



Cambodia

The ending of the Multifibre Arrangement will slash economic growth in 2005 from the estimated 2004 pace, and although growth will pick up in 2006 and 2007, it will not be by much. Against this backdrop, the Government faces the tasks of creating an environment for the private sector to play a greater role, and of raising revenues to promote development.

Macroeconomic assessment of 2004

GDP growth for 2004 is estimated to have strengthened to 6.0% from 5.2% in 2003, underpinned by a pickup in industry and a recovery in services. Industrial output is estimated to have grown by 16.9%, due mainly to a 25.0% rise in the textile, apparel, and footwear subsector as stronger world trade and a higher quota allocation by the US lifted garment exports. The services sector experienced robust 7.3% growth owing to a 30.0% increase in activity in restaurants and hotels, following a rebound in tourism from 2003 levels when the SARS outbreak and anti-Thai riots hurt visitor arrivals. In contrast, the agriculture sector is estimated to have contracted. Data for paddy production indicate a drought-induced decline of 3.7% in the dry-season crop and an 18.4% decline in the wet-season crop. In addition, agriculture was adversely affected by avian flu in the poultry industry, a smaller fish catch due to a lower Mekong river level, and the base effect of a large crop in 2003.

Although Cambodia has made important socioeconomic gains over the past decade, poverty remains widespread and intense: 35–40% of the population are below the poverty line and inequality appears to be widening. Relatively robust growth in the recent past has not led to a significant reduction in poverty, and achieving many of Cambodia's Millennium Development Goals will be difficult. The challenge of reducing

poverty has become more daunting with the expected sharp downturn in the economy caused by the ending of the Multifibre Arrangement (MFA) at the start of 2005.

During the first 11 months of 2004, government revenues and expenditures came in at 88% and 76%, respectively, of the target for the period. However, compared with the year-earlier period, revenues strengthened by 15% due mainly to a 25% rise in tax collection. This was a result of measures introduced in late 2003 to increase excise duties, and one-time factors such as revenues collected from an amnesty for the registration of cars not previously registered and taxed. However, nontax revenues fell by 5% because of collection difficulties. Total outlays during this period edged up by 0.5% from the previous year's level. Current expenditures rose by 6%, reflecting an increase in wages, whereas outgoings on nonwage operating costs and social transfers remained subdued. Despite efforts to push up priority social spending, cash shortages again caused delays in disbursements in this area. Capital expenditures fell by 8%, as those financed from domestic sources were constrained by the need to repay arrears to domestic suppliers.

Broad money (M2) growth in 2004 virtually doubled to 30.1% from 15.3% in 2003. The main reason for the increase was a rise in net foreign assets of the banking sector, reflecting an improved overall balance on the external account and robust growth in credit to the private sector.

Mindful of the shallowness of the market and that exchange rate policy has a limited impact on competitiveness, the central bank continued to intervene in the currency market to stabilize the exchange rate, which remained broadly stable at KR4,019/\$1 during 2004.

On a year-on-year basis, inflation rose steadily to 5.6% in December 2004 from 0.5% 12 months earlier, giving annual average inflation of 3.9% for 2004, up from 1.2% in 2003. Higher inflation was caused by upward pressure on transportation costs from elevated world oil prices and drought-related food price increases.

Merchandise exports grew by 21.8% to \$1.7 billion and imports by 22.4% to \$2.2 billion in the first 9 months of 2004. Exports were boosted by robust growth in garments and in rubber as world prices of the commodity rose. The increase in imports was driven by a rise in imported inputs to the export-oriented garment industry, and the higher cost of petroleum imports. Reflecting a higher base, import growth offset that in exports and led to a widening of the trade deficit to \$495.0 million in January–November 2004 from \$398.8 million a year earlier.

A larger net services surplus on account of the recovery in tourism only partially cushioned a higher net income deficit due to higher profit remittances and increased interest payments on official debt. As a consequence, the current account deficit (excluding official transfers) during the first 9 months of 2004 widened to \$431.7 million from \$323.8 million in the same period of the previous year. The deficit was more than matched by higher inflows of official loans and grants and an increase in FDI to \$90.8 million in the first 9 months from \$66.1 million in the same period of 2003. The stronger FDI was attributed to investments in the garment sector as, apparently, investors hedged against the possibility of the US imposing new limits on garment exports from the PRC with the phasing out of the MFA. These developments moved the overall balance of payments into a surplus of \$68.1 million during the first 9 months of 2004, from a deficit of \$70.4 million in the same period of 2003. Foreign exchange reserves rose to \$811.7 million at the end of 2004 from \$736.7 million 12 months earlier.

Table 2.6 Major economic indicators, Cambodia, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|--|------|-------|-------|-------|
| GDP growth | 6.0 | 2.3 | 4.1 | 4.7 |
| GDI/GDP | 20.7 | 18.5 | 19.0 | 19.5 |
| Inflation (CPI) | 3.9 | 3.5 | 3.0 | 3.0 |
| Money supply (M2) growth | 30.1 | 17.0 | 22.0 | 25.0 |
| Fiscal balance ^a /GDP | -6.4 | -6.3 | -6.0 | -5.4 |
| Merchandise export growth ^b | 21.7 | -9.1 | 1.7 | 5.2 |
| Merchandise import growth | 22.2 | -4.8 | 4.7 | 7.6 |
| Current account/GDP | -9.8 | -11.7 | -11.3 | -10.5 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. ^a Excluding grants.

^b Domestic exports.

Sources: National Institute of Statistics; National Bank of Cambodia; International Monetary Fund; staff estimates.

Total external debt at end-2004 is estimated at 68% of GDP. Debt to the Russian Federation and the US is being renegotiated and is currently not being serviced. As a result, the debt service ratio relative to exports of goods and services at the end of the year is estimated at only 2.3%. However, relative to government revenues it was 14.8% in 2003, placing Cambodia in the category of debt-stressed countries.

Macroeconomic policy developments

Recent sources of growth have been narrowly based on garments and tourism and there is widespread recognition of the need to nurture new sources of growth. This would require significantly higher rates of productivity and investment. However, prospects for a major increase in public investment are limited because of the very low government revenue base, while private investment is hampered by a poor business environment.

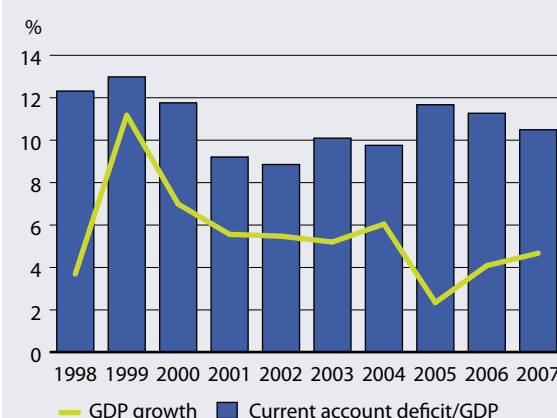
The need to broaden the growth base, and for the private sector to raise its competitiveness in light of the country's 2003 accession to WTO, has led to renewed attempts to promote private sector development. The new Government, formed in July 2004, a year after elections, launched a private sector development program focusing on trade facilitation, SME development, and private participation in infrastructure. Progress has

been made in several areas, including reducing the cost and time associated with import and export procedures and company registration, and further reforms are proposed for 2005. In trade facilitation, this includes the establishment of a single entry point, or window, that will allow parties involved in trade to fulfill all documentary requirements for import or export in a single transaction. For infrastructure, the Government has committed itself to implementing a new Concession Law, which defines a clear process for private participation. The Government is also committed to enforcing amendments to the Law on Investment that create a transparent 28-day process of investment approval. In the area of SME development, the Government is to approve an SME development framework to be used among all official agencies.

Despite progress, the outstanding reform agenda for private sector development remains large, particularly in the legal, judicial, and civil service systems, which forces the private sector to operate under uncertain rules. These and other constraints to the private sector such as a lack of access to, and high cost of, transportation and energy; a limited skills base; and limited access to land need to be addressed if the private sector is to promote growth and generate employment on a sustainable basis.

Although Cambodia's revenue-to-GDP ratio has increased in recent years (from 8.1% in 1998 to 10.4% in 2003), it remains among the lowest in the world. Weak revenues have constrained public spending and led to accumulated payment arrears to domestic suppliers. These repayments are expected to weigh heavily on future budgets. Given the need to substantially increase revenues and the difficulties in doing so as growth slows in the near term, improving revenue mobilization will depend on strengthened tax administration and improved tax policy. Toward this end, the Government, with the support of its development partners, has launched a comprehensive public financial management reform program that aims to (i) improve budget formulation by strengthening the links between policies and budgets, and by introducing a medium-term expenditure framework; and (ii) enhance budget execution by strengthening cash management and overhauling treasury operations.

Figure 2.6 GDP growth and current account deficit, Cambodia, 1998–2007



Sources: National Institute of Statistics; International Monetary Fund; staff estimates.

Given the extremely low domestic revenue base, external assistance will continue to be the dominant source of finance for the public investment program. In this context, the Government has prioritized strengthening its aid management capacity and effectiveness and improving donor aid coordination. Existing government-donor technical working groups are being restructured to enhance government ownership and to provide the basis for more effective management of official development assistance.

To implement the development vision set out in the new administration's Rectangular Strategy for Growth Employment and Equity, the Government and its development partners have agreed to prepare a single planning document, the National Strategic Development Plan (NSDP) 2006–2010, to replace the existing Second Socio-Economic Development Plan 2001–2005 and the National Poverty Reduction Strategy 2003–2005. Working groups are developing relevant action plans and monitoring indicators for the NSDP.

Outlook for 2005–2007 and medium-term trends

The economy has entered a new phase with the ending of the MFA. Notwithstanding investments in the garment industry in 2004, the sector is likely to be hurt by increased competition in

world markets, especially from the PRC where production costs are up to 30% lower. The slowdown in garment exports will be partly counterbalanced by expected strong growth in tourism. Agriculture (especially field crops) is expected to show some recovery from its drought-induced level in 2004. GDP growth in 2005 is forecast to drop to 2.3%, before picking up gradually to 4.1% in 2006 and 4.7% in 2007, reflecting both efforts to promote diversification and increased commercialization in agriculture that begin to raise productivity in that sector, and progress in implementing structural reforms.

Despite attempts to increase revenues in 2005, the projected budget deficit (excluding grants) for the year, at 6.3% of GDP, will remain at around the prior-year level of 6.4% due to difficulties in raising revenues in an environment of slower economic growth. The budget deficit is likely to narrow to 6.0% in 2006 and 5.4% in 2007 as compliance with tax laws and customs procedures improves, and as antismuggling actions are reinforced. Spending will increase on health, education, rural development, and agriculture. The ability of domestic-financed capital expenditures to influence development activity during the forecast period will, however, be limited by the need to repay arrears.

Inflation is likely to moderate to 3.5% in 2005 and slow further to 3.0% in 2006 as a gradual upswing in agricultural output reduces food price inflation, while somewhat lower world prices for oil reduce imported inflation. Helping contain inflation is a commitment by the authorities to avoid recourse to domestic bank financing of the budget deficit. A significant depreciation of the riel is also unlikely during the forecast period as this would have only a limited impact on competitiveness, since most costs in Cambodia, including wages, are denominated in US dollars.

Exports will decline in 2005 because of the phaseout of the MFA. Imports are also set

to decline, owing to a reduction in imports of garment-related inputs and lower oil prices, but at a more moderate pace than exports, given the import-dependent nature of the economy. As a result, the trade deficit is predicted to widen further. This will be offset to some extent by buoyant growth in tourism showing through on the services account. The current account deficit is, however, likely to deteriorate from an anticipated 9.8% of GDP in 2004 to 11.7% in 2005 and will be only partially covered by official grants and loans, and FDI (Figure 2.6). As a result, the overall balance of payments will switch to a deficit.

In 2006, exports are likely to climb modestly before recovering more strongly in 2007 due to an increase in agricultural exports and a gradual recovery in garment exports as measures taken to improve competitiveness in the sector begin to yield results. Import growth will once again outpace export growth in 2006–2007, leading to a further widening of the trade deficit. The current account deficit, however, could narrow to 11.3% in 2006 and 10.5% in 2007 as receipts from tourism, which are expected to grow by some 15% a year, outpace interest payments on external debt. Continued inflows of official loans and grants, coupled with a pickup in FDI resulting from an improved environment for private sector development, are seen as leading to an overall surplus on the balance of payments. Gross international reserves during the forecast period are likely to remain at around 3 months of imports.

Public external debt is expected to be sustainable over the forecast period as the terms are highly concessional. Assuming that the Government reaches a debt-rescheduling agreement with the Russian Federation and the US in 2005 on terms comparable with the 1995 Paris Club agreement, total external debt is projected to decline to 47% of GDP by end-2005. However, the net present value of public external debt would still represent around 230% of total revenues.



Indonesia

GDP growth picked up in 2004 and a smooth transition in government was achieved, paving the way for a further acceleration in the economy over 2005–2007 if the investment climate improves. The private sector could play a much greater role in the development of infrastructure to support stronger economic expansion. Key requirements are to increase spending that benefits the poor, create jobs for at least 2 million people who enter the workforce each year, improve the investment climate, and combat corruption.

Macroeconomic assessment of 2004

The economy expanded by a stronger than expected 5.1% in 2004 on the back of a 4.9% increase in private consumption and a 15.7% rise in fixed capital formation. Although fixed capital spending recovered strongly, much of it was concentrated in property development.

Improved productivity and higher prices helped push up growth in agriculture to 4.0%. Construction grew by 8.2%, spurred by investment in property, and the retail sector rose by 5.8%, as private consumption expanded. Transport and communications achieved a buoyant 12.7% growth. Manufacturing, lifted by booming demand for cement and transport equipment, grew by 6.2%. Mining and oil production, however, could not match this pace, despite higher global prices for minerals and oil.

Mining output fell by 4.6%, due to obsolete equipment, poor security at some mines, and lack of investment. Similar impediments held back oil production, which averaged 1.0 million barrels a day in 2004, down from 1.4 million barrels in 2000 and about 20% below the country's OPEC quota. Higher oil prices pushed up the cost of the Government's subsidies for fuel prices, to about \$6.8 billion for all of 2004, a quadrupling from 2003. The higher fuel subsidies meant that much-needed development expenditures had to be curtailed.

