ASIAN DEVELOPMENT Outlook 2005

Promoting competition for long-term development

Asian Development Bank

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The annual *Asian Development Outlook* provides a comprehensive economic analysis of 42 economies in developing Asia and the Pacific.

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Foreword

The *Asian Development Outlook 2005* is the 17th edition of the annual comprehensive economic report on the developing member countries of the Asian Development Bank (ADB).

ADO 2005 provides a detailed analysis and assessment of macroeconomic conditions—including fiscal, monetary, and balance-of-payments developments—for 42 Asian and Pacific economies for 2004, as well as projections for 2005–2007. It also provides a broad diagnosis of macroeconomic challenges and future growth prospects for the region's economies.

The major industrial economies expanded by 3.5%, their strongest growth in many years. Boosted by a strong revival in business investment and continued robust consumption spending, the United States (US) economy grew exceptionally fast in 2004, while Japan and the euro zone also experienced somewhat faster growth in spite of some setbacks during the second half of the year. Inflation has remained moderate in major industrial countries in spite of their strong economic performance and continued high oil prices. As a result, monetary policy remained unchanged in Japan and the euro zone, while a very moderate tightening started in the US in the second half of the year. In spite of significant global economic imbalances, the outlook for the major industrial countries remains definitely optimistic over the period 2005–2007. Macroeconomic policies, though tightening somewhat, should remain supportive of continued robust growth. However, increasing risks loom over the baseline, which could be substantially altered if world inflation and interest rates rise much faster than expected, and global uncertainties and imbalances lead to sharp depreciation of the US dollar.

The economies of developing Asia and the Pacific achieved their highest growth performance since the Asian financial crisis in 1997–98 as their aggregate gross domestic product (GDP) expanded by 7.3% in 2004. Such robust performance was underpinned by the combination of a highly favorable external environment and buoyant domestic demand, in particular as a result of a significant strength in business investment in many economies in the region. In spite of robust growth for the third year in a row and the burden of persistent, high oil prices, average inflation remained rather subdued in 2004, although inflation started to pick up in several countries in the latter part of the year, triggering some tightening of monetary policies. On aggregate, the region continued to register a significant current account surplus, of 3.7% of GDP, though this was lower than in 2003.

The strong economic momentum in most regional countries, together with a continued favorable external environment, augurs well for income growth over the forecast horizon of 2005–2007. There will be some moderation in growth since the cycle probably peaked in 2004, but average GDP growth is projected at between 6.5% and 6.9% over the next 3 years. While export demand from the major industrial countries might subside a little, intraregional trade should remain buoyant as the PRC economy seems set to achieve a soft landing and the forces of regional integration intensify. With inflation projected to remain moderate, macroeconomic policies should continue to support domestic demand.

This issue of the *Asian Development Outlook* includes a chapter on promoting competition for long-term development in Asia. Its key message is that government policy should promote competition to ensure efficient resource allocation, while preserving incentives for innovation. Removing restrictions to competition enables markets to deliver benefits to consumers, and supports sustainable economic growth. However, competition must sometimes be accompanied by regulation. In addition, competition complements intellectual property protection, as both seek to promote innovation and enhance consumer welfare. Overall, competition policy is important in its own right, and countries should strive to develop and implement it for domestic benefit.

HARUHIKO KURODA
President

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Acronyms and abbreviations

AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
CEPA	Closer Economic Partnership Arrangement
CPI	consumer price index
DMC	developing member country
EU	European Union
FATF	Financial Action Task Force
FDI	foreign direct investment
GDP	gross domestic product
GNP	gross national product
GST	goods and services tax; general sales tax
HIV/AIDS	human immunodeficiency virus/acquired immunodeficiency syndrome
ICT	information and communications technology
IMF	International Monetary Fund
IPR	intellectual property right
IT	information technology
Lao PDR	Lao People's Democratic Republic
M&A	merger and acquisition
MFA	Multifibre Arrangement
MNC	multinational corporation
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PBC	People's Bank of China
PRC	People's Republic of China
PRGF	Poverty Reduction and Growth Facility
R&D	research and development
saar	seasonally adjusted annualized rate
SARS	severe acute respiratory syndrome
SME	small and medium enterprise
SOCB	state-owned commercial bank
SOE	state-owned enterprise
UN	United Nations
US	United States
VAT	value-added tax
WTO	World Trade Organization

Definitions

The economies discussed in the *Asian Development Outlook 2005* are classified by major analytic or geographic groupings. For purposes of *ADO 2005*, the following apply:

- **Association of Southeast Asian Nations** (ASEAN) comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam. ASEAN+3 consists of the above countries in addition to People's Republic of China, Japan, and Republic of Korea.
- **Developing Asia** refers to 42 developing member countries (DMCs) of the Asian Development Bank discussed in *ADO 2005*.
- **East Asia** comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- **Industrial countries** refer to the high-income OECD countries defined in World Bank, available: www.worldbank.org/data/countryclass/classgroups.htm#High-income.
- **Southeast Asia** comprises Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- **Central Asia**—also referred to as the Central Asian republics—comprises Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **The Pacific** covers Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Republic of Palau, Papua New Guinea, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.
- The **euro zone** consists of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.
- Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars. Currency abbreviations are given in Statistical Appendix Table A19.

