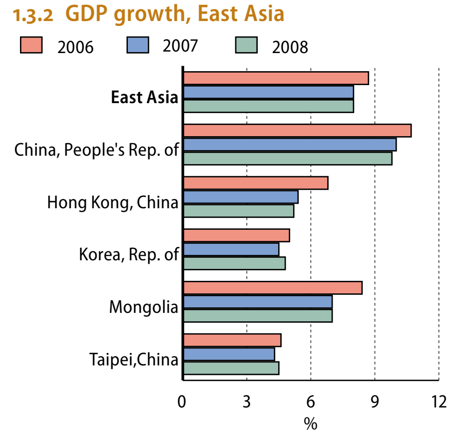
Third, surging foreign exchange inflows, whether due to oil revenues or remittances, are generating excess liquidity across the subregion. Thus far, the burden of mopping up the excess liquidity has fallen on central banks. Indeed in several cases, the fiscal stance has been part of the problem, not the solution. The challenge for policy makers is to pursue an effective strategy for price stability and enhance economic competitiveness.

East Asia

Subregional performance

A fourth consecutive year of double-digit expansion (10.7%) in the People's Republic of China (PRC) lifted aggregate subregional growth to 8.7% (Figure 1.3.2), easily exceeding the average of the previous 5 years. Buoyant demand for East Asia's manufactured exports helped underpin the growth acceleration: subregional exports grew by 19.0% in nominal terms (the PRC's by 26.0%). Net exports contributed significantly to GDP growth in the major subregional economies. Domestic demand also grew, with private consumption picking up in the PRC; Hong Kong, China; and Korea. However, private consumption decelerated in Taipei,China because of a tightening of consumer credit. Private investment strengthened in all those economies, as well as in Mongolia, which is attracting investment into mining. With a boost from the growth in exports, the subregional current account surplus vaulted to 7.0% of GDP, double the level of 4 years earlier. Inflation was low at 1.6% as generally favorable weather helped limit food price increases.

1.3.2 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

Measures taken over the past 2 years by PRC authorities to rein in fixed asset investment are expected to bite in 2007, trimming growth in that economy to about 10%. This will bring down aggregate growth to 8.0%. All the economies in the subregion are forecast to slow, but still achieve solid growth. External demand will soften as growth rates subside in industrial nations. Domestic demand will strengthen, though, in Hong Kong, China; Korea; and Taipei,China. In the PRC, consumption demand is projected to rise, providing some counter to the targeted reduction in fixed asset investment. The subregional current account surplus will be marginally lower than 2006. Inflation will stay around 2%, assuming normal weather patterns.

Country highlights

People's Republic of China

This economy expanded at a cracking 10.7% in 2006, the fastest rate in 10 years. Industry, including manufacturing and construction, was the main contributor, but services also grew robustly. On the demand

side, investment accounted for much of the growth, though net exports and consumption both made substantial contributions. Investment was driven largely by firms reinvesting profits into new industrial activity. The Government's efforts to restrain fixed asset investment pulled its growth down from about 30% in the first half of the year to 21% in the second. In particular, investment slowed sharply in industries that have built excess production capacity, such as textiles, coal mining, and electricity.

Faster growth in exports than imports boosted the trade surplus by $60 billion to $194 billion in 2006. Bilateral surpluses with the United States (US) and European Union (EU) surged, sparking trade friction and accusations of an undervalued yuan. The rising trade surplus, coupled with higher tourism receipts and interest income on the large official foreign reserves, boosted the current account surplus to 8.6% of GDP. Foreign direct investment (FDI) reached $69.5 billion and speculative capital flowed into property and stock markets. Foreign exchange reserves shot past the $1 trillion mark by year-end. In the job market, 11.8 million new jobs were created in urban areas last year, but millions of migrants from the countryside, new graduates, and laid-off workers still went without work. As a result of the excess capacity and strong competition in manufactured products, inflation moved down to 1.5%.

Steps taken to cool the economy included a raft of administrative measures to restrain investment, such as 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. Market-oriented tightening included five increases in the reserve-requirement ratio for commercial banks between mid-2006 and February 2007, and three hikes in the benchmark 1-year lending rate through March 2007. These measures moderated growth in domestic credit, but actual lending and broad money increased faster than targets set by the central bank. To ease upward pressure on the yuan from the surging trade surplus and strong capital inflows, the authorities allowed the currency to appreciate by 2.4% against the US dollar between July and December, a little faster than 0.9% in the first 6 months.