The higher rate of growth helped reduce the poverty incidence (based on a daily minimum food requirement of 2,100 calories and locally accepted requirements for shelter and clothing) from 17.6% in 2003 to 16.6% in 2004. However, an annual labor force survey showed the unemployment rate rising from 9.1% in February 2003 to 9.6% in February 2004. Of particular concern is a decline in formal-sector employment, by 4.7% in 2003, while the proportion of people employed in the informal sector has risen. Firms indicate that current labor regulations have terms that discriminate against employers' interests which, together with higher minimum wages, discourage hiring in the formal sector.

Inflation eased in the second half of 2004, from a year-on-year rate of 7.2% in July to 6.4% in December. It averaged 6.2% in 2004, the lowest rate in 4 years. This enabled Bank Indonesia, the central bank, to lower the reference interest rate—the rate on its 1-month certificates of deposit—from 8.3% in December 2003 to 7.4% in December 2004. In line with this reduction, lending rates for consumer loans declined by 195 basis points to 16.7%, and the rates charged on loans for working capital and investment dropped by 150 basis points to 13.6% and 14.2%, respectively. Commercial bank deposit rates fell, spurring a 26% rise in lending by commercial banks at end-2004. Lending for housing was

particularly strong, soaring by 84% in August 2004 from the year-earlier month. As a result, the loan-to-deposit ratio went up to 57.4% in December 2004 from 48.5% a year earlier. The proportion of total loans to SMEs increased from 44% in 2003 to 51% in 2004, partly reflecting greater optimism about SME activities. Gross NPLs of commercial banks declined by 1.6 percentage points to 6.6%.

Stock prices surged as a consequence of the rate reductions, the smooth transition in government, and improved earnings at several blue-chip companies. By the end of December, the stock-price index had climbed 47% over 12 months to touch a record high.

After holding at around Rp8,450–8,600/\$1 during the first 5 months of 2004, the rupiah depreciated to Rp9,000–9,300 in subsequent months, taking down the average exchange rate for the year to Rp8,940, 3.9% lower than in 2003. Although the dollar depreciated against most currencies, a relatively high domestic demand for dollars to meet debt repayments and rising imports kept the rupiah weaker against the dollar and regional currencies. This depreciation benefited tourism, with the number of visitors rising by 23.6% in 2004.

On the fiscal front, with revenues expanding more rapidly than expenditures despite a heavy fuel subsidy burden, the Government improved its fiscal performance in 2004. Revenues increased to 20.3% of GDP from 16.7% in 2003, while expenditures came in marginally higher at 21.6%, up from 18.3%. The deficit was contained at 1.3% of GDP. The Government met its 2004 bond issuance target of Rp32.3 trillion, including \$1 billion in sovereign bonds sold in March. Bond issues were oversubscribed by two to four times, with most buyers from the banking sector and pension funds. Remaining financing needs were met through external sources and privatization.

In 2005, the Government plans to raise Rp43 trillion from bond sales to finance the budget deficit, against a background of reduced scope for large-scale privatizations. Indeed, foreign investment approvals by the Capital Investments Coordinating Board fell by 26.8% to \$10.3 billion in 2004, mainly because there were fewer privatizations on offer to foreign investors. Also, foreign companies invested less

Table 2.7 Major economic indicators, Indonesia, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|---------------------------|------|------|------|------|
| GDP growth | 5.1 | 5.5 | 6.0 | 6.5 |
| GDI/GDP | 21.3 | 22.3 | 24.2 | 26.1 |
| Inflation (CPI) | 6.2 | 5.9 | 5.4 | 5.5 |
| Money supply (M2) growth | 8.1 | 12.0 | 12.0 | 12.0 |
| Fiscal balance/GDP | -1.3 | -0.8 | -1.0 | -0.5 |
| Merchandise export growth | 9.4 | 6.0 | 7.0 | 8.0 |
| Merchandise import growth | 13.3 | 9.6 | 11.0 | 12.0 |
| Current account/GDP | 2.6 | 2.1 | 1.5 | 1.0 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Badan Pusat Statistik; Bank Indonesia; Ministry of Finance; staff estimates.

in expanding their plants in 2004 than in 2003. However, the value of new foreign-invested project approvals rose slightly to \$5.4 billion.

Strong world prices for oil and commodities produced by Indonesia, plus the depreciation of the rupiah, lifted merchandise exports by 9.4%. Merchandise imports grew faster, by 13.3%. The trade surplus rose slightly to \$25.2 billion, but the current account surplus as a share of GDP fell to 2.6% and is on a declining trend. Foreign exchange reserves were steady over 12 months at \$36.3 billion at end-2004, representing almost three times outstanding short-term debt repayments, and providing cover for 6 months of imports. The overall ratio of public debt to GDP declined to 53% at end-September, from 59% in December 2003.

Macroeconomic policy developments

The smooth transition to a new administration after parliamentary and presidential elections in 2004 raised hopes for a period of stable government that will address the long list of challenges facing the country. Prior to its departure in October, the previous Government completed some key initiatives. These included amendments to laws on regional autonomy and the adoption of new laws on planning and social security. The Bankruptcy Law was amended to provide greater clarity for insolvency rulings on financial intermediaries, in particular. The Ministry of Finance was

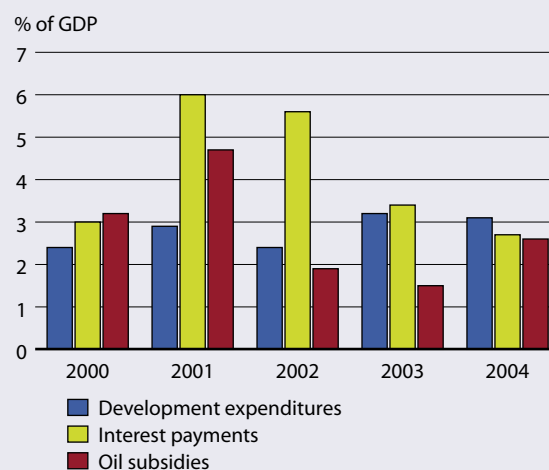
reorganized, a new treasury division was formed, and a unified budgeting system was adopted.

However, several challenges that faced governments in previous years remain. For instance, the overall legal and regulatory environment for investment is uncertain. Amendments to the Investment Law have not been finalized. These were intended to provide policies that do not discriminate between foreign and domestic investors, to open new sectors to foreign investors, and to streamline procedures on investment approvals. The previous Government issued a presidential decree to simplify the investment approval process, but resistance from various ministries and local governments has rendered the decree ineffective. Impediments to investments caused by problems, such as poorly managed decentralization and the issuance of conflicting regulations by local governments, can only be overcome by policy, legal, and role clarity to be provided by the central Government.

Exacerbating these impediments, the Constitutional Court in November 2004 annulled the Electricity Law No. 20/2002 on the grounds that it allowed for competition and the separation of generation and distribution in the electricity industry, which the court ruled was incompatible with the 1945 constitution. The court's decision, which throws into doubt the legal framework for the power industry, has created further uncertainty about the future direction of reforms. The Government has since issued a new regulation that allows private sector participation in the form of a partnership with state-owned utility company Perusahaan Listrik Negara. The partnership will be established by the utility calling for bids for new power generation projects; the utility will also act as the single buyer. To provide a legal framework for this proposal, the Government has undertaken to revise the 1985 Electricity Law, taking into account the Constitutional Court's concerns, and will submit the revised law to Parliament.

Fraudulent activity was disclosed in 2004 at three large state banks—Bank Mandiri, Bank Negara Indonesia, and Bank Rakyat Indonesia—reflecting the fact that risks remain in the banking sector. In addition, Bank Indonesia suspended regular banking operations of Bank Global and put Bank Perserikatan Muhammadiyah under surveillance. Further progress is required in

Figure 2.7 Selected budget components, Indonesia, 2000–2004



Sources: Badan Pusat Statistik; Ministry of Finance.

improving corporate governance in the banking system, with more stringent and coordinated supervision required by the central bank. Bank Indonesia has announced new regulations to facilitate bank mergers, which would pave the way for the implementation of a banking sector development blueprint unveiled in 2004.

At its inauguration, the new Government announced a near-term reform agenda based on identifying key issues quickly and achieving some tangible outcomes within its first 100 days, adopting a “shock therapy” approach to reduce corruption and to restore public trust in government through well-defined reforms that go beyond routine activities with a minimum burden on the budget.

Notwithstanding significant challenges imposed by the 26 December tsunami disaster, the Government went ahead with an infrastructure summit in January 2005 and hosted a government-donor consultative group meeting. Recognizing the infrastructure challenges facing the country, with investment needs estimated at upward of \$70 billion over 2005–2009, the Government is doing the following: focusing on ways to mobilize finance for infrastructure development; formulating a framework for risk management in infrastructure; creating a sound policy, legal, and regulatory environment in sectors such as energy, transport, and telecom-

munications; and tapping the private sector. The Government has offered 91 infrastructure projects with a total value of \$22.5 billion for potential private sector investment. The tender process for some projects has been initiated, while the rest will be pursued in the second half of 2005.

In order to strengthen SOEs and to facilitate their privatization, the new Government is preparing a blueprint for restructuring SOEs, including those with public-service obligations. As part of this, it plans to form a holding company to oversee more than 160 SOEs with combined assets of more than \$77 billion, to be modeled along the lines of the Singapore Government's Temasek Holdings. Various issues need to be resolved, though, before this restructuring can be implemented.

In December 2004, the Government announced its National Poverty Reduction Strategy, which adopts a "rights-based approach" to poverty reduction. Efforts will be directed to ensuring that the poor are given 10 basic rights, including adequate food, access to health care, decent housing, and work. The strategy envisages meeting these goals through budgetary mechanisms, with government intervention to be designed in accordance with the socioeconomic conditions of various regions.

The near-term reform agenda announced at the Government's inauguration was overshadowed by the tsunami tragedy, so that some key measures were not fulfilled by March, including the resolution of high-profile disputes with foreign companies in the cement and the oil and gas industries.

Outlook for 2005–2007 and medium-term trends

Indonesia's economy is on a moderate growth path with GDP expected to rise by 5.5% in 2005 and 6.0–6.5% in 2006–2007, supported by stronger domestic consumption and investment. Starting from a low base, gross investment is expected to increase to 22–26% of GDP, stimulated by the new Government's planned measures to enhance certainty for investors.

The impact of the tsunami disaster on GDP is estimated to reduce growth by 0.1–0.5 percentage point, although this could be offset by spending

on relief and reconstruction. The province of Aceh—the province most seriously affected by the disaster—accounted for 2.2% of total GDP in 2003. Of this contribution, 30% came from agriculture and 40% from production of oil and gas (these production facilities were not damaged on 26 December). A strong earthquake in March 2005 devastated Nias island. Reconstruction of housing and infrastructure, as well as labor-intensive projects and the revitalization of agriculture (including fishing), would help restore livelihoods.

In February, the Government raised the price of petroleum products by 29%, although the price of household kerosene, used mainly by the poor, was not increased. It is estimated that the higher fuel prices will add 0.7–1.0 percentage point to the inflation rate. This could be balanced to some extent in the short term by lower rice prices because the fuel price rises were made at harvest time, when rice prices usually decline. Inflation is forecast to average less than 6% annually in the next 3 years, although inflationary pressures will be greater if the rupiah continues to depreciate against the dollar. Bank Indonesia is likely to keep the benchmark interest rate on its 1-month certificates of deposit in the 7.5–8.0% range in 2005.

On the assumption of no downward pressures on commodity prices, exports may well grow steadily, though their full potential is constrained by the country's low productivity, competitiveness problems, and lack of financing for exporters. Given recent trends in domestic demand and investment, imports are likely to continue to grow strongly, and the ratio of the current account surplus to GDP is forecast to decline from 3.2% in 2003 to 1.0% in 2007.

The Government's new Medium-Term Development Plan for the next 5 years, signed by the president in January, raises the economic growth target to 6–7% a year. It aims to lower the unemployment rate from 9.1% in 2003 to 6.7% in 2009, and to achieve a reduction in poverty incidence from 16.6% in 2004 to 8.2% in 2009. Meeting these goals will, however, require greater public and private investments. These targets are ambitious, and achieving them depends on the containment of governance risks and enhancement of trade competitiveness.

The 2005 budget will likely be revised to take

into account the rehabilitation and reconstruction needs in tsunami- and earthquake-affected areas, reduced fuel subsidies resulting from the increase in fuel prices, and the additional social welfare spending made possible by the reduction in subsidies. The revised budget deficit will likely be 1% of GDP, above the previous projection of 0.8%.

The political risks of raising fuel prices are significant, although the Government's approach of better targeting subsidies by leaving the price of kerosene for household use unchanged will partly cushion the impact of increases in other fuel prices. Also, the Government aims to spend more than \$1 billion of savings made by reducing fuel subsidies on additional health care and education for the poor. It will establish a system to direct the additional spending to targeted groups, with help from local governments and the Family Planning Bureau. However, the continuing rise in global oil prices could have major implications for public expenditures, since raising domestic fuel prices again will not be a palatable option.

A major challenge is job creation, because at least 2 million people enter the labor market every year. The authorities have acknowledged that one way to unlock the economy's potential for growth is by raising productivity through shifting labor into the formal sector, which employs just one third of the workforce. In addition to efforts under way, the creation of more jobs in the formal sector is likely to require greater labor market flexibility, an improved investment climate, lower transaction costs, more legal certainty, and better infrastructure.

Combating corruption is a key part of improving the investment climate. The president

issued an instruction in December laying out principles aimed at improving integrity in central and local government institutions, and requiring all state officials to declare their wealth for review by the Commission on Eradication of Corruption. The instruction also sets in motion streamlined procurement procedures aimed at reducing bureaucratic discretion. The National Development Planning Agency has been asked to draft a national anticorruption action plan to guide the Government's efforts in this area until its term ends in 2009. The apparently tough stance, along with the prosecution of a few high-profile corruption cases in the early days of the new Government, is expected to have a positive impact, although it remains to be seen how the cases are resolved.

While external debt is at a manageable level, the economy is still vulnerable to sudden changes in investor confidence that may lead to capital outflows and sudden currency depreciation. Confidence may suffer if higher fuel prices, security problems, or regional disputes generate social unrest. The Government is aware of these risks and its agenda acknowledges the need to ensure peace and security.

There is a risk that the public is unrealistically optimistic on what the Government can achieve in the near term. For a start, the Government's ability to work with Parliament is yet to be tested. On balance, the Government has performed well in the first few months, given the challenges it has faced, including the tsunami disaster. The risk of losing momentum with regard to the reform agenda should be managed through monitoring and evaluation of progress.