The *Statistical Notes* give a detailed explanation of how data are derived.
ADO 2005 is based on data available up to 31 March 2005.

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Outlook
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Part 1
Developing Asia and the world

ASIAN DEVELOPMENT
Outlook 2005

Part 1
Developing Asia and the world

Developing Asia and the world

Overview of economic highlights and prospects

The major industrial economies grew at their strongest rate in many years in 2004. In turn, the economies of developing Asia and the Pacific achieved their highest growth since the Asian financial crisis as aggregate gross domestic product expanded by 7.3%. Domestic demand was buoyant and average inflation remained subdued. The strong economic momentum in most regional economies, together with a continued benign external environment, augurs well for growth over 2005–2007. Average real growth is expected to be between 6.5% and 6.9%, supported by more buoyant domestic demand and strengthening intraregional trade.

Developing Asia: Economic highlights of 2004 and prospects for 2005–2007

In 2004, developing Asia achieved its best growth performance since the Asian financial crisis of 1997–98. The region's aggregate real gross domestic product (GDP) expanded by a strong 7.3% (Table 1.1). In fact, with the notable exception of the Pacific developing countries, nearly all developing Asian economies grew by more than 5% in 2004, a remarkable feature for a region of about 4 billion people. Using purchasing power parity weights, developing Asia's GDP expanded even faster, at 7.7%. Some of the region's best performers were the People's Republic of China (PRC); Hong Kong, China; India; Kazakhstan; Malaysia; Singapore; Uzbekistan; and Viet Nam.

The overall growth performance was underpinned by continued strength in external demand, complemented by more buoyant domestic demand, in particular business investment. On the external front, the economies of the region were the main beneficiaries of robust growth in major industrial countries, in particular the United States (US). Associated with this was a significant revival in the global electronics market, for which many Asian countries are major exporters. In addition, with the economy of the PRC showing hardly any signs of a slowdown and regional economic integration further moving forward, intraregional trade remained remarkably buoyant in 2004 as exports from the economies in the region increased by 27.9% in the year to September. For 2004 as a whole, exports from developing Asia rose by 25.5%, compared with 19.3% in 2003.

However, rapid income growth for several years in a row, together with continued high oil prices, also led to surging imports in most Asian economies, as reflected in narrowing trade and current account surpluses or in widening deficits

Table 1.1 Selected economic indicators, developing Asia, 2003–2007

	2003	2004	2005	2006	2007
Gross domestic product (annual % change)					
Developing Asia	6.7	7.3	6.5	6.6	6.9
East Asia	6.7	7.8	6.7	7.0	7.2
Southeast Asia	5.0	6.3	5.4	5.6	5.9
South Asia	7.8	6.4	6.7	6.2	6.9
Central Asia	10.0	10.4	8.7	8.8	9.2
The Pacific	2.6	2.6	2.3	1.4	2.1
Consumer price index (annual % change)					
Developing Asia	2.4	3.9	3.7	3.3	3.3
East Asia	1.3	3.3	3.1	3.0	3.0
Southeast Asia	3.3	4.2	4.3	3.9	3.8
South Asia[a]	5.1	5.9	4.9	3.6	3.9
Central Asia	5.7	6.0	6.0	5.3	4.9
The Pacific	8.6	3.6	3.4	4.0	4.0
Current account balance (% of GDP)					
Developing Asia	4.3	3.7	2.6	2.1	1.6
East Asia	4.3	4.2	2.9	2.4	1.7
Southeast Asia	7.8	7.1	6.2	5.3	4.9
South Asia	1.9	-0.7	-1.2	-1.5	-1.9
Central Asia	-2.5	-1.9	-3.2	-0.5	1.8
The Pacific	0.3	-0.7	-0.8	-1.5	-0.5

[a] India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

in some economies. The average current account surplus in the region was reduced to 3.7% of GDP in 2004, down from 4.3% in 2003, whereas the contribution of net exports to GDP growth was uneven.