In 2007, the PRC's economic growth is projected to moderate to 10.0%. Growth of industry is forecast to edge down by about 1 percentage point to 11.0% because of significant oversupply in some sectors; slower growth in investment as a result of tightening measures; and easing export growth as external markets weaken a little. Agriculture is expected to benefit from a new official emphasis on rural development and services from higher incomes, both of which should maintain growth in private consumption.

Responding to various restrictions, especially those targeted at energy use and pollution, and others curbing property speculation, fixed investment growth is forecast to decelerate to 20%. 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. Import growth will ease to about 18% 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, and the

current account surplus will increase further. Inflation will likely stay below 2% in 2007. Over the next 5 years, GDP growth is expected to average about 9%.

Hong Kong, China

This economy grew robustly by 6.8% in 2006, a third successive year of above-trend growth, though the rate decelerated from the previous 2 years. Domestic and external demand supported this performance. Closer links with the booming PRC benefited the economy in several ways: most importantly through reexports of PRC goods, and through now-substantial financial services exports to the PRC. (Services account for more than 90% of the economy's GDP.) In 2007, GDP growth is projected to come down to 5.4%, given the expected slowing in the PRC and US economies. Consumer spending is expected to strengthen on the back of generous budget givebacks announced in early 2007. Inflation is seen easing from 2.0% to 1.6% in 2007 as budget initiatives exert downward pressure on prices.

Republic of Korea

Growth accelerated to 5.0% in 2006, the fastest rate in 4 years. It was spurred by a recovery in domestic demand and strong exports, though momentum slowed over the course of the year. Private consumption posted the best rate of expansion since the credit-card crisis of 2003. The recovery broadened with a pickup in capital investment as companies invested in machinery and equipment.

This year is likely to see a continued expansion of investment in manufacturing, joined by greater housing investment. Private consumption growth, weighed down by high levels of household debt, is expected to continue, albeit at a moderate pace. However, growth in exports will ease as a consequence of the slowdown in the US. Rapidly rising imports, driven in part by demand for overseas travel and education, will halve the contribution of net exports to growth. The economy is forecast to grow by 4.5% this year, a half percentage point down from 2006. Inflation will inch up to 2.4% from 2.2%, reflecting the strengthening domestic demand.

Mongolia

This narrowly based economy depends heavily on agriculture and mining. But as the winter was mild and copper and gold prices were high in 2006, the economy performed well. GDP growth rose to 8.4%, marking the fourth straight year of 6%-plus expansion. Growth is forecast to decelerate in 2007, since mineral prices are expected to stabilize, the rate of economic expansion in the PRC (Mongolia's main export market) will be tempered, and livestock growth rates will likely slow. Inflation, which often runs at relatively high levels in this economy, receded to just over 5% in 2006, but will come in a bit higher in 2007.

Taipei,China

On the back of stronger exports, the economy accelerated in 2006, recording growth of 4.6%. Exports of optical equipment, electronics, and machinery gained from the stronger international trade environment.

Domestic demand was subdued for most of the year, damped by a tightening of consumer credit that followed the bursting of a credit-card bubble in late 2005. This year, consumption and investment demand are expected to pick up, cushioning the economy from an expected slowdown in external demand. On balance, that will leave GDP growth slightly below last year's pace, at 4.3%. Inflation will remain at low levels (1.6% in 2007 compared with just 0.6% in 2006).

Development challenges

East Asia faces various challenges. In the PRC, concerned that rapid industrial and export-led growth has caused imbalances in the economy, the authorities aim to rebalance the economic structure. This will involve, on the demand side, reducing reliance on investment and exports for growth in favor of private consumption, and on the production side, a shift from industry-led growth to more emphasis on services. Planners view economic rebalancing as a social, as well as economic, objective. This policy has evolved over several years, but progress is slight: the dependence of growth on external demand is still high; the surge in investment and commercial bank lending has not yet been brought under control; and the share of gross capital formation in expenditure-based GDP rose in 2006, while that of consumption fell. Furthermore, the share of services in total GDP remains low, and actually declined in 2006. Environmental protection targets were not met, either.

On social metrics, income inequalities in the PRC have worsened and unemployment and underemployment have become serious concerns for policy makers. The Government is trying to steer policies in directions that will gradually achieve a rebalancing, while maintaining high enough rates of economic growth to absorb large numbers of people moving to the cities in search of higher living standards.

Korea faces the challenge of raising services productivity, since lagging productivity is holding back improvements in the labor market and damping consumption growth. This reflects, in part, incomplete structural reforms in services and, more broadly, in the labor market.

For its part, Taipei,China needs to nurture new sources of economic growth, given that much of its labor-intensive manufacturing has migrated to the PRC. Services firms in Taipei,China are mainly oriented toward the domestic market. The challenge is for manufacturers to move further up the value chain and for services firms to turn outward for expansion.