Lao People's Democratic Republic

Growth was robust in 2004 and, for the first time since mid-2002, inflation slowed to single-digit rates (late in the year). Over the next few years, investment in mining and hydropower projects is likely to support growth. While macroeconomic performance has improved, the country still needs, in particular, to mobilize revenues for essential social and development expenditures, implement banking and SOE reforms, and improve the private sector environment.

Macroeconomic assessment of 2004

Growth is estimated to have picked up to 6.5% in 2004, with a strong push from an 11.4% upturn in the industry sector as mining expanded. The dominant agriculture sector recorded only modest growth of 3.5%, hampered by lower than forecast dry-season rice production. Rice still accounts for the majority of agricultural production in the Lao People's Democratic Republic (Lao PDR), but other crops, including maize, sesame, cotton, and tobacco, are expanding their shares. The services sector grew by 7.3%, partly on account of a recovery in tourist arrivals, which were 30% higher in the first 5 months of 2004 than the year-earlier period when the regional SARS outbreak and local security concerns kept visitor numbers down (Figure 2.8).

According to preliminary findings of the third Expenditure and Consumption Survey that was completed in 2004, the incidence of poverty, based on minimum food consumption of 1,983 calories a day, declined to 32.7% in FY2003 (ended 30 September 2003) from 39.1% in FY1998, partly as a result of economic growth in recent years.

The Government made some progress in strengthening its weak revenue base. Revenue collection, excluding grants, is estimated to have risen to 11.9% of GDP in FY2004 from 11.0% in FY2003. Over the same period, central

government expenditures fell to 16.7% of GDP from 18.8%, and the overall fiscal deficit narrowed to 4.8% from 7.8%. Efforts were made to address an imbalance in public spending, reflected in an increase in recurrent expenditures (such as wages, transfers, and interest payments) to 8.4% of GDP in FY2004 from 7.8% in FY2003, while capital and onlending expenditures declined from 11.2% to 8.8%.

Growth in broad money (M2) stayed at around 20% for a second consecutive year. Apart from cautious lending practices by banks, the Bank of the Lao PDR issued bonds and took other steps to maintain monetary control. The price of imported gasoline shot up, but this had limited impact on inflation, which slowed from 15.8% in 2003 to an estimated 10.6% in 2004. Food prices, accounting for 46.2% of the CPI basket, were relatively stable. In August, inflation fell to 9.2%, the first time since June 2002 that it has been in single digits; it declined to 8.7% at year-end. The exchange rate was broadly stable in 2004.

Exports, driven by minerals, electricity, garments, and coffee, increased by 7.6% in 2004, and imports by 9.5%. The merchandise trade deficit widened to \$144.8 million from \$126.6 million, as did the current account deficit to an estimated 0.5% of GDP from 0.3% (excluding official transfers) over this period. The level of external debt stock was estimated at nearly \$2 billion in 2004. However, given the

concessional nature of most of the debt, the debt service ratio stayed at the manageable level of 9.4% of exports.

Macroeconomic policy developments

The Government, moving to address perhaps its greatest challenge—raising the revenues needed for social and economic development—committed to introducing a VAT by January 2007. However, there is a potential problem with a tax exemption for investment, which may erode the revenue base, depending on how incentives under new laws on domestic and foreign investment are implemented. In FY2004, revenue collection achieved an estimated 99.8% of target.

Some progress was also made in reforming the banking sector, with the cabinet approving a proposal to lower entry barriers and improve market access for foreign and private banks. (The proposal still has to be cleared by the National Assembly.) An external audit and review for 2003 of the two dominant state-owned commercial banks (SOCBs)—Banque Pour Le Commerce Extérieur Lao and Lao Development Bank—indicates that NPL ratios remain at high levels, but the quality of new lending has improved as a result of enhanced credit policy and capacity-building efforts by international banking advisors.

Activity picked up a little with regard to reforming debt-burdened SOEs. The Government included five more SOEs in the group to be restructured—DAFI (a rural developer), Agriculture-Industry Development, Lao State Fuel, Lao Import-Export, and Road-Bridge Construction Company No. 13. Plans will be drawn up that aim to make the SOEs commercially viable and able to service their debts without public subsidies.

To promote private sector development, amendments to the laws on domestic and foreign investment were adopted to equalize tax incentives for foreign and domestic investors and streamline the investment process. The Government's commitment to strengthening the business environment is explicitly stated in the National Growth and Poverty Eradication Strategy. A decree on promotion and development of SMEs issued by the prime minister in April 2004 authorized the establishment of a development fund

Table 2.8 Major economic indicators, Lao People's Democratic Republic, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|-----------------------------------|------|------|-------|-------|
| GDP growth | 6.5 | 7.0 | 6.5 | 5.8 |
| GDI/GDP | 22.0 | 22.0 | 20.7 | 20.7 |
| Inflation (CPI) | 10.6 | 7.0 | 5.0 | 5.0 |
| Money supply (M2) growth | 21.3 | 18.0 | 20.0 | 20.0 |
| Fiscal balance ^a /GDP | -4.8 | -5.3 | -3.9 | -3.8 |
| Merchandise export growth | 7.6 | 27.4 | 17.8 | 3.0 |
| Merchandise import growth | 9.5 | 12.7 | 13.1 | 6.6 |
| Current account ^b /GDP | -0.5 | -1.8 | -13.3 | -13.5 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. ^a Excluding grants.

^b Excluding official transfers.

Sources: Bank of the Lao PDR; Committee for Planning and Investment; Ministry of Finance; National Statistical Center; International Monetary Fund; staff estimates.

that is envisaged to provide financial support to SMEs. To sustain private sector-led growth, further improvements are required in business registration processes and in making the application of regulations more transparent.

In the area of external economic relations, the first meeting of a working party for the country's accession to WTO was held in Geneva in October 2004. Members of the working party generally supported the country's membership bid and requested the Government to prepare a first set of offers for market access in goods and services. The US Congress and president approved legislation to normalize trade relations with the country, which brings into effect the 2003 bilateral trade agreement such that the country receives most-favored-nation (MFN) treatment for exports to the US.

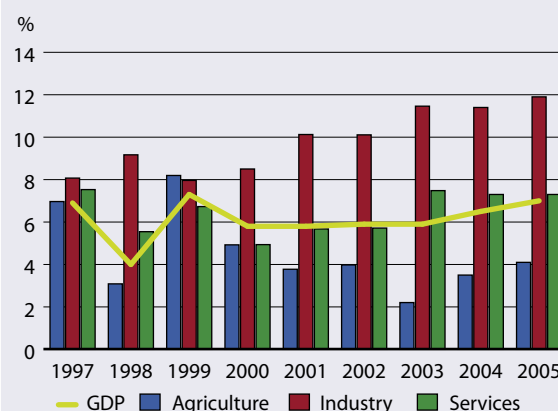
Outlook for 2005–2007 and medium-term trends

GDP is projected to grow at around 6–7% annually over 2005–2007, underpinned by planned expansion of gold and copper mining projects and the planned construction of the Nam Theun 2 hydropower dam. Nam Theun 2 is expected to start producing electricity for export in 2009, which may accelerate growth further. Continued monetary discipline by the Bank of

the Lao PDR, together with new revenue-raising measures, should keep inflation in the single- or low double-digit range. The external debt stock will remain high, although exports of hydropower from Nam Theun 2 in the medium term should allow for a reduction in the size of debt relative to GDP. Reasonably robust economic growth is expected to reduce the incidence of poverty and enable the country to achieve the income-target Millennium Development Goal by 2015.

In the longer term, accession to WTO, if achieved, is likely to encourage the development of a more predictable and transparent business environment, which, combined with enhanced market access, should facilitate private investment. The country's trade liberalization is at present proceeding mainly through fulfillment of commitments under the ASEAN Free Trade Area (AFTA). To date, however, utilization of AFTA's preferential tariff rates among member countries seems to be low (below 0.1% of AFTA imports in the case of the Lao PDR), apparently as a result of product exclusions and rules of origin requirements. This may be a problem for the Lao PDR in particular, because its trading partners are mainly in the subregion. To gain maximum benefits of trade policy reforms, the economy would benefit more from the MFN-based approach, which would facilitate trade by removing administrative burdens arising from the rules of origin requirements. The

**Figure 2.8 GDP growth by sector,
Lao People's Democratic Republic, 1997–2005**



Sources: Committee for Planning and Investment; staff estimates.

multilateral reform path through WTO accession may play a catalytic role to that end.

Potential risks to the outlook include a possibility of excessive fiscal expansion, which would worsen budgetary problems, and a rise in SOCB credit, which may undermine monetary policy. Public financial management needs to be strengthened on both the revenue side (with measures including the VAT) and the expenditure side (achieving a better balance between recurrent and capital spending).



Malaysia

After recording strong growth in 2004, expansion will slow somewhat over 2005–2007. Robust private domestic demand will spur activity as external demand eases and the Government cuts spending. Challenges include achieving fiscal consolidation without abruptly slowing growth, maintaining FDI inflows, and reforming government-linked companies.

Macroeconomic assessment of 2004

Led by robust expansion in consumption spending, the economy accelerated to its fastest pace in 4 years in 2004. From a SARS-induced low base in 2003, growth picked up to 8.0% in the first half, with a combination of strong external and domestic demand outweighing a reduction in fiscal stimulus. As the benefit of the low base faded, growth slowed to 6.7% in the third quarter and 5.6% in the fourth. For the year as a whole, the economy grew by 7.1%.

Consumption spending, bolstered by strong household outlays, contributed 5.7 percentage points to GDP growth. Public investment bore the brunt of the fiscal consolidation, though a recovery in private investment was sufficient to keep total investment growth in positive territory; total investment contributed 3.8 percentage points to growth. Net exports subtracted 2.4 percentage points (Figure 2.9).

Exports expanded strongly in the first half, owing to the recovery of the global economy and the electronics cycle, before slowing in the second. Given the high import content of manufactured exports, import growth of 25.8% outpaced exports' 20.5%. This resulted in a trade surplus of \$26.8 billion in 2004. The current account surplus remained sizable, at 12.5% of GDP, underpinning a healthy balance-of-payments position. FDI increased to \$4.7 billion

in 2004 from \$2.5 billion in 2003. Supported by the higher current account surplus and capital inflows, international reserves soared to \$66.7 billion, a near doubling over 2 years.

By sector, the expansion was broad based. Manufacturing showed the greatest momentum for the second consecutive year, at 9.8%. Construction was the only major sector recording a contraction, of 1.9%, hurt by the cuts in public investment. Mining output climbed by 4.1%, shored up by higher production of crude oil, in turn supported by strong external demand and high prices. In agriculture, crude palm oil and rubber continued to perform well, while forestry production increased in response to higher demand from wood-based industries, bringing overall sector growth to 5.0%.

Strong consumption spending, tourism, and trade-related activities continued to fuel the services sector, which rose by 6.6%, particularly the transportation, storage, and communications subsector (8.4%) and the wholesale and retail trade, and restaurants and hotels subsector (7.1%). A better stock market performance, plus increased demand for bank loans and insurance, underlay 6.5% growth in the finance, insurance, real estate, and business services subsector.

With no need for further pump priming in 2004, the Government tightened fiscal policy. The budget deficit as a share of GDP narrowed to a 5-year low of 4.1%, or below the official target of 4.5%. To reduce external debt exposure, the bulk

of the Government's funding requirement was sourced domestically, which did not crowd out private investment because liquidity remained ample. Total outstanding federal government debt came down marginally to the equivalent of 46.6% of GDP at end-September from 47.8% a year earlier.

Monetary conditions were accommodative for a seventh straight year in 2004. The ringgit remained pegged to the US dollar and interest rates were kept stable at historically low levels. Year-on-year loan growth, mainly consumer credit, picked up to 8.5% in December from 5.3% in July.

Many companies opted to use internally generated funds and tap the capital markets, such that corporate borrowing was flat. Because of aggressive sterilization operations by Bank Negara Malaysia, the rise in monetary aggregates—M3 grew by 12.4% in December—was sustained at a level consistent with the pace of real economic activity.

The asset quality of the banking system continued to improve. A slowdown in new NPLs, better loan recovery, bad debt write-offs, and a widening loan base brought down the net NPL ratio of the banking system, based on 6-month arrears, to 5.9%, the lowest level since the 1997–98 Asian financial crisis. Also, the banking institutions' risk-weighted capital ratio, at about 13.7%, was much higher than the Basle minimum requirement of 8%.

Constrained by fuel-price subsidies and price controls, Malaysia's inflation rate in 2004—an average of 1.4% over the year—was the lowest in Southeast Asia. Demand pressures were generally benign, but cost pressures, reflected in higher food prices and transport charges, nudged up inflation from 1.2% in May to a 5-year high of 2.1% in December. Job creation outstripped additions to the workforce, and the unemployment rate fell to 3.5% from 3.6% in 2003. However, under- and unemployment among university graduates remain a problem.

Spared the worst of the Asian tsunami, the economy is likely to feel only a slight impact because key industries and infrastructure were left unscathed. The knock-on effect from countries more seriously affected by the tsunami will also be limited.

Table 2.9 Major economic indicators, Malaysia, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|---------------------------|------|------|------|------|
| GDP growth | 7.1 | 5.7 | 5.3 | 5.8 |
| GDI/GDP | 22.5 | 21.6 | 21.0 | 21.5 |
| Inflation (CPI) | 1.4 | 2.4 | 2.5 | 2.5 |
| Money supply (M2) growth | 25.4 | 13.5 | 11.7 | 13.3 |
| Fiscal balance/GDP | -4.1 | -3.1 | -2.2 | -1.5 |
| Merchandise export growth | 20.5 | 12.0 | 10.2 | 12.6 |
| Merchandise import growth | 25.8 | 15.8 | 13.5 | 15.3 |
| Current account/GDP | 12.5 | 10.2 | 8.3 | 6.7 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Bank Negara Malaysia; Department of Statistics; Ministry of Finance; staff estimates.

Macroeconomic policy developments

The Government has focused on providing infrastructure and an enabling environment for businesses to compete globally. This focus involves laying out a reform agenda to fight corruption, improving the delivery of government services, reducing red tape, helping improve efficiency, and lowering the cost of doing business. Efforts are being made to limit broader fiscal risks by reforming the government-linked corporations (GLCs). The new administration has moved away from huge, prestige projects to smaller ones that have a higher multiplier effect. It is also putting greater emphasis on diversifying sources of growth into sectors such as services and agriculture.

Preventing an excessive buildup in liquidity remains the key challenge for the central bank. The strong current account position, the inflow of foreign direct and portfolio investment, and strong tourist receipts have sharply pushed up foreign reserves. Most of these inflows have been sterilized, as indicated by the limited rise in base money relative to the upsurge in reserves. As of mid-December, the central bank had absorbed an estimated RM130.6 billion from the banking system, mainly through interbank borrowings.