A major feature of economic developments in 2004 was a marked revival of business investment, particularly in East Asia and Southeast Asia where it had been lagging since the Asian crisis—with the notable exception of the PRC where it has remained robust over the past decade. In most countries in South Asia and the energy-rich countries of Central Asia, investment spending also showed a healthy upward trend in 2004, a positive sign for stronger long-term growth. High capacity utilization was in part due to robust external demand, low interest rates, and ample liquidity, as well as strengthening business confidence. Almost all countries showed an increase in their investment-to-GDP ratio. The revival of business investment, combined with continuing or strengthening consumption demand in most countries, and partly supported by further expansionary fiscal policies, translated into the robust rates of growth experienced in 2004.

On the supply side, in many countries the agriculture sector accounts for a significant share of GDP. Conditions were favorable in Fiji Islands, Indonesia, Kyrgyz Republic, Mongolia, Nepal, Philippines, and Uzbekistan, but in India, agricultural growth could not match the exceptional recovery of 2003, thus contributing to somewhat lower GDP growth there.

In spite of generally sustained high growth over the past few years and high oil prices, inflation in most countries remained largely subdued in 2004. In the PRC, even with continuing concerns about overheating of the economy, inflation averaged 3.9% in 2004 compared with 1.2% in 2003. There were, of course, exceptions where inflation became a concern over the course of 2004, notably Azerbaijan, Cambodia, India, Mongolia, Pakistan, Philippines, Samoa, Sri Lanka, Thailand, Tonga, and Viet Nam, though inflationary pressures became more apparent across the region as the year progressed. This led several countries to adopt a more flexible exchange rate stance and, as a result, a raft of Asian currencies—including the baht, New Taiwan dollar, Singapore dollar, and won, as well as the yen—appreciated against the US dollar, reducing the impact of imported inflation. Nevertheless, with relatively low inflation, monetary policies remained mostly accommodative during the year.

The strong economic showing by most of developing Asia in 2004 was marked by a further accumulation of foreign exchange reserves, which are estimated to have reached about $1,624 billion at the end of the year. The region benefited from strong capital inflows, notably FDI that is estimated to have climbed to $69.3 billion (on a net basis) over the year. Foreign exchange reserves increased at about the same rate as in 2003, but were mainly concentrated in the PRC. In several countries, the holding of large amounts of foreign exchange reserves in dollar-denominated assets came under scrutiny in 2004 as the risks of a further substantial depreciation of the US dollar became more apparent and the need to signifi-

cantly boost domestic investments, particularly in infrastructure, in order to boost competitiveness, was increasingly realized.

Any acknowledgment of developing Asia's strong economic performance in 2004 must be tempered by the fact that too many economies, in particular smaller economies, are still far from closing the income gap with the better-off countries in the region. These economies remain highly vulnerable to external shocks and have weak domestic fundamentals. Among their number are: many of the economies of the Pacific; Mongolia in East Asia; Cambodia, Lao People's Democratic Republic (Lao PDR), and Myanmar in Southeast Asia; Afghanistan, Bangladesh, and Nepal in South Asia; and Kyrgyz Republic and Tajikistan in Central Asia.

Over the forecast period 2005–2007, the overall outlook for developing Asia will of course depend heavily on developments in the world economy as a whole—particularly in major industrial countries and the PRC. The prospects for growth in major industrial countries and for world trade—in spite of significant downward risks—remain relatively buoyant, auguring well for the economies of developing Asia over the forecast period. At the same time, domestic market conditions have become stronger over the past 2 years in most countries, providing some cushion against a potential deterioration in the external environment.

In spite of a rather confident baseline outlook for developing Asia, this environment could become much more somber over the next 3 years, depending on how the current uneven expansion among some major world economies affects key economic variables across the globe. A much more robust growth projection for the US economy, while Japan and the euro zone go through a relatively rough patch, implies that the problem of external imbalances in the US could become worse, triggering a sharp depreciation of the dollar, a spike in inflation, and more sudden increases in interest rates, thus ultimately restraining world growth and trade. In addition, stronger growth in relatively energy-intensive countries, particularly the PRC and the US, points to continued high oil prices and an exacerbation of the global imbalances.

In short, while the region has built up significant resilience against external shocks, many economies remain vulnerable, particularly some of the poorer ones.