One challenge facing Hong Kong, China is how to broaden the tax base. It must also attend to environmental issues and an aging population. Perhaps the biggest test is to maintain the high institutional standards that support its financial services industry at a time when these services are increasingly tied to mainland companies that have operated according to different standards.

Mongolia, at an earlier stage of development than the other economies, still confronts a poverty incidence estimated at nearly one third. An important challenge is to use government revenues from mineral resources to set the country on a sustainable development path, while addressing social and environmental problems.

South Asia

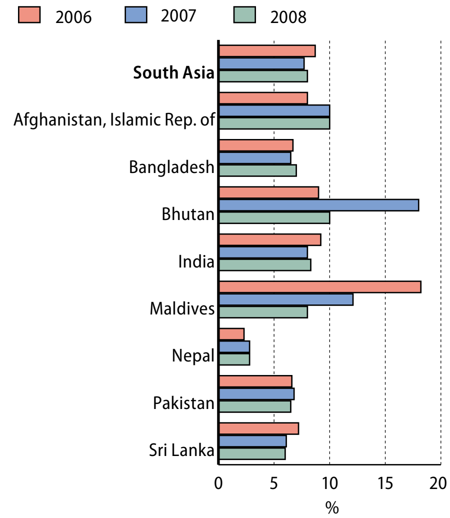
Subregional performance

South Asia's GDP grew by 8.7% in 2006 (Figure 1.3.3), the second year above 8.5%, having averaged more than 7.5% a year growth since 2003. The GDP of nearly every country in the subregion grew at over 6.0% in 2006. India turned in the highest growth rate of 9.2% among the large economies and the Maldives grew at 18.2%, fastest among the small economies. The services sector contributed most to growth in South Asia, but industry sector growth accelerated in India and Bangladesh, buttressing the sustainability of high growth rates in the future. High levels of consumption and investment boosted growth rates. Domestic demand expanded because of rising incomes, credit expansion, and strong workers' remittances. World economic expansion kept external demand strong fostering export growth, while an improved business climate attracted increased domestic private investment and foreign direct and portfolio investment, both reaching the highest historical levels in the large economies.

Demand pressures and high world oil and commodity prices led to an increase in the subregion's inflation rate to 6.0% in 2006. Inflation picked up in Bangladesh, India, and Nepal, but came down in Pakistan and Sri Lanka (though from much higher levels). Despite several central banks' monetary policy measures that increased nominal interest rates to tighten liquidity, rising inflation rates kept real interest rates low. Simultaneously, government budget deficits remained at elevated levels to reinforce credit expansion, partly because of the increased subsidy to buffer rising oil prices, reconstruction efforts following natural disasters, and high development expenditures.

South Asia's current account deficit increased marginally in 2006 to 2.1% of GDP. Although merchandise exports grew at a robust rate of 18.8%, imports grew at an even higher rate of 24.9%, induced by domestic demand pressures and high world commodity prices. Exports of services and the surge in workers' remittances brought the current account to a narrow deficit. The subregion's foreign exchange reserves increased because of large net capital inflows. Real effective exchange rates remained stable.

1.3.3 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Subregional prospects

Economic growth in developed countries is expected to slow in 2007 and stage a modest recovery in 2008. The world price of oil and other commodities is likely to fall. With this backdrop, South Asia's prospects still remain bright due to strong domestic demand and investment. Nevertheless, regional economic performance is likely to modulate in step with developed-country trends, though at robust levels of GDP growth of 7.7% in 2007, rising to 8.0% in 2008. Larger countries in the subregion are forecast to maintain high rates of growth, with India averaging about 8% a year and Pakistan and Bangladesh around 7% a year over the next 2 years. GDP growth in the smaller countries over the same period is likely to be varied, ranging from yearly average growth rates of 14% in Bhutan to 3% in Nepal. The services sector is anticipated to lead economic growth, backed by accelerated growth in manufacturing.

Monetary policy measures taken in 2006 by several countries are likely to curb credit growth to the private sector for consumption and investment, reinforcing sluggish demand from developed countries. Moreover, improving fiscal balances resulting from increased tax revenues and lower subsidies to buffer high oil prices are also expected to rein in credit growth to the public sector. These developments will probably dampen the pace of economic growth and reduce the subregion's rate of inflation to about 5% a year during 2007 and 2008.