On the exchange rate front, strong economic fundamentals, marginal misalignment against regional currencies, and narrowing interest-rate differentials between domestic and US interest rates suggest little pressure on the ringgit peg.

Despite that, and while the ringgit peg arguably offers an environment of stability against the background of volatile global foreign exchange markets, a shift to a basket peg with a more flexible rate may put the economy in a better position in the event of serious exchange rate corrections and could help manage excess liquidity. The longer the peg is maintained, the larger the adjustment and the associated costs are likely to be upon exit.

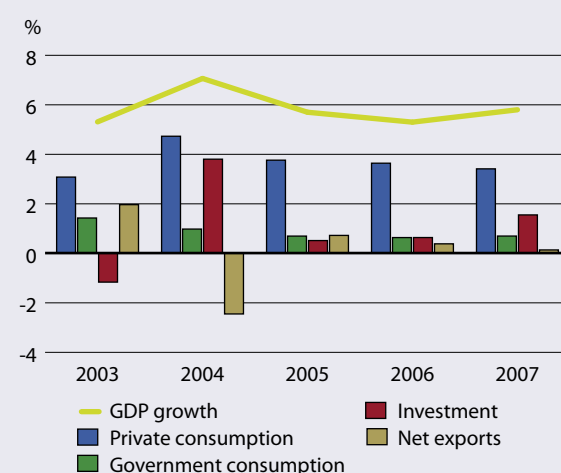
With the banking system having recovered from the Asian financial crisis, Danamodal, the agency established during the crisis to recapitalize financial institutions, was closed in early 2004. The Corporate Debt Restructuring Committee, established to help corporate debt resolution, had already been closed in late 2002. Danaharta, the national asset management agency, is on track to cease operations by the end of 2005.

Signaling a shift to a more market-driven approach to interest rate determination, a new interest rate framework was introduced with the overnight policy rate replacing the 3-month intervention rate as the policy benchmark.

Legislation was amended to allow mergers of commercial banks and finance companies within the same banking group, in order to improve operational efficiencies. This cleared the way for five such mergers in 2004. Another significant development was the acquisition by Temasek Holdings, Singapore's state-owned investment company, of a substantial stake in Alliance Bank, evidence that Malaysia is gradually opening its financial services to foreign participation. Taking a step toward greater bilateral trade and economic cooperation, the Singapore and Malaysia securities exchanges agreed to jointly develop a cross-trading link, which will increase liquidity and access to capital.

The major challenge for fiscal policy is to rein in the deficit in the medium term without derailing economic growth, through a focus on projects with high returns, low-import content, and strong industrial linkages. This would involve small projects awarded to Malaysians in areas such as agriculture and rural development. Deficit reduction is being carried out on two fronts, by cutting spending and by improving revenue-collection efforts through improved compliance. Other steps include a gradual reduction of

Figure 2.9 Contribution to GDP growth by expenditure account, Malaysia, 2003–2007



Sources: Bank Negara Malaysia; Malaysian Institute of Economic Research; staff estimates.

subsidies on gasoline and diesel fuels, and in the longer term, changes to the tax structure. A goods and services tax is proposed, starting in January 2007, to broaden the tax base.

To improve their efficiency and profitability, the GLCs were put under the oversight of Khazanah, the Government's investment corporation, which will revamp their operations so as to turn them ultimately into market-driven entities. This will involve further board and management changes and the introduction of key performance indicators, such as fixed-term contracts and performance-linked compensation for management. Privatization, another strategy aimed at improving economic efficiency, has slowed, but the reform of the GLCs may be initial steps in preparing some for divestment in the future.

Outlook for 2005–2007 and medium-term trends

A slowing global economy in 2005 implies an easing of growth for Malaysia because the economy remains vulnerable to the global economic slowdown and to the technology down-cycle. (Exports as a share of GDP increased to 114% in the fourth quarter of 2004 from 97% in 1995, and the share of electronics exports in total manufactured exports increased to 49% during the first 3 quarters of 2004 from 39% in 1995.) To

diversify the economic base away from overreliance on external trade, the Government has been encouraging domestic demand and providing tax incentives and funding for new growth areas, such as education, tourism, and ICT.

Forward-looking indicators also suggest a softening in growth in the first half of 2005. The rise in the leading composite index, which suggests business activity 6–9 months ahead, slowed sharply to 3.8% in December 2004 from 15.4% in March 2004. The Malaysian Institute of Economic Research's forward-looking business conditions and consumer sentiment indexes also fell in the fourth quarter of 2004.

Still, the downturn in the electronics cycle is expected to be mild and brief, so that by the second half of 2005 the economy will likely have recovered momentum. GDP growth for the year is forecast at a respectable 5.7%. With slower growth in external demand and cuts in government spending, the economy will rely more heavily on private domestic demand for growth. Expansion in the private sector is expected to remain favorable, as public investment shrinks for the second year running. Complementing the predicted rise in household spending, the recovery in private investment is seen as continuing, albeit at a slower pace. Looking further ahead, growth in 2006–2007 is forecast to average about 5.5%.

A stronger domestic economy relative to the external sector will result in a slightly lower trade surplus. On that basis, the current account surplus will also decline, but remain substantial. Hence, the country's foreign reserves position is set to improve further, providing strong support to the ringgit peg.

On the supply side, growth in all major sectors is projected to slow in 2005. Manufacturing and services will be the engines of growth in the next 3 years. Manufacturing expansion is estimated to moderate to 7.5% in 2005, supported by the recovery in external demand in the second half and a still buoyant domestic economy. Services sector growth is forecast to ease to 5.7% in 2005. Agriculture is also likely to decelerate, while firm prices and demand, and new oil and gas fields, will enhance mining growth. Construction is expected to post a mild recovery in 2005, reflecting demand for residential housing.

Fiscal consolidation is expected to be gradual, so that government spending can make a contribution during a time of uncertain external conditions and slower growth in the next 3 years. The fiscal deficit is projected to narrow from 4.1% in 2004 to 1.5% in 2007, in steps that do not hurt the economy. Government spending as a percentage of GDP is expected to decline, while the share of revenue will remain stable at around 19% of GDP in view of the moderate economic growth. The Government will finance the deficit mainly from domestic sources, with a small portion from foreign sources. The level of total external debt is expected to rise in the forecast period as the private sector seeks some funding from abroad. Relative to GDP, though, external debt will probably decline slightly as the economy expands.

The Government, under little external pressure and wanting to help exporters compete in the face of falling demand, appears likely to favor an undervalued currency and so maintain the ringgit peg, at least through the first half of 2005. Likewise, Bank Negara Malaysia has room to keep interest rates steady for some months. However, inflation is expected to accelerate to 2.4% in 2005, pushed by rising inflationary expectations, higher transport charges, withdrawal of subsidies and, possibly, an electricity tariff increase. That would lead to a decline in real deposit rates. And with interest rate differentials narrowing, the central bank may raise rates by perhaps 50 basis points in the second half of the year.

Challenges include handling fiscal consolidation without slowing the economy too abruptly and competing for FDI against subregional neighbors and the much larger economies of the PRC and India. A fall in FDI would mean lower growth than forecast in 2005. The authorities also need to consider alternatives to the current exchange rate peg.

A near-term challenge is replacing an estimated 450,000 illegal overseas workers who left Malaysia under an amnesty, prompting concerns about potential labor shortages on plantations, on building sites, and in factories. As part of a longer-term strategy, the education system needs to be reformed to correct labor demand-supply mismatches, especially among graduates.

Myanmar

GDP growth was officially estimated at low double-digit rates in FY2003 and the target for FY2004 was at a similar high level. However, rapid growth was not corroborated by the performance of inputs such as power and fertilizer. The economy underperforms because of macroeconomic imbalances and structural problems that include a wide fiscal deficit due to losses by SOEs and a dual exchange rate system.

Macroeconomic assessment of 2004

Official estimates put GDP growth at 13.8% in FY2003 (ended 31 March 2004), up from 12.0% in FY2002 (revised up from an earlier estimate of 10.0%). Growth in agriculture in FY2003 was estimated at 11.7%, industry at 20.7%, and services at 14.5%. Consumption accelerated by 12.6% and investment by 24.1%, according to the official figures. The impact of trade and investment sanctions imposed by the US and other governments was particularly evident in foreign trade, with exports and imports of goods and services declining by 30.0% and 22.5%, respectively. For FY2004, GDP growth was targeted at 12.6% with the agriculture sector the main source of growth.

However, the trends in essential inputs to production, such as power and fertilizer, indicate that actual GDP growth rates could be much lower than the official estimates. Also, high inflation in recent years and lagging nominal income levels do not suggest strong growth in real national output.

Deficiencies in data, in terms of reliability, comparability, completeness, and timeliness, make an objective assessment of the economy difficult and affect the ability of the authorities to formulate policies. For example, dual exchange rates and the large gap between the parallel and official exchange rates distort the official statistics.

The official estimate of poverty incidence at

almost 23% in 1997 suggests that poverty is not as widespread as in other countries with a comparable level of per capita income. However, a fall in spending on social services such as health, education, and social welfare relative to GDP indicates that the poor are receiving less assistance. In FY2003, spending on social services was 1.3% of GDP, down from 5.7% in FY1990.

Government spending and tax revenues both surged by 52% in FY2003, and the overall fiscal deficit widened from 3.6% of GDP in FY2002 to 4.9%. The deficit is largely financed through central bank credit creation, which results in macroeconomic and fiscal instability. Subsidies to SOEs to cover their losses accounted for about 38% of the budget deficit in FY2003, although this was down from 50–93% of the budget between FY1998 and FY2002. The tax revenue system was strengthened by raising the exchange rate used to value imports for tariff purposes, a reduction in tax evasion, and steps toward a value-added tax system.

Inflation decelerated from 54.0% in March 2003 to 2.3% in June 2004, but then turned up to almost 7% in October 2004. A temporary ban on rice exports to increase the supply of rice for domestic consumption seemed to contribute to the fall in inflation in early 2004. However, the ban hurt incomes of rural households as well as national foreign-exchange earnings. It also delayed the liberalization of trade and agriculture.

Developments in the financial sector point to progress in recovering from a banking crisis in 2003 and to a restoration of confidence in the banking system: two private banks opened branches over the course of FY2003; three major banks resumed operations in February 2004; and three private cooperative banks merged in June 2004. Growth in broad money (M2) picked up from just 3.7% in September 2003 to 11.0% in March 2004 and then rose sharply to 30.5% in September.

Sanctions have hit FDI levels as FDI fell by 33% from the previous year's level to \$128.1 million in FY2003. Over 5 years, FDI has fallen by 81%.

Macroeconomic policy developments

While the moves to mobilize greater tax revenues have had a positive impact, much more needs to be achieved before the Government has adequate funding for crucial social and economic investment. New measures for generating revenues, widening the tax base, and further reducing tax exemptions and evasion should be considered. On the expenditure side, reductions in budgetary transfers to SOEs would help stabilize the fiscal position. Subsidies to the SOEs could be cut if more serious efforts were made to privatize some of them. Rigorous cost-benefit analysis of projects would ensure better targeting of government resources.

The dual exchange rate, under which the ratio of the kyat-US dollar parallel rate to the official rate has widened to about 150:1, contributes to fiscal deficits and fosters corruption. This provides an imperative for moving toward a unified exchange rate. Also, the adoption of a flexible interest rate regime would strengthen the regulation of monetary aggregates by the central bank. Complete recovery from the 2003 banking crisis is likely to require a more prudential regulatory framework for the sector in consonance with international best practices.

Strengthening the agriculture sector should be a key goal since it accounts for a major share in the country's GDP, and since about 70% of the population live in rural areas. Policy measures

worthy of consideration are the further liberalization of the sector, including the removal of the temporary ban on exports of rice and increasing the accessibility of credit to rural households. More generally, sustained growth requires greater investment in basic infrastructure and an improved environment in which the private sector can develop.

In the area of external relations, several agreements were concluded with neighboring countries. The Government adopted a framework agreement for a free trade area under the BIMST-EC grouping that involves Bangladesh, India, Myanmar, Sri Lanka, Thailand, Bhutan, and Nepal. This aims to fast-track tariff reductions among these countries. Other agreements were concluded with PRC, India, and Thailand to provide Myanmar with credit facilities and economic and technical cooperation. The Government also lifted a restriction that limited its rubber exports to 55% of production, in an effort to encourage exports.

Outlook for 2005–2007 and medium-term trends

With a limited reform agenda, the medium-term growth prospects are expected to be quite modest compared with the official double-digit targets. While the growth in government revenues is set to continue, it may still be inadequate to offset rising expenditures. Moreover, continued monetization of the fiscal deficit is likely to cause inflationary pressures and jeopardize fiscal stability. Growth prospects remain diminished by sanctions and the related contraction in trade, aid, and FDI. Advances against poverty are hindered by the lack of funding for social spending and the often high inflation rate that exceeds growth in incomes.

The export of natural gas in recent years and possibilities for expanding gas exports through construction of pipelines are important developments. Natural gas constituted about a quarter of total exports in FY2003 and the first 4 months of FY2004. Exploration planned both onshore and offshore may further increase the potential of this industry.



Philippines

Helped by higher agricultural output, GDP growth picked up to its highest rate in 15 years, but is likely to ease somewhat over the next 3 years. The Government has initiated important reforms in public finance to raise revenues and reduce the budget deficit. Further challenges include unemployment reduction, debt management, power sector reforms, and investment climate improvement.

Macroeconomic assessment of 2004

The economy performed better than expected in 2004: GDP grew by 6.1%, surpassing the government projection. A beneficial international economic situation, favorable weather, and growth in all regions of the country were important determinants. Although remittances by overseas workers rose by 11.8% to \$8.5 billion, gross national product (GNP) grew by the same amount as GDP. This was due to increasing external debt service payments, which lowered net factor income growth to 4.9% in 2004 from 17.9% the previous year. Growth in personal consumption expenditure, accounting for about two thirds of aggregate demand, accelerated to 5.9% from 5.3%—higher farm output, stronger remittances from overseas workers, and booming demand for telecommunications services were the largest contributors.