The 2005–2007 baseline assumptions for external conditions (Table 1.2) indicate only a moderate slowdown of average GDP growth for developing Asia as a whole to 6.5–6.9% (7.1–7.5% on the basis of purchasing power parity weights). In East Asia, average GDP growth will be in the range of 6.7–7.2% as the PRC economy experiences only a mild slowdown while the economies of Hong Kong, China and Taipei,China perform somewhat better than the average of the past 4 years. In Southeast Asia, average GDP growth is forecast at 5.4–5.9%, higher than the average of the past 4 years, since most countries are projected to perform markedly better. (For Indonesia, the most populous country in the subregion, this is a very positive development.)

In South Asia, growth is projected at 6.2–6.9%, substantially higher than historical averages, largely reflecting continued robust growth in the Indian economy, which accounts for about 80% of the subregional average. In Central Asia, growth rates, though fluctuating widely due to developments in the energy sector in some countries, are expected to settle to more sustainable levels as the effects of economic transition fade. In the Pacific, GDP growth rates will remain on average at around 2%, as the two largest economies—Fiji Islands and Papua New Guinea—are not projected to perform particularly well.

While developing Asia's economies will show significant divergence, domestic demand will increasingly play a significant role in supporting overall growth in 2005–2007. Generally robust income growth over the past few years has boosted consumer confidence and spending. At the same time, investor sentiment is strengthening in many major economies of the region, and increased domestic and foreign investments are forecast in the baseline. Even as the pace of the world economic expansion moderates over the next 3 years, developing Asia will remain a preferred investment location, provided that countries can enhance—or at the least, keep—their competitive advantage. In this context, furtherance of economic, governance, and administrative reforms, as well as improvements to infrastructure, will be particularly important.

Table 1.2 Baseline assumptions for external conditions, 2003–2007

	2003 Actual	2004 Actual	2005	2006	2007
GDP growth (%)					
Industrial countries	2.0	3.5	2.5	2.5	2.4
United States	3.0	4.4	3.7	3.4	3.1
Japan	1.4	2.7	1.1	1.3	1.3
Euro zone	0.5	2.0	1.6	1.8	2.1
Memorandum items					
United States Federal Funds rate (average, %)	1.1	1.4	3.1	4.2	4.4
Brent crude oil spot prices ($/barrel)	28.8	38.3	41.0	39.0	37.0
World trade volume (% change)	5.5	10.2	7.4	6.0	6.0

Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic Model.

Sources: US Department of Commerce, Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N; Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/quart&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html; World Bank, *Global Economic Prospects 2005*, available: http://siteresources.worldbank.org/INTGEP2005/Resources/GEP107053_Ch01.pdf; World Bank Commodity Price Data, available: http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html; US Federal Reserve, available: www.federalreserve.gov/releases; staff estimates.

Investment rates are expected to remain firm over the forecast period and to average about 30% for the region.

The potential contribution of domestic demand to growth could, however, be negatively affected by inflationary trends and the response of the monetary authorities. Projections indicate that inflation in developing Asia could, on average, fall somewhat in the forecast period, leveling off in 2006–2007. No significant tightening of monetary policies is required, but it could be if the baseline assumptions are not realized. Higher interest rates would particularly affect countries where household or public debt is high, including PRC, Indonesia, Republic of Korea (hereafter Korea), Kyrgyz Republic, Philippines, Sri Lanka, Tajikistan, and Thailand. As often discussed in the *Asian Development Outlook* (*ADO*) in previous years, fiscal discipline is the best protection against potential external shocks.

The external sector will remain important, but might contribute somewhat less to growth than in the recent past, since imports are projected to continue increasing rather rapidly in many countries. Although projections indicate that export growth will moderate over the next 3 years, the world trading environment remains relatively buoyant compared with historical averages. Moreover, intraregional trade should continue to expand at a brisk pace as the rest of developing Asia integrates further with the PRC and increasingly with India. Robust growth in the region, combined with continued trade liberalization reforms, will also lead to strong import growth, resulting in declining current account surpluses or widening deficits (mainly in South Asia). The external sector might therefore contribute less to growth than in recent years.

As the external environment runs a risk of becoming less bright over the forecast period, initiatives by developing Asian governments to enhance competitiveness and promote stronger regional integration will become more important, and will be key factors in attracting foreign investment flows. In this context, the significant divergence in exchange rate movements in Asia relative to the US dollar could become a significant policy issue over the forecast period. For the countries of the region, some coordination of these movements is a preferred solution, and should be put high on the policy agenda.

Economic prospects for developing Asia remain auspicious over the next 3 years. While inevitably such a vast region presents significant divergences, income growth will generally remain

robust under the baseline scenario. Most of the larger economies in the region are well placed to weather external shocks, which current imbalances in the world economy could very well trigger over the next few years. However, and very importantly, the long-term prosperity of the region can only be built on robust economic growth that is inclusive. There is evidence that inequalities have increased significantly in many of the rapidly growing economies of the region. Policy measures to mitigate these inequalities will be particularly important over the next few years.