Despite the reduction in world commodity prices, South Asia's growth of merchandise imports is likely to outstrip exports because of high regional growth rates and lower demand in developed countries. Vigorous growth in exports of services and workers' remittances is expected to substantially compensate for the trade shortfall, leaving the current account with small deficits of about 2% of GDP for the next 2 years. High growth rates in the subregion will continue to attract large capital flows. Countries are likely to add to their international reserves and maintain stable exchange rates.

Country highlights

Islamic Republic of Afghanistan

In the licit economy, economic growth slowed to 8.0% in 2006 as agriculture was hit by another drought, while reconstruction-linked construction and services continued to expand. Growth is expected to recover to 10% in 2007, assuming normal rainfall.

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 in 2006. Since current, licit, drivers of growth cannot provide sustained growth, creating a private sector enabling environment and diversifying the economy remain crucial tasks.

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 in January 2007 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.

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 and grow by 6.5% in 2007. Inflation, which has trended upward in recent

years, is expected to keep inflation in check at 7% by a tightened monetary policy.

Bhutan

The huge Tala hydropower project started commercial production in July 2006 boosting GDP growth for the year to 9.0%. Tala is forecast to double electricity export capacity, boosting GDP growth to 18% in 2007, raising government revenues significantly and pushing the current account into surplus. This is all highly beneficial, however, the employment elasticity of hydropower is low and has little impact on creating jobs for the many tens of thousands of young people entering the labor market or migrating to urban areas. While some progress has been made, Government policies need to stimulate further greater private sector activity and to diversify the economy.

India

Two years of above-trend growth at around 9% 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, since 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 as growth is expected to decelerate smoothly to 8% in 2007.

Maldives

The economy took a downturn in 2005, largely due to the impact of the December 2004 tsunami but growth rebounded sharply in 2006 as tourist arrivals essentially reached their earlier peak level. However, the Government's expansionary fiscal policy adopted in response to the disaster, building on long-standing structural issues, is worsening the fiscal indicators. This deterioration could threaten long-term prospects. Nevertheless, tourism is expected to expand further in 2007 and growth is projected at 12.1%.

Nepal

Economic growth in 2006 remained hobbled at 2.3% 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.

Pakistan

Buoyant growth, improved macroeconomic fundamentals, and strengthened international credit ratings have been the economy's hallmarks in recent years. In 2006, high oil prices, a weak agricultural performance, as well as the effect of the October 2005 earthquake, trimmed the expansion to 6.6%, while strong demand-side pressures have exposed macroeconomic stresses.

The economy is expected to pick up slightly in 2007 to grow by 6.8%, reflecting some strengthening in agriculture and manufacturing. Inflation is set to moderate to 7.0% (from 7.9% a year earlier), after a further tightening of monetary policy, but still come in above the central bank's target (6.5%). Spurred by an expansionary, pro-growth fiscal policy, the budget deficit will widen slightly (to 4.5% of GDP), as will the current account deficit (also to 4.5% of GDP). The medium-term outlook remains positive, but macroeconomic stability has to be maintained and structural issues addressed.

Sri Lanka

Despite resurgence of the civil conflict, the impact of the Asian tsunami, and near doubling of oil prices since 2004, the economy in 2006 grew at 7.2%, its fastest rate since 1978. This strength was fueled by buoyant private activity and expansionary macroeconomic policies that, though, accelerated Colombo consumer price inflation to 20.5% by January 2007. Growth is forecast to moderate to 6% 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.

Development challenges

South Asia's recent economic performance shows it can match East Asia's growth rates. To sustain this accelerated growth, the subregion faces challenges and opportunities at global, regional, and country levels. Although the world price of oil is expected to decline somewhat with the slowdown of the US and EU economies, it may not happen because of political developments in the Middle East. The earlier oil price hike hit South Asian economies hard, imposing a burden of about 20% of export earnings. Moreover, governments shielded their economies from the full impact of rising prices with subsidies, which are unsustainable. South Asia needs to develop an energy policy aimed at reducing demand, supporting the expansion of local energy supplies, and developing

regional distribution networks that allow cost-effective transfers of power and gas among countries.

Growing global payments imbalances pose a risk to South Asia as a disruptive correction could abruptly check capital flows, increasing the cost of funds, and possibly deflating the ballooning asset prices in the subregion. To buffer such an eventuality, reforms of the subregion's financial systems, which started in the early 1990s, must continue apace, especially in the inefficient public sector banks that still predominate in several countries.

The incomplete pass-through of oil prices implies that inflationary tendencies remain suppressed throughout the subregion. If domestic demand pressures are not successfully checked by tightening monetary and fiscal policies, inflation and the current account deficits could rise to acute levels. Macroeconomic policies therefore have to be carefully crafted to sustain economic growth and maintain price stability to insure the regional economies a soft landing.