The Government's cautious cash spending resulted in a further decline of government consumption expenditure by 0.8% in 2004. Growth of fixed capital formation accelerated to 5.1% from 2.9%, due to stronger private investment. Investment in construction expanded by 6.2%, marking a healthy rebound from the decline of 2.9% in 2003. According to the National Statistics Office, total exports increased by 14.0% (4.4% in 2003) as merchandise exports and nonfactor services gained momentum. Total import growth slowed to 6.3% from 10.2%,

reflecting decelerating growth in several categories, including transport equipment and manufactured metals. Growth of net exports contributed about 2.6 percentage points to GDP growth, after subtracting from growth in recent years.

On the production side, all three sectors improved growth. Agriculture, which contributes a fifth of the country's economic output and employs slightly above one third of its workforce, grew by 4.9%, thanks to favorable weather. Industrial growth rose to 5.3%, due to better outturns by manufacturing and construction. Manufacturing, the biggest contributor to the growth of the domestic economy, continued to pick up pace, expanding by 5.0% in 2004. This is a particularly positive development because manufacturing generates flow-on benefits to the rest of the economy. Services continued to improve, by 7.3%, with the top contributors being trade, transportation, communications and storage, and finance.

High unemployment remains the country's single clearest indicator of a weak economy, averaging 11.8% of the labor force, up from 11.4% in 2003. Likewise, underemployment rose to 17.6% in 2004 from 17.0% the prior year. Adding the number of unemployed to the number of underemployed and dividing it by the size of the total labor force gives an index of "labor underutilization." In the Philippines, this rate increased from 26.5% in 2003 to 27.4% in 2004. The number of workers joining the labor market

in most years exceeds the number of jobs created (Figure 2.10). In 2004, the economy created 977,000 new jobs (67% in services, the rest divided equally between agriculture and industry) compared with 574,000 in 2003, while there were 1.29 million new entrants. This implies that the number of unemployed rose by a further 313,000, and this at a time that GDP grew faster than any year since 1989.

The Government operated under the reenacted 2003 budget for the whole year of 2004. In a favorable development, the full-year deficit of P186.1 billion (3.8% of GDP) was below the programmed ceiling of P197.82 billion (4.2%). Revenue collection rose by 11.4% to P698.3 billion in 2004, with tax revenues up by 11.2% and nontax revenues by 12.6%. However, the revenue-to-GDP ratio declined to 14.4% from 14.6%.

On the expenditure side, the Government maintained fiscal discipline. Its spending rose by 7.0% to P884.4 billion. Mandatory expenditures for interest (30%), personnel (30%), and grants to local governments (20%) constituted 80% of the budget, crowding out urgently needed capital outlays. Total public expenditures have been hovering at about 19% of GDP for many years, below the average of other countries in the region. The lack of financial resources continued to force the Government to borrow to meet its operational needs, and its debt stock climbed to P3.80 trillion in November 2004 from P3.36 trillion a year earlier. Foreign public borrowing reached P1.81 trillion in November, equivalent to 47.6% of total government borrowing.

Inflationary pressures were more pronounced in 2004. The overall CPI rose by 7.9% in December 2004, while the average inflation rate for the year was 5.5%, above the Government's target of 4.0–5.0%. The acceleration was the result of higher food and fuel prices. The stock market responded to the improved growth rate, with the composite index of share prices increasing by 35%. The peso continued to depreciate, to an average of P56.03/\$1 in 2004 from an average of P54.20 in 2003, adding to domestic price pressures. However, the real effective exchange rate index of the peso averaged P54.44 (P56.94 in 2003), indicating that the real extent of the depreciation was smaller in terms of the peso-adjusted inflation-rate differentials, i.e., the Philippines had higher inflation than the

Table 2.10 Major economic indicators, Philippines, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|---------------------------|------|------|------|------|
| GDP growth | 6.1 | 5.0 | 5.0 | 5.0 |
| GDI/GDP | 17.0 | 18.5 | 19.0 | 19.5 |
| Inflation (CPI) | 5.5 | 6.5 | 6.0 | 5.5 |
| Money supply (M3) growth | 8.2 | 6.0 | 7.0 | 7.5 |
| Fiscal balance/GDP | -3.8 | -3.6 | -3.2 | -2.8 |
| Merchandise export growth | 9.6 | 8.0 | 8.0 | 7.0 |
| Merchandise import growth | 10.6 | 5.5 | 6.0 | 6.5 |
| Current account/GDP | 2.4 | 3.0 | 2.2 | 2.0 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Bangko Sentral ng Pilipinas; Bureau of the Treasury; National Statistical Coordination Board; National Statistics Office; staff estimates.

countries in the basket used for the index. The upshot is that the peso lost competitiveness.

Domestic liquidity (M3) expanded by 8.2% in December 2004 from 12 months earlier, accelerating from 3.3% in December 2003, with domestic borrowing dominated by the Government, as corporate demand remained subdued. On the credit supply side, although there was a slight decline in the NPL ratio (to 13.6% in November 2004 from 14.1% at end-2003), weak asset quality continued to hamper the commercial banks' ability to expand operations. The policy rates of the Bangko Sentral ng Pilipinas (BSP)—the overnight borrowing rate and the overnight lending rate—have been unchanged since July 2003, at 6.75% for the former and 9.0% for the latter. Continuing high demand for deficit financing pushed the 91-day treasury bill rates up to an average of 7.3% in 2004.

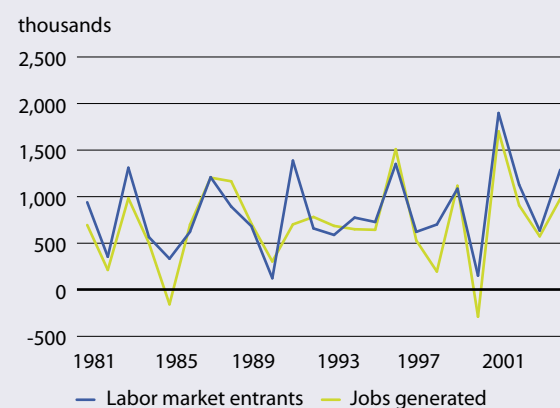
The current account surplus widened to \$2.1 billion in 2004, from \$1.4 billion in 2003. The financial account showed a deficit of \$1.7 billion, reflecting higher overseas investments by residents than nonresidents' investments in the Philippines. The balance of payments registered a fall in reserves of \$1.6 billion. Gross international reserves decreased to \$16.0 billion, which is the equivalent of about 4.1 months of imports of goods and services. The decline came as a result of the debt service payments by the Government.

Macroeconomic policy developments

The major priorities of President Arroyo's new administration were outlined in the Medium-Term Philippine Development Plan (MTPDP) 2004–2010, unveiled in October 2004. They include an acceleration of growth, job creation, and reform of the energy sector. Fiscal consolidation and achievement of a balanced budget by 2010 have the highest priority. Relieving the Government's debt burden is a prerequisite for raising more funds to finance development. Power sector reforms, crucially the privatization of the National Power Corporation, are also necessary to cut the debt burden. Given the magnitude of the fiscal pressures, the Government faces great challenges in designing a package of policies and measures that can achieve the key MTPDP targets while maintaining fiscal discipline.

Creating more jobs, arguably the country's most important task, would greatly assist in reaching the goal of reducing the poverty incidence from 25.5% to about 18.0% by the end of this decade. This will require many more jobs, particularly higher-paid positions in the formal sector, and an increase in agricultural productivity. As reflected in the MTPDP, the new administration has pledged to generate about 1.5 million jobs a year between 2004 and 2010, for a total of about 10 million new jobs (60% in the services sector). Although in the past the economy has created over a million jobs in a single year, generating 1.5 million jobs consistently until 2010 will be hard. Moreover, this may not make much of a dent in unemployment if the number of new jobs is surpassed by entrants into the labor market. The Philippines has about 30 million people under the age of 15, and about 13 million of them are expected to join the labor force over the next 14 years. Hence, the economy needs to create about 1 million jobs a year just to absorb new entrants. But given the current number of unemployed, the unemployment rate in 2010 would still be 8.9% according to the MTPDP. Clearly, sound population control policies are needed to reduce population and labor-supply pressures. This also requires an increase in the rate of capital accumulation and the implementation of policies to achieve full employment. These should go well beyond labor market reforms. The dilemma that

Figure 2.10 Labor market entrants versus jobs generated, Philippines, 1981–2004



Sources: Bureau of Labor and Employment Statistics, Department of Labor and Employment; Labor Force Survey, National Statistics Office.

the Philippine administration faces on this front is that it cannot use active monetary and fiscal policies; in the former case, because BSP's policy is anchored in inflation targeting, and in the latter because of the debt and its financing problems.

In the social sphere, policy priorities include improvement of social services and infrastructure, which will require increased financial resources, and the articulation of a population policy to reduce population growth. Improvements to infrastructure would attract more domestic and foreign investment, reduce production costs, and facilitate exports. Channeling more private investment into energy, roads, and water supply would help in this area. Civil service reforms, such as removing functional duplications among agencies, would improve the Government's ability to implement the MTPDP and attract investment. Governance issues—weak enforcement of the rule of law, and corruption, for example—also require attention because they contribute to the perception that the country is an unattractive destination for foreign investment.

Although the Government maintained fiscal discipline in 2004, the public sector's deficit remains the most significant macroeconomic imbalance due to its impact on debt sustainability. The system is unable to fully mobilize revenues, whether through taxes, tariffs, fees, or charges. Acknowledging that low revenue collection is a fundamental cause of the budget deficit, the new Government proposed a package of measures to

increase tax revenues. A series of bills has been filed with Congress for an increase in the basic VAT rate from 10% to 12%; reimposition of a 3% franchise tax on telecommunications companies; adoption of gross income taxation for corporations and self-employed individuals; rationalization of fiscal incentives for investors; and indexation to inflation of excise taxes on alcohol, tobacco, and petroleum products, among other measures.

The approval by Congress in December 2004 of higher tax rates on alcohol and tobacco should improve the fiscal situation in 2005 by raising an additional P15 billion over the year. However, the Government needs to raise at least P90 billion in new taxes to cut its dependence on borrowing. (In 2004 the Government borrowed P241 billion to meet its financial requirements, equivalent to 28% of total expenditures.) Another advance was the signing in January 2005 of a law that encourages staff of the internal revenue and customs bureaus to be more efficient in collecting taxes. A bill that would overhaul the VAT system was passed by the House of Representatives in January and went to the Senate for discussion.

Increased borrowing during 2004 prompted various international financial institutions and credit rating agencies to urge the Government to significantly raise revenues and control spending. Debt interest payments escalated to 29.5% of total public expenditures in 2004, from 19.5% in 1998. Without appropriate and effective reform, in the next few years the country will face a situation of lower public expenditures, and hence declining public services, and a further deterioration in its credit rating. An increasing debt stock could also trigger a significant depreciation of the peso. Despite efforts from the Government and an appreciation of the peso in early 2005, credit downgrades by Standard & Poor's and by Moody's in the first 2 months of 2005 are hurting the economy by increasing its cost of borrowing, given that this cost is already 500 basis points above the US treasury bill rate, and that ratings of neighboring countries are improving. The downgrade will probably also affect the country's ability to attract greater volumes of FDI.

Another reason for the Government's fiscal vulnerability stems from the high level of contingent liabilities, primarily for underwriting the finances of government corporations (including

some financial institutions) and the public pension system. As the Government continues to guarantee further loans to these corporations, its contingent liabilities reached P821.3 billion in the first 3 quarters of 2004, of which 95% was foreign debt. The National Power Corporation's liabilities represent about 65% of the Government's total contingent liabilities. Moving forward with the MTPDP's measures to privatize state-owned power generation and transmission assets would go some way to overcoming this pressing problem. In addition, the creation of a sound regulatory framework for the power sector is required to attract private investment. Once that has been done, the Government should consider initiating steps to build partnerships with the private sector to address the physical deficiencies in the power system so as to avoid power shortages.

Outlook for 2005–2007 and medium-term trends

The MTPDP forecasts GDP growth rates of 5.3–6.3% for 2005, 6.3–7.3% for 2006, and 6.5–7.5% for 2007. The forecast rate increases to 6.8–7.8% in 2008 and 7.0–8.0% in 2009 and 2010. According to the plan, unemployment will decrease steadily from the current 12% to about 9% in the last 2 years, with elimination of the fiscal deficit by 2010. The key to achieving GDP expansion of 7–8% by the end of the decade is to attain growth rates of the capital stock of at least 10% (in net terms), substantially higher than the current rate (around 3%), as the experience of other Asian economies during their high-growth periods suggests. This requires an extended investment push to create a virtuous cycle of higher rates of productivity, wages, and employment. However, given the current problems with the budget deficit and debt, which affect the Government's investment capacity, and the poor investment climate, which affects the private sector's investment willingness, it will be difficult for the capital stock to grow by the pace required to achieve the targeted GDP growth rate.

While raising the investment-to-GDP ratio is important, the variable that matters for growth is the rate of increase in the capital stock, which depends on both the investment-to-GDP ratio and the productivity of capital. Unfortunately, the Philippines has a very low investment-to-GDP

ratio (around 20%) and low capital productivity (around 0.35, i.e., 0.35 pesos of GDP is created per peso of capital stock, according to ADB estimates). The MTPDP assumes an increase in the ratio of gross investment to output of 8 percentage points to 28%, by 2010. This effort alone will probably not suffice to lift significantly the growth rate of the capital stock, because it requires an unrealistically high increase in the productivity of capital, of about 50%, in a short period.

With the current level of capital productivity, an investment-to-GDP share of 28% will lead to an expansion of the capital stock of only about 4.8%. The MTPDP's projected GDP growth rates for 2005–2007 are mainly in the 6–7% range. This requires capital accumulation to increase by 7–8%. But even assuming some gain in capital productivity, this accumulation rate target still necessitates an investment share above 30%. Even if the Philippines manages to increase its investment-to-GDP ratio to 28% in the next 2 years and increase capital productivity by 10%, this would lead to a growth rate in the capital stock of 5.7%, insufficient to achieve the forecast GDP target. Higher capital productivity requires reforms at the industry and company level. A rate of increase in the capital stock of about 5% would contribute about 1.5 percentage points to GDP growth.

This would not be enough to put the country on the virtuous cycle, though. For the Philippines to achieve GDP growth rates of 6–7%, the contribution of capital accumulation to output growth must be in the neighborhood of 2.5 percentage points, or about 40% of total GDP growth.

This analysis leads to the conclusion that the growth targets set by the MTPDP are probably too high. On more realistic assumptions, the growth rate for the next 3 years will hover at around 5%, below the government targets. (Momentum slowed in the fourth quarter of 2004 due to inflation pressures, lower agricultural expansion, higher debt repayments, and low investment.) GNP will grow at approximately the same rate due to high debt service payments. From the high rate in 2004, agriculture is expected to decelerate to about 4.0% in the next 3 years, as a result of less

favorable weather that is forecast for this period. Industry growth will also be lower, at around 4%. The services sector is expected to maintain its high growth of close to 7%.