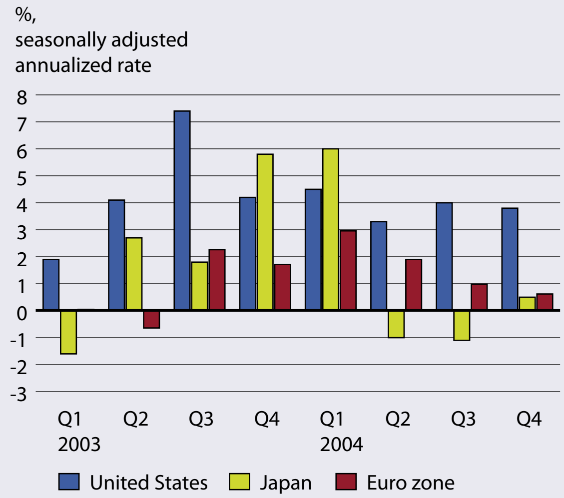
Prospects for the world economy in 2005–2007

The economies of major industrial countries are projected to continue a moderate expansion in 2005, following heady growth of 3.5% in 2004. However, a strong and synchronized recovery in these countries between the latter half of 2003 and the first quarter of 2004 gave way to uneven growth over the course of 2004, which is expected to continue widening the growth gap between major industrial economies in the near term (Figure 1.1). With projected growth in the US again outpacing that in the other major industrial economies, the ongoing problem of large external imbalances of the US economy will likely remain unresolved, casting a shadow over the medium-term sustainability of the current rebound. Reflecting such concerns, the dollar declined sharply against the yen and the euro in the fourth quarter of 2004.

The US is poised to continue further expansion, whereas Japan and the euro zone have been experiencing an extended setback since the second quarter of 2004. Taking a hard hit from high oil prices and slowing external demand, some large economies—notably Germany, Italy, and Japan—slumped in the second half of 2004. However, economic fundamentals remain relatively sound even in these countries, on the grounds of stronger corporate balance sheets and healthy profits. Business investment has been on the rise, even as export growth has eased. In addition, business surveys point to an improving outlook in industrial production through 2005.

Meanwhile, a broadening of the recovery continues in the US, on the back of robust private consumption and business capital spending. With prospects of a continued benign outlook for some major economies—namely the PRC and the US—exports should start lending help again in Japan and the euro zone over the rest of 2005, although the rate of export growth will be lower than the previous peak.

Figure 1.1 Real GDP growth rate of US, Japan, and euro zone, Q1 2003–Q4 2004



Sources: US Department of Commerce, Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N, downloaded 31 March 2005; Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/quart&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0, downloaded 4 March 2005; Economic and Social Research Institute of Japan, available: http://www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html, downloaded 14 March 2005.

Nevertheless, the widening growth gap entails a significant medium-term risk to the outlook, while sustained high oil prices compound the difficulties for major industrial countries to maintain both internal and external balances. Despite the level of oil prices, core inflation in these economies remained largely under control in 2004. Behind such remarkably subdued inflationary developments lie slow, but accelerating, generation of employment in this economic recovery as well as slackness in most economies. However, excess supply in the labor market in the US is dissipating, with relatively healthy job creation seen in 2004 as a whole.

At the same time, strong US domestic expenditures are deepening the trade deficit,

adding downward pressure on the dollar, while exacerbating inflationary conditions in the medium term. Inflationary risks are tilted up with higher labor and nonlabor costs as well as softening productivity growth in the US. These could lead, later in 2005, to interest rates being considerably higher than currently expected, limiting further expansion in the US economy in the medium term. Against this backdrop, sluggish domestic demand in Japan and the euro zone poses a considerable downside risk. As the rest of the world economy, particularly Japan and the euro zone, still relies heavily on exports for growth, a sharp slowdown in US demand could lead to a worldwide slowdown.