Moreover, the structural policy reforms that have spurred recent private sector-led growth should continue with emphasis on reducing barriers to employment growth that would alleviate poverty. In South Asia, the agriculture sector provides the most employment, but falling levels of public investment, deterioration in support services and inappropriate output pricing, marketing and subsidy policies in several countries have led to erratic performance.

As industrial growth is picking up, policies that improve the business climate and infrastructure are needed to sustain that accelerated pace. Despite recent liberalization policies, South Asia's regulations for industry, trade, labor, finance and taxes are limiting its growth and employment potential. A recent analysis concluded that improving these regulations to the level of Thailand would generate additional GDP growth of 0.8% in Bangladesh and Pakistan, and 1.6% in India. Electricity, water, road, rail, airports, and port services are poor throughout the subregion. Improvements within every country and in intraregional connections would yield substantial dividends by reducing costs of production and trade.

India accounts for 80% of South Asia's GDP, and so its accelerated growth can benefit the subregion by policies to integrate regional economies. South Asia has not done well in integrating with the rest of the world and, although steps for regional integration have been taken, the subregion is still far behind Southeast Asia on both counts, achieving only about one fourth of its total trade to GDP and intraregional trade penetration levels.

Through integration, enhancing efficiency and improving product quality offers immense opportunities for sustaining rapid growth and reducing poverty. As India shares borders with most South Asian countries, it could be the hub for expanded trade and investment for goods and services in the subregion. Obstacles to intraregional trade remain high, but can be overcome by following the example of the ASEAN group of countries, which eliminated nontariff barriers, reduced tariffs, and simplified and harmonized customs procedures.

Southeast Asia

Subregional performance

The economies of Southeast Asia expanded by 6.0% in aggregate in 2006 (Figure 1.3.4), above the average growth of the previous 5 years. Most countries grew at a faster rate than in 2005, reflecting strong external demand, supportive monetary conditions, and for some, the beneficial impact on agriculture of favorable weather conditions for most of the year.

For the subregion, export growth accelerated to nearly 18% in nominal terms, with exports from Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam rising at faster rates than this. Exports from several economies were boosted by the upturn in global demand for electronics (Malaysia, Philippines, Singapore, and Thailand), others from high prices for oil or natural gas exports (Indonesia, Malaysia, Myanmar, and Viet Nam), and many gained from high prices of agricultural commodities, such as natural rubber and palm oil. Agricultural production also benefited from favorable weather conditions, although floods and typhoons had an adverse impact for parts of the year in Philippines, Thailand, and Viet Nam.

Economic growth in general was supported by ample domestic liquidity, reflecting buoyant inflows from the external balance of payments. Central banks' accommodative monetary policies also kept liquidity flush in several countries. Fiscal policy was more mixed: the general bias was to maintain fiscal consolidation, even if some governments began to shift more of their budgets to development expenditures.

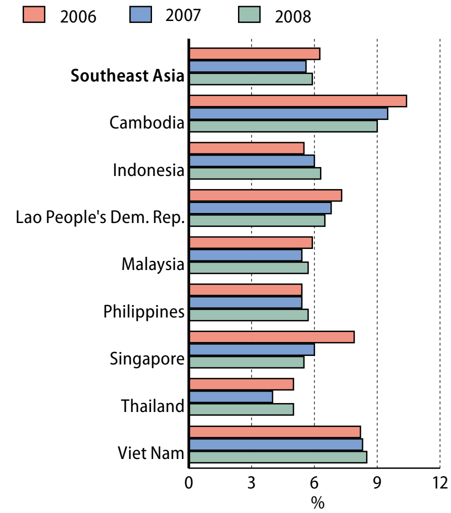
As exports surged, current accounts strengthened across the subregion. Furthermore, investment was weak in Indonesia, Philippines, and Thailand, which moderated growth of imports. Southeast Asian inflation averaged 7.1% in 2006, up from 6.3% the previous year. The average was raised by high 13.1% inflation in Indonesia—the biggest economy in Southeast Asia—which saw price pressures surge from late 2005 when the Government reduced subsidies on fuel.

Subregional prospects

Growth is projected to slow modestly to 5.6% in 2007, primarily reflecting the likely softening in some major export markets. Only in Indonesia and Viet Nam is growth projected to be higher this year. Inflationary pressures are forecast to subside significantly (to average 4.2%) on the expectation of a moderation in world fuel prices and appreciation of subregional currencies.

The aggregate current account balance for the subregion as a whole is projected to deteriorate slightly. The deceleration in growth of global trade and the expected easing of some commodity prices will contribute to lower export growth. Imports are likely to record a solid expansion despite the expected decline in world fuel prices, as investment is set to pick up, especially in Indonesia. Continued buoyancy of remittances from overseas workers and in tourism receipts should provide support to current accounts in several countries.