On the expenditure side, it is expected that personal consumption will swell by around 5% over the medium term, and government consumption—helped by revenue increases—by 3.0% in 2005. Gross fixed capital formation is expected to rise at an annual average of 7.5% (public investment by 7.0%). Exports are forecast to grow more slowly, by 7.5%, because of a weaker global economy and strong international competition. Imports are forecast to expand by 6.5% due to a slight rise in the price of imported inputs used in industrial exports. The current account will record a surplus of around 2–3% of GDP.

Given continuing high oil prices, wage rises, and transport cost increases, inflation in 2005 will likely rise to average 6.5%, above BSP's target (inflation in January 2005 reached 8.4%). Over 2005–2007, unemployment is projected to remain slightly above 11%.

The fiscal situation will continue to be the key factor to be monitored over 2005–2007. The 2005 budget as proposed by the House of Representatives was approved by the Senate without amendments. Revenues are expected to be 15.0% of GDP, edging up to 15.3% in 2006 and to 15.5% in 2007, thanks to the introduction of new taxes over this period. The fiscal deficit is expected to be 3.6% of GDP for 2005, 3.2% for 2006, and 2.8% for 2007. Underpinning the fiscal program are measures to boost the revenue-to-GDP ratio to 18% in 2010, mainly from higher revenue collection efficiency.

President Arroyo has set the tone for her administration's focus on fiscal consolidation. With the passage of new revenue measures and higher economic growth in 2004, the stock and currency markets rallied. The initial steps have been positive and the MTPDP 2004–2010 provides a platform for the Government to proceed, even though some of the targets are, perhaps, optimistic. The next few years will show if there is the will to put the Philippines on a high-growth path.



Singapore

Growth was stronger than expected in 2004, reflecting a broad recovery in both domestic and external demand, as well as the SARS-induced low base of the previous year. This led the Government to move from an accommodative macroeconomic policy stance to a moderate tightening. A slower, more sustainable growth path is expected in the medium term.

Macroeconomic assessment of 2004

Driven by strong domestic and external demand, the economy experienced a robust recovery in 2004, with GDP growth climbing to 8.4% from 1.4% in 2003. However, growth momentum was more moderate in the third and fourth quarters (Figure 2.11), largely reflecting the diminishing effects of the post-SARS rebound.

With regard to domestic demand, private fixed investment picked up by 13.9%, in sharp contrast to a 4.2% contraction in 2003. The upturn in the global electronics cycle boosted business confidence in Singapore's manufacturing subsector, resulting in higher spending on machinery and equipment. However, public investment continued to fall, by 10.6% in 2004, and lowered total fixed investment growth to 8.4%. Excess capacity in manufacturing was gradually worked down while inventory adjustments slowed, which greatly contributed to the output growth. Economic recovery also gathered momentum from a revival in private consumption, which rose by 8.6%, marking a post-SARS upturn and an improvement in labor market conditions. Overall, domestic demand accounted for 8.2 percentage points of the GDP expansion in 2004, with a contribution of 4.8 percentage points from total investment and 3.4 percentage points from consumption.

Export demand strengthened in 2004 on the back of the improved global economic

environment and strengthened IT demand. Merchandise exports in US dollars swelled by 24.2%, led by electronics, petrochemicals, and pharmaceuticals. Booming regional demand, particularly from the PRC, also boosted exports. Exports of pharmaceuticals grew rapidly as a result of earlier investment in the country by EU pharmaceutical companies. Import growth escalated from 8.5% in 2003 to 27.1% in 2004, due to strong demand for intermediate inputs for electronic products and for machinery and equipment.

With the exception of construction, all manufacturing and services subsectors registered growth in 2004, indicating a broad-based economic recovery. Manufacturing value added rose by 13.9%, led by biomedical manufacturing and transport engineering, which grew by 25.7% and 24.0%, respectively. Biomedical manufacturing, the second-largest manufacturing subsector after electronics, posted strong gains of 20.8% in the first quarter and 52.8% in the second on a year-on-year basis, then contracted by 16.9% in the third and grew by 56.7% in the fourth. The volatility reflects Singapore's reliance on a limited number of companies in this industry. Electronics recorded an upswing of 14.9%, underpinned by the rapid expansion of semiconductors and IT and of consumer electronic products.

With oversupply in the property market, construction declined by 6.5% in 2004, the sixth consecutive year of contraction. In contrast,

services bounced back by 7.2%, largely reflecting the post-SARS rebound and rapid development of regional trade, especially for trade- and tourism-related services. Both wholesale and retail trading and the hotel and restaurant services subsectors posted double-digit growth in 2004. Transport and communications registered growth of 9.1%. Financial services grew modestly by 6.0%, with foreign-exchange trading, fund management, and insurance the major contributors.

The economy's acceleration had the effect of raising government receipts, which largely offset a 2 percentage point cut in the corporate income tax rate and other tax exemptions introduced in 2004. Operating revenues, excluding investment, interest, and capital income, climbed by 6.9% in 2004. Government operating expenditures increased by 3.6%, mainly due to a rise in spending on security, education, and social welfare. Development spending rose by 6.7%, driven by increased spending on transport infrastructure as well as research and development. The primary operating deficit in 2004 shrunk to S\$2.1 billion (1.1% of GDP) from S\$2.5 billion (1.6%) in 2003.

In the financial markets, domestic monetary conditions tightened slightly after mid-2004, in tandem with US rate rises. The 3-month interbank rate nudged up from 0.75% to 0.81% by end-June and to 1.44% in September. The prime lending rate was kept at 5.3% though, reflecting ample liquidity in the banking system. Buoyed by the strength of the economy and renewed interest in many Asia-Pacific stock markets, the Straits Times Index gained 15% over the year.

Inflation edged up to a year-average 1.7% in 2004 from 0.5% in 2003. Prices of oil-related items, such as electricity and gasoline, jumped, while the costs of some services, such as education and health care, also contributed to higher consumer prices. Labor market conditions improved as the economy gathered momentum, with total employment expanding by an encouraging 66,200 jobs. Accordingly, the unemployment rate fell from 4.7% in 2003 to 4.0% in 2004.

Despite the surge in imports, the trade surplus rose to US\$31.1 billion in 2004, and the current account surplus moved up to US\$27.8 billion, equivalent to 26.1% of GDP. The net outflow on the capital and financial account declined to

Table 2.11 Major economic indicators, Singapore, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|----------------------------------|------|------|------|------|
| GDP growth | 8.4 | 4.1 | 4.5 | 4.4 |
| GDI/GDP | 18.3 | 21.7 | 23.0 | 24.1 |
| Inflation (CPI) | 1.7 | 1.4 | 1.2 | 1.2 |
| Money supply (M2) growth | 6.2 | 6.0 | 6.0 | 6.0 |
| Fiscal balance ^a /GDP | 3.4 | 3.3 | 3.2 | 3.1 |
| Merchandise export growth | 24.2 | 8.0 | 8.0 | 8.0 |
| Merchandise import growth | 27.1 | 7.6 | 8.5 | 8.5 |
| Current account/GDP | 26.1 | 26.0 | 25.7 | 26.2 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

^a Refers to the differences between total revenues (receipts credited to the Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account, including investment income, capital receipts, and investment adjustments) and total expenditures (outlays made from these accounts).

Sources: Ministry of Finance; Monetary Authority of Singapore; Singapore Department of Statistics; staff estimates.

US\$13.0 billion from US\$20.1 billion a year earlier, mainly due to increased overseas borrowings by the nonbank sector. Both direct investment inflows and outflows rose significantly, spurred by the Government's effort to attract FDI and by the greater merger and acquisition activity overseas by domestic companies. Gross international reserves rose to US\$112.8 billion at end-2004.

Macroeconomic policy developments

As the more self-sustained recovery gradually reduced the need for policy stimulus, the authorities switched from an accommodative macroeconomic policy to a moderate tightening. The Monetary Authority of Singapore in April 2004 shifted its stance from zero appreciation of the trade-weighted nominal effective exchange rate to a modest and gradual appreciation, aimed at reducing the risk of imported inflation. The Singapore dollar appreciated by 4.1% against the US currency over the year, supported by stronger capital inflows to the region associated with an improved regional economic outlook. However, the local currency weakened against the euro, sterling, and regional currencies such as the Korean won and New Taiwan dollar, resulting in a

slight appreciation of the trade-weighted nominal effective exchange rate over the year.

The budget for FY2004 (beginning 1 April) continued to tweak tax policy in an effort to improve competitiveness and attract FDI, and included a reduction in the corporate income tax rate to 20% from 22%, tax exemptions for newly incorporated companies, and tax exemptions for foreign-sourced income and Singapore-sourced investment income. Overall, the fiscal stance was more prudent in terms of its narrower budget deficit than in FY2003. The budget for FY2005 projects a small surplus of S\$210 million, or 0.1% of GDP.

Aiming to attract internationally mobile talent, the Government will reduce the upper end of the personal income tax rate to 20% from 22% in two steps, starting in the 2006 assessment year. Also, the budget for FY2005 includes some fine-tuning of tax measures to support financial services, logistics, and tourism, such as a waiver of stamp duty on transfers of Singapore properties into real estate investment trusts for a 5-year period, removal of stamp duties for Islamic real estate transactions, and a concessional corporate tax rate of 10% for events companies that have tourism events approved in the next 5 years.

In the past three decades, Singapore has recorded budget surpluses for most years and the Government has accumulated significant assets. Temasek Holdings, the Government's main investment corporation, published its first annual report since it was established in 1974. This shows that the average annual rate of return over the past 30 years was 18%, but the return over the past 10 years averaged only 3%, mainly because of the 1997–98 Asian financial crisis. Although the annual report does not provide full financial accounts, its disclosure represents a significant step toward greater transparency in the management of government surpluses.

In contrast, the case of PRC-controlled China Aviation Oil (Singapore) Corp. (CAO Singapore) raised questions about Singapore's regulatory system. In November, CAO Singapore reported US\$550 million in losses from trading oil derivatives. The Singapore Exchange took swift steps to protect the market's credibility by suspending trading in CAO Singapore shares. The Monetary Authority said it will work with the exchange to

Figure 2.11 GDP growth, seasonally adjusted, Singapore, Q1 2001–Q4 2004



Source: www.singstat.gov.sg/keystats/mqstats/ess/aesa12.pdf, downloaded 3 March 2005.

review corporate governance and market conduct rules once all investigations into the affair are finished.

In response to the challenge of an aging population, the Government announced several measures to boost the population, through improving the fertility rate and broadening the immigration criteria. As a city-state with just 4.2 million people, Singapore is highly exposed to world market conditions and vulnerable to external shocks. A larger population would help build domestic demand to better balance fluctuations in international demand. Moreover, the Government has targeted some export-oriented services, such as tourism, entertainment, health care, and education, as new sources of growth. A larger population would also help increase demand for such services and thus lower production costs. With a more open immigration policy, the country may be able to increase its population to 6 million–8 million over the long term and to raise its potential growth rate by 0.5–1.0 percentage point.

Another government strategy is to strengthen external economic linkages through bilateral and multilateral trade arrangements. The Government signed a free trade agreement with Korea in 2004, which is expected to take effect this year. Under this agreement, almost 75% of domestic exports to Korea, which amount to over S\$3 billion, will benefit from the immediate elimination of tariffs. Furthermore, Singapore is pursuing bilateral free trade agreements with other countries, including

the PRC and India. Given its strategic location and prominence as a regional hub for business and financial activities, it aims to play a role as a bridge between these two growth engines in Asia.

Outlook for 2005–2007 and medium-term trends

After the peak in the first half of 2004, a mild cyclical downturn appears to be under way. During 2005, the moderation of global growth and downswing in the electronics cycle will slow the momentum. The economy is expected to decelerate to a more sustainable track and GDP is forecast to expand by 4.1% in 2005. A slight pickup is expected in 2006 and 2007, to 4.5% and 4.4%, respectively, on the resumption of an upturn in the global electronics cycle in late 2005 and 2006.

The recovery in domestic demand will provide a partial buffer against the weakening of external demand. After the peaking of structural and business cycle-related unemployment in 2003, consumer confidence has improved in line with the gradual decline in unemployment and rising real wages. Private consumption, which strengthened by 8.6% in 2004, is forecast to rise by 4.6% in 2005 and by 4.5% in 2006–2007. The growth of fixed asset investment is expected to slow to 4.5% in 2005, as decelerating exports damp the business outlook. However, inventory building is likely to continue contributing to the growth of total investment.

The upward trend in exports will moderate in line with weaker demand in the world electronics market. Still, robust growth in Asia, outside of Japan, will keep regional import demand healthy, which will stimulate Singapore's economy. The PRC, which accounted for 9.0% of Singapore's domestic exports in 2004, will become a more important trade partner, even as PRC growth slows. Overall, merchandise exports measured in US dollars are forecast to advance by 8.0% in 2005. Imports will likely rise at a slower pace than exports, owing to the softening domestic investment demand and reduced demand in electronic intermediate goods. The current account surplus is forecast to stay at around 26.0% of GDP

in 2005, mainly because income payments to overseas investors will increase.

From a sector perspective, electronics is expected to register modest growth in 2005, while biomedical manufacturing will continue moving ahead since more pharmaceutical companies plan to expand capacity. The momentum in services is likely to ease, reflecting the effects of moderating domestic consumption spending, though some subsectors, such as tourism and financial services, are expected to continue their trajectory through 2005, underpinned by robust regional economic growth and some strengthening in capital market activities.

The Monetary Authority is likely to keep to its tightened policy stance by allowing a modest appreciation of the Singapore dollar, in the context of the general weakness of the US dollar and the rise in imported inflation. Wages are expected to edge up following the improvement in the labor market. Due to lingering structural unemployment, however, the unemployment rate may stay at around 4%. The monetary policy stance, combined with slower growth in domestic and external demand, will contain the rise in the CPI to around 1.4% in 2005.

Downside risks to this outlook include any severe and protracted downleg in the global electronics cycle, a sharp correction of the US external imbalance, and much higher oil prices. Although the oil refining sector may benefit from rising oil prices in the short term, the negative impact of higher oil prices on the world economy would ultimately hurt Singapore.