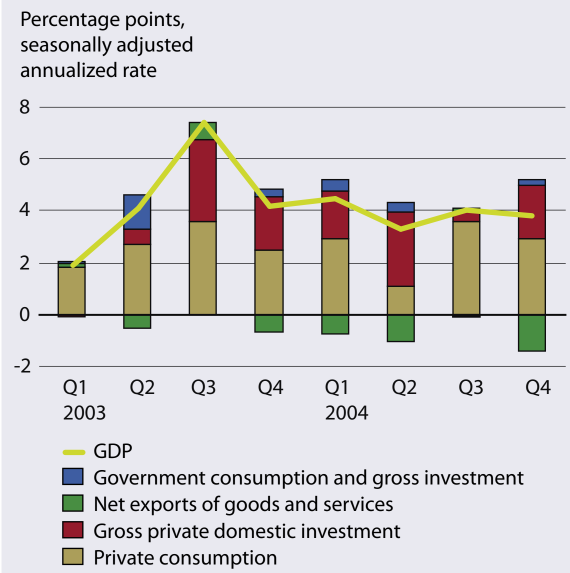
Overall, the economies of industrial countries are projected to grow at 2.5% in 2005 and 2006 (Table 1.2 above), lower than the robust performance of 3.5% last year, but still considerably higher than the average growth rate during the 1990s. Nevertheless, there are signs that a gradual deceleration in the economic growth of these countries is likely to continue. With a number of downside risks weighing on the medium-term outlook, growth in major industrial countries will slow to 2.4% in 2007.

United States

The US economy continues its healthy expansion on the back of a strong upturn in fixed investment and robust private consumption (Figure 1.2). GDP growth registered a remarkable 4.4% in 2004, up from 3.0% in the previous year. Private consumption expenditure remained a major contributor to the increase in GDP, rising by 3.8% from 2003. The rebound in private domestic investment, aided by a strong pickup in business capital spending since the latter half of 2003, also continued to provide growth impetus. However, renewed vibrancy in exports during the second half of 2003 and the first half of 2004 has waned amid the extended slowdown in the other major industrial countries since midyear, giving rise to the concern that external imbalances in the US economy may further deepen, at least in the near term.

Meanwhile, a weakening in the dollar, together with sustained high oil prices, continues to exert upward pressure on the import bill. A visible reduction in net exports was the primary reason for the deceleration in GDP growth in the fourth quarter: GDP growth fell from a seasonally adjusted annualized rate (saar) of 4.0% in the third quarter to 3.8% in the fourth.

Figure 1.2 Contribution to change in GDP, United States, Q1 2003–Q4 2004



Source: Bureau of Economic Analysis, available: www.bea.gov/bea/dn/nipaweb/TableView.asp?SelectedTable=2&FirstYear=2002&LastYear=2004&Freq=Qtr, downloaded 31 March 2005.

Business activity remains buoyant. Industrial production was 4.2% higher in December 2004 than in December 2003, pushing capacity utilization to 79.1% at year-end, or over 2 percentage points higher than 12 months earlier. The January Institute for Supply Management (ISM) survey suggests healthy expansion in both manufacturing and nonmanufacturing, with the ISM composite purchasing managers index for manufacturing and the ISM nonmanufacturing index reading 56.4% and 59.2%, respectively. (A reading above 50% indicates that business activity generally is expanding.) In spite of slowing exports, manufacturers' new orders and shipments continue to post decent gains on resilient domestic demand. This ongoing demand-side pressure should sustain sound production through 2005.

Strong sales and production have bolstered corporate profits, which grew by an estimated 15.7% year on year in 2004 despite hurricane damage in the third quarter. Solid profit gains as well as a brighter business outlook in 2004

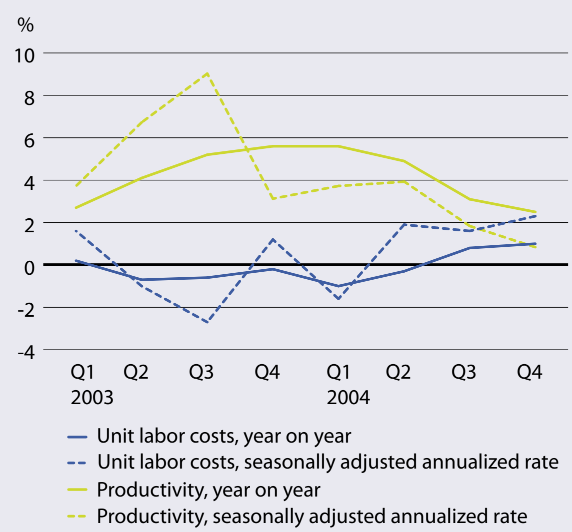
paved the way for a sharp rebound in corporate spending. Fixed investment rose by 10.3% year on year, buoyed by increased spending on equipment and software. Following several years of conservative corporate spending, the release of pent-up demand turned out to be enduring. Many firms took advantage of still-favorable tax and financing conditions to replace obsolete computers, software, machinery, and other types of business equipment. However, as interest rates rise further and profit growth slows, the pace of business spending on equipment and software will likely moderate in the latter half of 2005. Enhanced corporate discipline in the aftermath of the high-tech boom of the late 1990s will also keep inventory building under control, restraining excessive capital spending. Residential construction peaked in the second quarter of 2004 and is expected to continue stabilizing with a cooling in the housing market over the rest of 2005.