1.3.4 GDP growth, Southeast Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Country highlights

Cambodia

Consolidating rapid growth over the previous 2 years, the economy expanded strongly by 10.4% in 2006, reflecting strong clothing exports, tourism receipts, and construction activity. Forecast growth averaging just 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 FDI, and greater government capital spending.

Indonesia

Moderate economic growth of 5.5% 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. Economic growth is expected to pick up by a half percentage point in 2007, supported by greater development spending and some improvement in the poor investment climate. If the Government can accelerate reforms, it could pave the way for a significant lift in investment and a boost in growth, which in turn would make headway in job creation and poverty reduction.

Lao People's Democratic Republic

Foreign investment in hydropower and mining, together with rising exports of minerals in 2006, continued to drive double-digit expansion in industry, the major contributor to the GDP growth rate of 7.3%. Inflation slowed to levels not seen for 12 years. Economic growth is projected to decelerate moderately this year to 6.8%, mainly because export markets and mineral prices will not be as strong as in 2006.

Malaysia

Consumption spending produced a pickup in growth to 5.9% 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 increase substantially.

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, which returned to double-digit levels and could go higher.

Philippines

Achievements included another year of moderate economic growth (5.4%), 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, growth 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.

Singapore

Growth in 2006 hit 7.9%, well above the economy's trend rate for a 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 of 6.0%. Closer links with global economic networks and structural reforms have contributed to the healthy performance, but also led to widening income gaps.

Thailand

Strong exports drove a pickup in economic growth to 5.0% 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 of 2006, paving the way for the central bank to start lowering rates early in 2007. Economic growth is projected to slow to 4.0% this year, and the outlook for 2008 depends heavily on elections being held and on the incoming Government providing a clear and credible economic program.

Viet Nam

This economy maintained a rapid rate of growth in 2006, estimated at 8.2% according to the Government. It was supported by robust exports, rising consumption spending, and strong investment. Inflation also stayed high, averaging 7.5%. Membership of the World Trade Organization from January 2007 has added impetus to development and market-oriented reforms. Provided that further progress is made on structural reforms, brisk growth of just over 8% is projected this year and next.

Development challenges

Southeast Asian economies face a number of challenges to sustainable growth, social development, and poverty reduction. While countries across the subregion have improved their fiscal performance, spending on social and physical infrastructure has lagged. In Indonesia, Malaysia, and Thailand, where debt ratios are at manageable levels, fiscal policy has more scope for increased expenditures on social and physical infrastructure. In the Philippines, although progress in fiscal consolidation has been significant, the debt level remains high and, consequently, the shift toward development expenditures is likely to be more gradual.

Recent success in raising revenues as a share of GDP in the Philippines and the smaller economies of Cambodia and the Lao PDR needs to be prolonged to ensure that these governments achieve an adequate level of public spending on development.

Institutional reforms to reduce the costs of doing business and to improve the investment environment remain a challenge in most of

Southeast Asia's economies. Optimism in financial markets is yet to spill over into the real sector in Indonesia and, especially, the Philippines where investment has declined as a share of GDP in the past few years. Key priorities should be improving the provision of infrastructure, chiefly power, water, and transport, including an adequate regulatory framework for private sector participation; reducing the costs of complying with regulations in customs, trade, and (particularly in Indonesia) labor markets; and enhancing the delivery of public services.

Concerns caused by decentralization in Indonesia and political uncertainties in Thailand underscore the importance of ensuring predictable policies on which investors can base long-term decisions. Malaysia and Thailand need to enhance the skills of their workforces to move up the value-added chain in production. In Viet Nam, where investment is high as a share of GDP, the key challenge is to raise the efficiency of capital, with reforms of state-owned enterprises and banks, development of capital markets, and regulations to ensure transparency and accountability.

Among the smaller economies, Cambodia's main challenge is to diversify its sources of growth, given the economy's high dependence on clothing and tourism. Reforms in agriculture, notably in land management, as well as legal and judicial moves to improve the environment for private sector activity, are key priorities.

The discovery of apparently significant oil and gas reserves has raised the prospects of substantial revenues for the Cambodian Government in the medium term. These revenues could provide a much-needed boost to social spending and infrastructure. However, appropriate policies to guard against the "natural resource curse" and to enhance transparency and accountability in the use of these resources need to be put in place. Similar policies are necessary in the Lao PDR and Myanmar, which also benefit from large receipts from natural resources. They, too, have a need to promote the development of agriculture and rural small businesses to lift more people out of poverty.