Structural changes under way could improve the economic outlook. In manufacturing, efforts to diversify the pharmaceutical manufacturing base and develop the entire supply chain of pharmaceutical-related activities could pay off in terms of higher medium-term economic growth and reduced exposure to swings in global electronics demand. In services, further liberalization in banking, the cultivation of fund management, and efforts to deepen and broaden the capital markets will enhance Singapore's position as a regional financial hub and cushion the economy from some of the effects of manufacturing volatility.



Thailand

Economic growth slowed in 2004, partly as a result of drought, avian flu, and rising oil prices. Investment became a more significant contributor to the final outcome. Growth is expected to slip further this year, even though the authorities plan major infrastructure spending. Issues to watch include implementation of the infrastructure program, potential private debt imbalances, and whether the Government uses its strengthened parliamentary position to promote economic reforms.

Macroeconomic assessment of 2004

In contrast with most of East Asia and Southeast Asia, Thailand's expansion slowed in 2004, to a still strong 6.1% from 6.9% in 2003. The deceleration was attributable to a prolonged drought, avian flu, increasing oil prices, and unrest in the southern provinces, which hurt consumer and investor confidence. But against this broader trend, investment continued to accelerate, rising by 16.1% and contributing 3.6 percentage points to total growth. The main factor was an 11.7% surge in public investment, after a 0.8% fall in such investment in 2003. Private investment grew by 15.3%, slowing a little from 17.5%.

Consumption grew by 5.4% and contributed 3.4 percentage points to GDP growth, similar to the input from investment. In consumption, too, government spending growth picked up, to 4.1% from 2.0%, while the rise in private consumption decelerated, to 5.6% from 6.4% (Figure 2.12). Expansion in imports outpaced that in exports, and net exports subtracted 1.1 percentage points from growth.

On the production side, agriculture was affected by the drought, avian flu, and reduced export demand for shrimps due to US anti-dumping measures. Consequently, agricultural production fell by 4.4% in 2004, switching from growth of 8.7% in 2003. The growth rate of manu-

facturing eased to 8.3% from 10.4%. Production of chemicals was strong, partly reflecting high demand from the PRC. Some light manufacturing industries, especially food and beverages, were also hit by avian flu and drought, although they recovered in the third quarter. The capital goods and technology industries continued to slow through 2004, partly due to declining demand for motor vehicles prompted by higher oil prices and revisions to excise taxes, which caused some consumers to delay purchases until after July when the revisions took effect.

Among services, growth in wholesale and retail trade eased a bit but hotels and restaurants grew by 12.4%, recovering strongly from 2003 when the regional SARS outbreak set back these subsectors. Hotel occupancy rates increased from about 57% in 2003 to 64% in 2004 and the number of foreign tourist arrivals rose by 17.3% to 11.7 million. Construction recorded high growth of 12.7% in 2004, up from 3.3%, reflecting an increase in private and public construction. Transport and communications also grew faster in 2004, by 7.7%, or more than double the pace of 2003, while growth in the financial sector was high at 14.2% in 2004, although this was 2 percentage points below its 2003 rate.

Unemployment has been on a downward trend since the Asian financial crisis, from 4.4% in 1998 to 3.3% in 2001 and 2.1% in 2004. Indeed, the labor market is tight in some industries.

Government revenues and expenditures both increased by about 17% in FY2004 (ended 30 September 2004). The budget registered a surplus of B19.4 billion and there was a nonbudgetary deficit of B2.2 billion, so that the overall government balance was a surplus of B17.2 billion, or 0.3% of GDP. In FY2003, the Government had recorded a surplus of 0.6% of GDP.

The general level of prices edged up in 2004, largely due to higher prices of farm and oil products, but started slowing toward year-end. Consumer price inflation averaged 2.7% in 2004, higher than 1.8% in 2003. Core inflation, excluding food and energy, was 0.4%, up from 0.2%, but within the target range set by the Bank of Thailand (BOT). The central bank raised its benchmark 14-day repurchase rate three times in the second half of 2004, by a total of 75 basis points to 2.0%, in order to lean against inflationary pressures. The overnight interbank rate rose from 1.02% in January to 1.79% in December, though the 1-year fixed deposit rate remained at 1.0% and the prime lending rate stayed in a range of 5.5–5.75%.

In the banking sector, commercial bank deposits increased by just 2.6% in 2004, compared with 4.4% growth in 2003. Commercial bank private credits expanded at a much higher rate of 6.8%, accelerating from 3.6% in 2004. The ratio of NPLs in Thai commercial banks was about 12% in December 2004, down from almost 14% in the previous year, although some estimates put NPLs for the whole economy at around 20%. The Stock Exchange of Thailand Index gave back some of the large gains it made in 2003, when this measure of share prices more than doubled. In 2004 the index declined by 16%. The baht firmed to an average rate of B40.27/\$1 from B41.53/\$1 in the previous year, while the real effective exchange rate fell slightly.

External performance remained strong in 2004. Merchandise exports climbed by 23.0% to \$96.1 billion, accelerating from the rate of expansion in 2003, mainly a result of sharply higher shipment volumes to the EU, ASEAN economies, and Japan. Merchandise imports grew even faster, by 26.9%, to \$94.4 billion. The surge in imports was attributable to oil price increases and imports of intermediate products and capital goods. The trade surplus fell by half

Table 2.12 Major economic indicators, Thailand, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|----------------------------------|------|------|------|------|
| GDP growth | 6.1 | 5.6 | 5.8 | 6.0 |
| GDI/GDP | 27.1 | 24.0 | 26.0 | 27.0 |
| Inflation (CPI) | 2.7 | 3.5 | 3.0 | 2.5 |
| Money supply (M2) growth | 5.4 | 5.5 | 5.0 | 4.0 |
| Fiscal balance ^a /GDP | 0.3 | 0.0 | 0.2 | 0.2 |
| Merchandise export growth | 23.0 | 10.0 | 5.0 | 8.0 |
| Merchandise import growth | 26.9 | 13.5 | 6.0 | 8.0 |
| Current account/GDP | 4.5 | 2.3 | 1.3 | 1.3 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

^a Includes national Government's budgetary and nonbudgetary accounts.

Sources: Bank of Thailand; National Economic and Social Development Board; staff estimates.

to \$1.7 billion, but the services account recorded an increased surplus, producing a current account surplus of \$7.3 billion, or 4.5% of GDP, compared with 5.6% in 2003. Gross international reserves rose to a comfortable \$49.8 billion in December 2004, from \$42.1 billion at end-2003. External debt fell to \$50.6 billion from \$51.8 billion and the debt service ratio declined from 16.0% to 8.4%.

Macroeconomic policy developments

The Government strengthened its position in Parliament in elections in February 2005, ensuring continuity of its dual-track policy of building up domestic economic fundamentals while enhancing Thailand's links to world markets through international trade, investment, and financial cooperation. The Government is expected to continue its programs, such as the Village Fund that provides loans to communities, as well as assistance for SMEs.

High crop prices in 2003–2004 led to significant increases in farm income, by 28.5% in 2003 and 15.4% in 2004. These increases, plus government programs that injected funds into rural districts, contributed to reducing poverty. However, income inequality among different regions and groups remains a problem. Thailand is likely to attain most of the Millennium

Development Goals, and is now going beyond them in some areas.

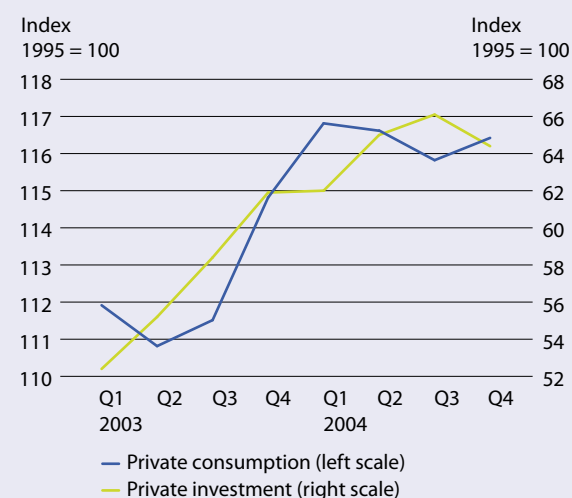
Investment plans that call for spending of up to B2.7 trillion (\$69 billion) between FY2005 and FY2008, mainly on infrastructure projects in transport and energy, have been drawn up by the Government and SOEs. Large-scale projects, each costing more than B3 billion, account for 56% of the total. Planned funding sources are the government budget (36%), domestic loans (25%), international loans (24%), and SOE income (15%). The investment will raise GDP growth on average by about 0.2 percentage point a year over the investment period, according to the Ministry of Finance. However, it may also result in a smaller current account surplus. Although spending on infrastructure will boost the competitiveness of the economy, in implementing such a large investment program the Government should give paramount consideration to debt sustainability and macroeconomic stability.

The Government provided tax breaks that it hopes will spur private investment. From the start of 2005, the corporate income tax rate on the first B1 million of profit was lowered for businesses with registered capital not exceeding B5 million. From April 2005, the level of business income at which VAT applies is to be raised from B1.2 million a year to B1.8 million.

After raising its benchmark repurchase rate three times in the second half of 2004, BOT increased the rate by another 25 basis points to 2.25% in March 2005, and further tightening appears possible because of inflationary pressures, rising global rates, and a less pressing need for low rates in Thailand. The central bank will be cautious, though, because adjusting rates too rapidly could hurt private investment, economic growth, and the banks if their borrowers are strained by higher rates.

In response to the rehabilitation needs after the tsunami disaster, the Government said that expected expenditures for emergency and rehabilitation assistance could be about B10 billion. Of that amount, B5 billion was allocated to immediate programs, including direct assistance to families, support for industries, and low-interest loans for businesses. BOT will provide funding for commercial banks to lend at low rates to businesses in tsunami-affected areas.

Figure 2.12 Private consumption and investment, Thailand, Q1 2003–Q4 2004



Source: Bank of Thailand.

Outlook for 2005–2007 and medium-term trends

Growth is likely to ease further—to 5.6%—in 2005 because of the global growth slowdown, high oil prices, and impact of the tsunami. The negative impact of the tsunami is estimated at 0.3–0.5 percentage point of GDP, which will be partly offset by government and private sector rebuilding. Consumption growth is forecast to slow to around 4% in 2005. This reflects in part two increases in diesel fuel prices in the first quarter of 2005 and the higher inflation and interest rates in 2005 that will slow spending.

Consumer confidence was in a downward trend early in 2005. Investment growth, though, will pick up to around 16% in 2005, because of post-tsunami reconstruction, high capacity utilization rates in certain manufacturing industries, and stronger corporate profitability in 2004. Also, some of the big public infrastructure projects are expected to be under way by the end of 2005, and the Government plans a supplementary budget that will fund public investments. These factors will more than offset the negative impact on investment of the slowing economic growth and rising interest rates.

On the production side, agriculture is expected to slowly recover after the 2004

contraction, provided that the drought eases and avian flu sees no nationwide recurrence. However, the drought remained a serious concern through the first quarter of 2005 and, if it continues, could slow the economy further. Growth of industry is put in the 7–8% range over the forecast period, slightly below 2004's pace.

Services growth will slacken to about 4.0% in 2005, reflecting the impact of the tsunami on tourism. BOT commented in March 2005 that economic growth had moderated in December and January as a result of the tsunami, drought, and a softer trend in exports. (The coastal provinces affected by the tsunami usually host about 15% of Thailand's foreign and domestic tourists.) After this year, GDP growth is expected to edge up to 5.8% in 2006 and 6.0% in 2007.

Net exports will be a slight drag on growth for at least the next 2 years as imports are expected to grow faster than exports, largely because of high oil prices and demand for imported capital and intermediate goods. The faster growth of imports will tip the trade balance into deficit from 2005 and the current account surplus will shrink. However, it is expected that external debt will fall further and that international reserves will be maintained at a comfortable level. Inflation is set to move up by nearly 1 percentage point to 3.5% on average in 2005, before subsiding in 2006–2007.

Investors will be watching to see if the Government uses the opportunity presented by

its strengthened parliamentary position to make a renewed push on corporate and banking sector restructuring, on legal reforms in corporate governance and bankruptcy, and on privatization. Another issue under scrutiny will be the Government's attitude toward off-budget spending now that it is more secure. Off-budget spending has raised concerns about the size of the Government's contingent liabilities.

External risks to the outlook include lower than expected economic growth in Thailand's major markets and higher than expected oil prices. The country's active participation in regional cooperation programs and bilateral economic cooperation frameworks may help it minimize the impact of some types of externally generated problems.

Domestic risk factors include the drought, threat of a nationwide outbreak of avian flu, and sociopolitical tension in the south. In addition, close attention needs to be paid to private debt levels because property investment and household debt levels have been rising. Excessive credit expansion could increase the vulnerability of the economy as a whole, and the financial sector in particular, to rises in interest rates.

Over the longer-term, a long-standing challenge is higher education, in terms of quality and accessibility. A larger pool of trained employees, especially in technical fields, is needed to help the economy remain competitive.



Viet Nam

Bolstered by strong global markets for oil and commodities and buoyant domestic demand, the economy recorded further robust growth in 2004, and the outlook is good for the medium term. However, the economy will bump up against constraints in the longer term unless the Government accelerates reforms among SOEs and banks. Avian flu may become a serious risk factor.

Macroeconomic assessment of 2004

Supported by buoyant consumption and investment, growth maintained its rapid rate in 2004, reaching 7.5%. Private consumption grew by 12.9% and government consumption by 8.0%. Total investment climbed by 24.6% to reach 35.5% of GDP. A little more than half of the investment, 56%, originated from the state sector, while the domestic private sector contributed 27% and foreign investment 17%. Around 27,000 new private enterprises were registered during the first 10 months of the year, with a total capital of \$3.4 billion, representing a year-on-year increase of 24% in number and 25% in capital value.

Investment projects and expanding export industries lifted demand for imports, but exports too were buoyant, narrowing the trade deficit to 11.5% of GDP in 2004 from 12.6% in 2003.

On the supply side, industry and services, together accounting for nearly 80% of GDP, were the main sources of growth. The industry sector, which covers manufacturing, mining, construction, and utilities, grew by 10.2% and contributed 3.9 percentage points to GDP growth. Within this sector, the GDP of the domestic private and foreign-invested subsectors grew faster (22.8% and 15.7%, respectively) than the state-owned subsector (11.8%).

Services grew by 7.4% in 2004, driven mainly by wholesale and retail sales, which were up by 9.0%, and transport, postal, and tourism services,

up by 8.5%. After a slow start at the beginning of the year due to the outbreak of avian flu, visitor arrivals jumped by 20.5% from the 2003 level, to nearly 3 million. The easing of visa requirements for tourists from Japan and Korea was a factor, prompting an upsurge in tourists from these countries. Overall, services contributed 3.0 percentage points to GDP growth.