The labor market is making slow, but steady, progress. Nonfarm payroll employment gained a total of 2.2 million during 2004, lowering the overall unemployment rate to an average of 5.5% in 2004 from 6.0% in 2003. Reflecting the improvement in the job market, hourly compensation in the business sector increased by 4.2% in the fourth quarter (saar) following a 3.8% rise in the previous quarter. Higher compensation has underpinned a strong turnaround in private consumption since the latter half of 2004, while continuing wage increases are expected to exert upward pressure on inflation in 2005. Meanwhile, the household financial position is poised to improve on rising incomes, heralding an orderly consolidation in household balance sheets in the coming years. Personal saving as a share of disposable income appears to have bottomed out, though it remained low at 1.6% in the fourth quarter, while growth in consumer credits outstanding shows signs of stabilization.

Strong domestic demand is being slowly translated into price increases. The consumer price index (CPI)—which measures headline inflation—rose by 3.3% in 2004. The price deflator for private consumption expenditure less food and energy—the basis for a preferred measure of core inflation by the Federal Reserve (the Fed)—edged up by 1.5% over the same period. Although core inflation remains in check and high oil prices have been primarily responsible for headline inflation, there are signs that inflationary risks are inclined upward. With the labor market gradually closing the demand gap, unit labor costs in the nonfarm business sector rose at 2.3% (saar) in the fourth quarter, after a 1.6% increase in the third (Figure 1.3). High productivity growth, which has been a basis for the sound expansion of output without putting undue pressure on inflation, is also reaching a plateau. Fourth quarter labor productivity grew by only 0.8% (saar) in the nonfarm business sector, down from 1.8% growth in the third.

Inflation will be a key variable to watch in the US economy over the forecast period. First, the cyclical demand pressure on overall wages and price levels will likely increase, as the economy continues to work off the slack in the labor market. While wage gains were relatively muted, benefits picked up rather sharply in 2004, pointing to a tightening in the labor market. Second, the downward trend of the dollar is expected to persist, with significant external imbalances weighing on its strength, pushing up import prices. Third, sustained high prices in energy and nonenergy commodities will likely eventually feed into final sales prices. Increasing labor and nonlabor costs, along with slowing productivity

Figure 1.3 Change in unit labor costs and productivity, United States, nonfarm business sector



Source: www.bls.gov/news.release/pdf/eci.pdf, downloaded 1 March 2005.

growth, suggest dwindling profit margins, which may induce many companies to pass on such increased costs to customers.

With inflationary pressures building, US interest rates could move significantly higher in 2005. Unlike 2004 when the Fed started raising interest rates from a historically low base of 1.0%, the US economy will begin to feel tightening effects as the Fed continues its rate increases this year. As of March 2005, the Federal Funds rate stood at 2.75%, pushing real interest rates back into positive territory. Meanwhile, the financial positions of both the public and household sectors in the US have yet to improve significantly. The large fiscal deficit aside, the household sector remains considerably indebted. In 2004, the increase in Federal Funds rate notwithstanding, long-term interest rates did not move much, keeping under control the cost of borrowing for the household sector as well as for long-term business investment. However, this could change significantly this year, given the inflationary pressures and the forces of global rebalancing.

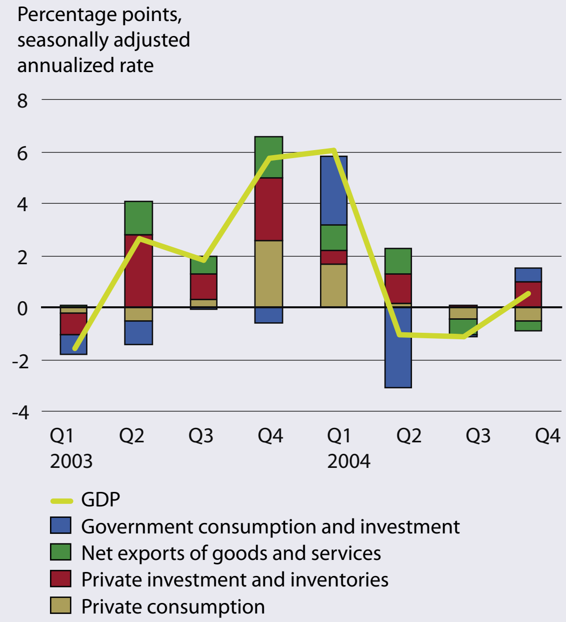
Nevertheless, growth momentum still favors the US economy. The baseline GDP projection is 3.7% for 2005. Business surveys point to continued expansion across a broad swathe of business activities, while demand-side pressure will continue to support corporate spending and hiring. As the economy moves toward its potential, higher wages will ensue, slowing further expansion. In spite of significant downside risks arising from inflation, the weakening dollar, higher interest rates, and the global adjustment forces, the relatively controlled pace of job creation and remarkably subdued inflation so far suggest that growth will likely remain healthy at 3.4% in 2006, subsequently moderating toward 3.1% in 2007, nearer its long-term potential.