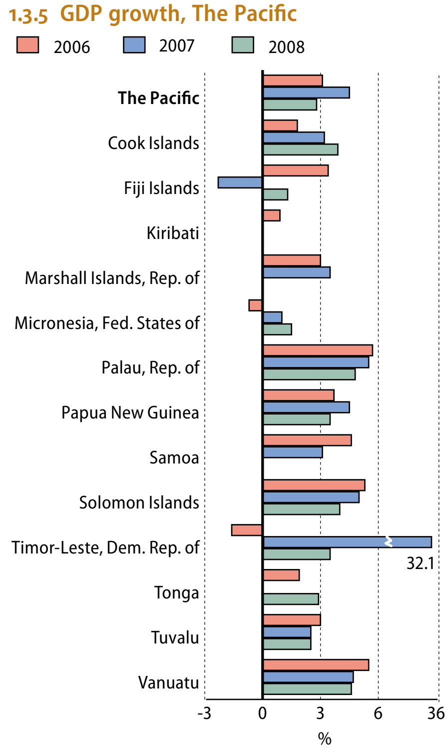
Vulnerability to natural disasters and the rising incidence of communicable diseases, such as avian flu, pose another important challenge to subregional economies. This underscores the importance of building into the planning and budgeting processes precautions to mitigate the effects of natural disasters and to manage them once they occur. Information dissemination and putting in place measures for prompt action are also important to curtail the spread of communicable diseases.

The Pacific

Subregional performance

Aggregate economic growth in the Pacific islands was a modest 3.1% in 2006 (Figure 1.3.5), improving from average growth of about 2% over the previous 5 years. Stronger growth in the two biggest Pacific economies—Papua New Guinea and Fiji Islands—lifted the subregional aggregate. In terms of numbers of economies, however, growth picked up in only half of them, and two economies—the Federated States of Micronesia and Timor-Leste—contracted.

1.3.5 GDP growth, The Pacific



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

Where gains in growth were achieved, they mainly reflected contributions from favorable mineral and commodity prices, aid flows, income from fishing license fees and tourism, and receipts from trust funds. High prices for natural gas and oil assisted the energy exporters, Papua New Guinea and Timor-Leste, but also strained the external balances and put upward pressure on inflation in other countries.

The subregional inflation rate accelerated by about 1 percentage point to 3.3%.

Subregional prospects

Aggregate growth is forecast to rise to 4.5% this year, essentially because Papua New Guinea's expansion will strengthen further while Timor-Leste is projected to rebound from recession. However, the economy of the Fiji Islands is likely to contract in 2007, and growth will slow in about half the Pacific economies. External conditions are mostly favorable, so that tourism receipts, export revenues, remittances, and incomes from trust funds should be reasonable. The outcome for some countries will depend partly on fishing license fees and farm production, which are affected by weather conditions.

In a subregion where the climate for private sector development is generally unfavorable, countries that create more hospitable conditions for the creation of small and medium businesses are likely to be rewarded with stronger performances in growth and employment generation. Subregional inflation in 2007 is forecast to edge higher to 3.5%.

Country highlights

Fiji Islands

Growth rebounded to 3.4% in 2006 because of a pickup in sugar production, expansion in construction, and growth in services stimulated by consumption demand. However, exports were weak and the current account deficit widened, placing pressure on foreign reserves. The country's gold mine closed late in the year. Even before the Government was removed from office by a military coup in December, the outlook for 2007 was a concern because fiscal pressures required a reining-in of the public sector. After the coup, several donors suspended most new aid proposals. Tourist arrivals are expected to fall. Recession is now forecast for this year, followed by a modest recovery.

Papua New Guinea

Rising global prices for export commodities and strong supply responses from the agriculture and minerals sectors lifted economic growth to 3.7% in 2006. Formal private sector employment rose by nearly 5%. The outlook is for faster expansion of 4.5% this year, based on stronger mineral production and construction activity. The agriculture, forestry, and fisheries sectors are also expanding, which benefits a broad span of the population, given that the minerals sector is not labor intensive. Inflation is expected to remain moderate at about 3%, if sound fiscal and monetary policies remain in place. Moving to higher levels of growth requires the resolution of problems of law and order, poor infrastructure, and inadequate service delivery.

Democratic Republic of Timor-Leste

Revenues from oil and gas surged in 2006, increasing the national petroleum fund and foreign reserves. However, non-oil GDP is estimated to have contracted, after an extended outbreak of civil unrest. A sharp rebound in non-oil GDP is projected this year, based on increased spending by the Government and by international personnel deployed in the country for peacekeeping and to assist in elections. Growth could get a further boost from additional funding for infrastructure from the United States Millennium Challenge Account. This will also require an improvement in the public sector's ability to execute budget projects.