The agriculture, forestry, and fisheries sector was the slowest expanding at 2.8%, because of a prolonged drought in many parts of the country and higher prices for imported fertilizers. The share of this sector declined to 20.2% of GDP in 2004 and it contributed only 0.6 percentage point to economic growth. Rice farmers benefited from high domestic and international prices. The shrimp industry grew by 8.5%, supported by domestic demand at a time that antidumping action in the US restricted access to that market.

Strong economic growth helped reduce the number of households in poverty by 300,000 to 1.4 million. This is as measured by the national poverty standard, which puts households below the poverty line if they have consumption spending of less than D80,000–D150,000 (depending on the location) per person per month. The poverty rate was consequently reduced from 11.0% in 2003 to 8.3% in 2004. The poorest regions continued to be the Northwest (16.4% poor), the Central Highlands (13.6%), and the Northern Central Coast (12.7%). Ethnic minorities generally have a high incidence of poverty.

Growth created jobs for an estimated 1.6 million people in 2004, lowering the unemployment rate in urban areas from 5.8% in 2003 to 5.6% in 2004. Unemployment rates were higher in large cities—6.5% in Hanoi and 6.4% in Hai Phong and Ho Chi Minh City. Nearly 65,000 Vietnamese took jobs abroad in 2004, bringing the total to 340,000. These workers' remittances contributed an estimated \$1.5 billion, equivalent to 3.5% of GDP, to the national economy.

Government revenues benefited from strong economic growth and from higher world oil prices (Viet Nam is a net exporter of oil), with receipts from the production and export of crude oil exceeding budget targets by 60%. Total budget revenues were 14.5% higher than expected. Expenditures also exceeded the budget level, by 10.9%, as the Government eased its fiscal position, particularly in the fourth quarter of 2004. Some of the increase in spending was caused by avian flu, which required more resources in the health sector and for subsidies to farmers who culled their poultry stock. The fiscal deficit was estimated at 3.8% of GDP, including onlending and excluding grants, or below the Government's target of 5.0%.

In response to the rise in the price of imported petroleum products and to curb likely border leakages due to lower domestic petroleum prices, the Government increased the domestic price of diesel, kerosene, and gasoline in June and again in November. This raised transport costs, including costs of food production and distribution. Food prices also came under upward pressure from the drought, the avian flu outbreak (which raised meat prices), and higher world prices for rice. As a result, the price of food increased by 15.6%. The CPI rose by 9.5% in December and annual average inflation for the year was estimated at 7.7%, up from 3.2% in 2003. However, excluding food, the CPI rose much more moderately at 3.0%.

Credit growth accelerated to 28% year on year at end-2003, and was estimated to have picked up further to 36% in July 2004. The State Bank of Viet Nam kept the prime lending rate steady at 7.5%, and the dong depreciated by less than 1% against the dollar.

Buoyant world prices for oil and commodities were a boon for Viet Nam in 2004, helping boost total export revenues by 30.3% to \$26.0 billion.

Table 2.13 Major economic indicators, Viet Nam, 2004–2007, %

| Item | 2004 | 2005 | 2006 | 2007 |
|---------------------------|------|------|------|------|
| GDP growth | 7.5 | 7.6 | 7.6 | 7.5 |
| GDI/GDP | 35.5 | 36.1 | 37.1 | 37.7 |
| Inflation (CPI) | 7.7 | 5.7 | 5.2 | 5.2 |
| Money supply (M2) growth | 28.0 | 28.0 | 27.0 | 25.0 |
| Fiscal balance/GDP | -3.8 | -4.9 | -5.0 | -4.8 |
| Merchandise export growth | 30.3 | 11.4 | 8.9 | 8.6 |
| Merchandise import growth | 26.0 | 12.0 | 10.0 | 10.0 |
| Current account/GDP | -5.7 | -5.6 | -5.8 | -6.6 |

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: General Statistics Office; Ministry of Finance; State Bank of Vietnam; International Monetary Fund; staff estimates.

Crude oil, which accounted for 22.0% of total exports, recorded a 48.3% rise in value on a 14.1% increase in volume. The country is a significant exporter of rice, coffee, rubber, pepper, cashew nuts, and tea, which all benefited from stronger global prices. The export value of wooden furniture and related products soared by 86% to over \$1 billion, mainly because of improved access to the US market. Textiles and garments also performed well in 2004, with exports growing by 17.2% to \$4.3 billion. The US remained the main market for textiles and garments, although Canada, EU, and Japan were also major destinations.

Steeper world prices also pushed up the cost of some imports, in particular refined petroleum products, fertilizer, and steel. The total import bill rose by 26.0% to \$30.9 billion, resulting in a trade deficit of \$4.9 billion. The current account deficit was similar to the 2003 level, but as a share of GDP fell to 5.7%.

In response to an improved investment climate, FDI commitments were strong in 2004, reaching \$4.0 billion, or almost one third higher than in the previous year. Net FDI rose from \$1.2 billion to \$1.7 billion. Foreign exchange inflows were pushed up by official development assistance and by private remittances through official channels. These private remittances rose from \$2.6 billion in 2003 to about \$3.2 billion in 2004.

Gross international reserves (including gold) rose by \$300 million to an estimated \$6 billion in

2004, equivalent to about 2.5 months of imports. The ratio of external debt to GDP is estimated at 34% for 2004, down from 38.7% in 2003. Total debt servicing amounts to 6.7% of the total value of exports of goods and services.

Macroeconomic policy developments

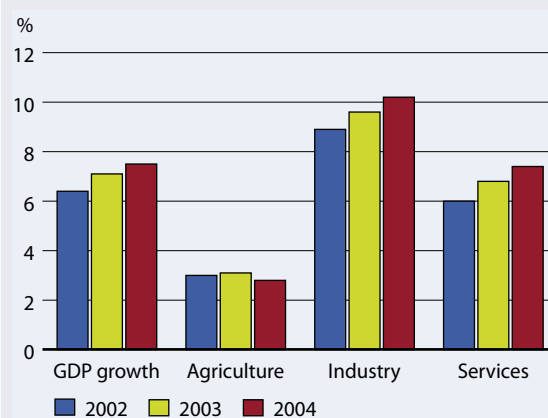
The Government continued to pursue an expansionary fiscal stance. In 2005, the last year of the current 5-year socioeconomic development plan, it is aiming for 8.5% growth to achieve the 7.5% annual average growth envisaged in the plan. At the same time, the authorities recognize the increasingly important role and potential of the private sector. Improvements were made in the business environment in 2004, resulting in increased private investment.

Among the improvements, the Government started to prepare a unified law for all types of enterprises and one investment law for all types of investments by 2006. These changes are expected to simplify procedures, enhance transparency, and promote good corporate governance. Legislation on competition issues, bankruptcy, and land ownership was updated, and decrees were promulgated on the conversion of businesses with foreign investment into joint-stock companies and on allowing foreign investors to own up to 30% of the registered capital of Vietnamese businesses.

The Viet Nam Business Forum's 2004 survey showed that more than two thirds of surveyed foreign businesses plan to expand over the next 3 years. The other third indicated that bureaucracy, corruption, high costs of doing business, and poor enforcement of laws were obstacles to expansion. Half of the surveyed companies noted evidence of improvements in access to financing, in administrative and customs procedures, and in transparency.

Business community representatives, at a meeting in December with government officials, suggested that the authorities focus efforts on further streamlining administrative procedures, curbing corruption, facilitating the introduction of modern technologies and management skills, improving infrastructure, developing capital markets, and allowing the private sector to compete on a level playing field with state enterprises. Such changes would improve the viability

Figure 2.13 GDP and sector growth, Viet Nam, 2002–2004



Sources: General Statistics Office; staff estimates.

of domestic producers as the economy is opened wider to external competition.

Related to the improvements in the business climate is reform of the public administration system, which is important in the context of the transition to a market economy as well as further economic integration with the rest of the world. In addition to further progress in training civil servants and the computerization of state administration, the Government paid long-awaited salary increases to civil servants in December 2004. Low salaries are considered to be one of the root causes of corruption in the civil service.

In response to the accelerating growth of credit, the central bank raised compulsory reserve requirements for dong and US dollar deposits in July 2004. It subsequently increased discount and refinancing rates by 50 basis points to 3.5% and 5.5%, respectively, in January 2005. However, it kept the prime lending rate at 7.5%. In an effort to slow inflation, the Government lowered tariffs on petroleum and steel products (until January 2005) and instructed SOEs not to take advantage of their monopolistic positions to raise prices.

While Viet Nam has made solid progress in its macroeconomic performance and in improving its business climate, it has lagged in removing structural weaknesses, particularly in the SOE and state-owned commercial bank (SOCB) sectors. The Government has grappled with technical problems, such as a lack of legal mandates for the equitization program for SOEs, under which the

state retains a large shareholding in an SOE and sells the rest to employees and the private sector. Building a consensus for reform among SOE stakeholders, such as employees and state agencies, is also taking time.

The state seems to be concerned about minimizing social costs and revenue erosion (about 70% of tax revenues come from SOEs). Nevertheless, several decrees were announced to facilitate planned SOE equitization. The social safety net, which compensates SOE employees who lose their jobs during restructuring or equitization, was brought into operation.

In the first 10 months of 2004, 461 SOEs, mainly smaller and provincial-level ones, were partially privatized. As part of its preparation to reform larger SOEs, the Government undertook a performance assessment of 42 of them, mainly manufacturers, which disclosed that about 80% were profitable, albeit with low rates of return on investment. It also drew up plans to group many “government corporations,” which are large SOEs that are supposed to be run on a commercial basis, into holding-company structures in an effort to improve their performance. Few advances were made as regards the development of capital markets in 2004, to a degree a result of the drawn-out procedure on partially privatizing SOEs.

All SOCBs have been recapitalized, although they do not yet meet the internationally accepted capital-adequacy ratio of 8%. Amendments to the Law on Credit Institutions became effective in October 2004. Among other reforms, the amendments clarify the separation of policy and commercial lending, strengthen the decision-making autonomy of credit institutions, allow banks to offer loans without collateral, and require independent audits of SOCBs.

On the external trade front, Canada and the EU agreed to eliminate quotas on Vietnamese exports of textiles and garments from 1 January 2005, and the US approved a \$1.8 billion quota for Vietnamese garment exports. The Government is pushing ahead with its bid for WTO entry and has said that it will amend or abolish trade- and investment-related laws that are inconsistent with WTO rules. The chances of joining WTO by late 2005 seem to have improved following the successful conclusion of the ninth round of multi-

lateral negotiations in December 2004, as well as bilateral agreements with the EU and Singapore. The final round of multilateral negotiations is scheduled for mid-2005.

The next 5-year socioeconomic development plan (2006–2010) has a target of 7.5–8.0% annual average GDP growth, broken down into 3.0–3.5% in agriculture, forestry, and fisheries; 10.0–15.0% in industry; and 7.2–7.5% in services. The aim is to create 8 million additional jobs and reduce the number of poor households. The plan is expected to achieve the Government’s Comprehensive Poverty Reduction and Growth Strategy and Viet Nam Development Goals—the local version of the Millennium Development Goals. Given that the country has achieved rapid economic expansion and poverty reduction over the past decade, the targets seem plausible, provided that the Government ensures that total investment stays at about 35% of GDP, improvements are made in the productivity of capital, and economic growth benefits all sectors of society.

Outlook for 2005–2007 and medium-term trends

Continued robust growth is likely over the forecast period. The export environment looks favorable, with high crude oil prices and an upward trend in global commodity prices, as well as Viet Nam’s closer integration into the world economy. Domestic demand is expected to remain strong.

GDP growth is projected at around 7.5% annually over the next 3 years, supported by domestic demand that is forecast to increase by 8.0%, 8.7%, and 8.5%, and export growth of 11.4%, 8.9%, and 8.6% in 2005, 2006, and 2007, respectively.

The Government’s target for 8.5% growth in 2005 calls for total investment of about \$19 billion, of which about 70% will go to economic infrastructure such as roads, bridges, and power generation. The fiscal position is expected to remain expansionary to cover the cost of reforms and infrastructure. Growth in revenues will be constrained by further cuts in import tariffs, but the buoyant economy and more efficient tax collection will ensure that revenues remain fairly robust. The budget deficit will widen to around 5% of GDP in 2005–2007.

Inflation will likely moderate to 5.7% in 2005 and 5.2% in 2006–2007. The CPI rose by 3.6% in the first 2 months of 2005 from December 2004, mainly caused by higher food prices during the Lunar New Year. For the rest of the year, the CPI is likely to increase at a slower pace.

While key macroeconomic variables are expected to remain reasonably stable, risks to the medium-term outlook come from a further opening of the economy to competition from abroad, uncertainty over market access, falls in commodity prices, rapid credit expansion, inflation, and possible public health scares.

Opening the economy further over the next 2 years in compliance with ASEAN Free Trade Area commitments and WTO accession (assuming it happens) will likely bring more external competition for domestic enterprises. The economically less efficient and state-protected enterprises will have difficulty in adjusting to the more competitive environment. In aggregate, though, the additional market access gained for local products should more than offset the impact on the enterprises that lose domestic market share.

The issue of market access will arise if the planned accession to WTO fails or is delayed. Garment markets are more competitive since the MFA ended, and the country needs to join WTO to secure the favorable treatment accorded to members. Still on trade, the economy is now running a trade deficit, which could widen the

current account deficit if foreign exchange inflows are constricted for any reason. Continuing improvement in the business climate will be required to ensure a high level of foreign exchange inflows from FDI, overseas aid, and private remittances.

International commodity prices look likely to remain robust, but if prices instead turn down, consumption spending will be vulnerable as many people depend on income from production of rice, coffee, spices, and other commodities.

High rates of credit expansion could potentially exacerbate inflation and raise the risk of more NPLs, because SOCBs and the state-owned Development Assistance Fund, which provides credit to SOEs, have limited credit risk assessment and management capabilities.

The major public health risk is avian flu, which reappeared late in 2004 in southern parts of the country and spread to many provinces. By late March, 14 human deaths had been recorded in the latest outbreak. No human-to-human infection has been confirmed, but concern is growing that transmission in this manner may occur, which could spark a pandemic. The incidence of HIV/AIDS has increased, too.

In the longer term, as Viet Nam emerges as a fully open economy, its prospects for rapid growth and poverty reduction will be put at risk if progress remains slow in the areas of reforming SOEs and SOCBs, improving capital productivity, and making the economy more competitive.