Small Pacific countries

Republic of Palau, Samoa, Solomon Islands, and Vanuatu recorded relatively high growth in the range of 4.6–5.7% last year. Palau's high growth was supported by tourism and donor-funded large capital projects. In Samoa, expansion was led by construction and services, buttressed by remittances. Solomon Islands overcame the impact of civil unrest to record stronger growth. Log production, fisheries, and palm oil contributed. Vanuatu's expansion was supported by tourism-related services. These four economies are forecast to register slightly lower growth rates in 2007.

The Republic of Marshall Islands and Tuvalu grew by 3.0% last year. In the Marshall Islands, the United States Compact grant was the main source of income, and much of it went into infrastructure and public sector employment. The Tuvalu economy was bolstered both by increased public expenditures on higher inflows of aid, and by remittances and offshore earnings.

The Cook Islands and Tonga experienced disappointing 2006 growth of just under 2%. Lower production in agriculture and a decline in construction hurt the Cook Islands, but the economy will pick up in 2007. Tonga was weakened by a poor season for the squash crop, slower construction activity, and civil unrest late in the year. In 2007, Tonga's economy is expected to be flat, as reductions in the public service and damage caused by the unrest are offset by the start of urban reconstruction. Nauru's economy is forecast to contract this year because of public sector cuts. In the Federated States of Micronesia, economic activity contracted last year partly because aid was reduced, but a resumption of growth, at low levels, is forecast for this year. Growth in Kiribati, which depends heavily on Government spending, faded to less than 1% in 2006.

Civil unrest

Last year will be remembered in the Pacific islands for outbreaks of civil and political unrest. The underlying causes—including high levels of youth unemployment—in most cases remain to be addressed.

The first civil unrest for 2006 broke out in Solomon Islands. Following general elections in April, riots erupted in the capital, Honiara, in reaction to the announcement of the new prime minister. Serious damage to property was sustained in the Chinatown area. The Regional Assistance Mission to Solomon Islands, established in 2003 as a Pacific Islands Forum initiative, was reinforced with police and army personnel,

and law and order was quickly restored. Subsequently, the military component of the Regional Assistance Mission was scaled down and urban reconstruction commenced. In Timor-Leste, civil unrest began in the capital Dili in April and continued for some months. About 2,200 houses were burned. The Government requested external assistance and more than 2,000 international personnel were deployed. This restored a degree of stability.

In the Fiji Islands, tensions between the Government and the military became evident by October. The open threat of a coup by the military caused international concern. Australia and New Zealand made evacuation plans for their citizens. On 5 December, the Government was removed in a coup led by the military commander, who subsequently presided over the establishment of an interim government. Several donor countries suspended most new aid proposals.

In Tonga, a pro-democracy demonstration in November sparked a riot that led to burning and looting of many businesses in the capital Nuku'alofa, and the loss of life. Again, law and order was quickly restored with external assistance. But in Tonga, and more generally in most countries that experience such civil unrest, political and social divisions usually deepen, and business confidence is undermined.

The impacts are being felt differently in the affected countries, and the speed of recovery will be varied. In general, countries with mineral resources and sufficient foreign reserves are better insulated from the adverse impacts. Solomon Islands and Timor-Leste fall into this category. Fiji Islands and Tonga face more severe fiscal constraints and some of their industries are in decline. Any continuance of unrest could severely affect such economies, particularly impacting key income-generating sectors, such as tourism and foreign investment.

Development challenges

The challenge for the majority of the Pacific island governments is to facilitate private sector-led and more self-reliant economies that can generate employment. Constraints to private development include governance problems, policy uncertainty, investment restrictions, and traditional communal land ownership.

Regional initiatives like the Pacific Plan, approved in October 2005 and endorsed by 13 Pacific island governments, will support development objectives of the national authorities. The Pacific Plan pursues the goals of sustainable development, economic growth, and good governance, and an action plan has been formulated to achieve these goals. However, the subregion is struggling to implement many of the proposals, partly because of limited public service capacities.

There is a risk that countries with mineral resources come to depend on incomes from exporting those resources, and neglect sectors such as agriculture and small and medium business development. Global prices for energy and minerals are not guaranteed to remain at high levels. Moreover, resources are depleted over time. Sustained growth cannot be based solely on exports of minerals. Implementing structural reforms, sustainable fiscal policies, and prudent monetary policy will be necessary to facilitate faster economic growth and to generate employment.