Japan

The Japanese economy fell into another mild recession after posting encouraging growth of 6.0% (saar) in the first quarter of 2004, followed by 2 consecutive quarters of contraction (Figure 1.4). The exceptional growth witnessed from the second quarter of 2003 to the first quarter of 2004 failed to last, as exports—the major engine of growth during the latest recovery—faltered amid slowing global expansion, a cyclical downturn of the global information technology sector, and rising oil prices. A broadening of the recovery as strong exports helped lift business and consumption spending was also cut short before such a domestic demand recovery could become self-sustainable. Both business and consumer confidence fell, reflecting the lack of growth momentum (Figure 1.5). Future growth prospects are heavily influenced by underlying structural difficulties, which are compounded by the burden of an aging demographic profile.

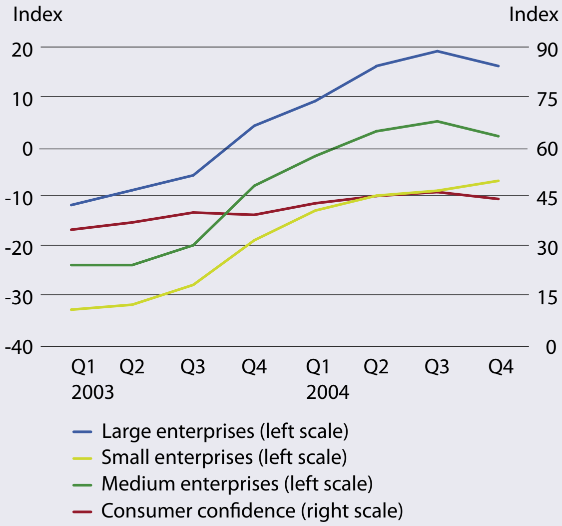
GDP growth was 2.7% for 2004 as a whole, drawing largely on the exceptional performance of the first quarter. However, softening demand (both external and internal) put a heavy drag on growth in subsequent quarters. Export growth slowed sharply to 2.6% (saar) in the third quarter, although somewhat improving to 4.9% in the fourth, from first and second quarter growth rates of 20.2% and 14.8%, respectively. Meanwhile, high global oil and raw material prices kept import costs up, as a result of which

Figure 1.4 Contribution to change in GDP, Japan, Q1 2003–Q4 2004



Source of original data: Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/en/sna/qe044-2/gdemenuea.html, downloaded 14 March 2005.

Figure 1.5 Tankan survey of business conditions and ESRI consumer confidence, Q1 2003–Q4 2004



Notes: ESRI consumer confidence survey is a monthly survey conducted by the Economic and Social Research Institute. Consumer perceptions of the following four categories are surveyed: overall livelihood, income growth, employment, and willingness to buy durable goods.
Sources: Economic and Social Science Research Institute, available: www.esri.cao.go.jp/en/stat/shouhi/0412shouhi-e.html; Datastream, downloaded 26 January 2005.

the contribution of net exports to growth turned negative in the last 2 quarters.

A tentative recovery in domestic demand also petered out. Private consumption rose by 3.0% (saar) in the first quarter, contributing 1.7 percentage points to growth. A gradual improvement in the job market from late 2003, combined with some advance in wages, sent consumer confidence up, boosting household spending until the first quarter of 2004. But the momentum was short lived against the strong headwind of slowing exports and production. Consumer spending has since retrenched, contracting by 0.9% and 1.0% (saar) in the last 2 quarters, consecutively. To make matters worse, a deterioration in the business environment is quickly translating into falling wages and household income. Total cash earnings of employees plunged in December, clouding the prospect of a consumption recovery in the first half of 2005.

Private investment demand was also hit, with gross fixed capital formation growth in the private sector falling from a peak of 13.4% (saar) in the second quarter to 0.3% in the third. However, private investment demand remains a relatively positive spot on the grounds of strong profit gains in the corporate sector and a recovering real estate market since 2003. Final quarter growth in private gross fixed capital formation ended slightly higher at 0.8% (saar) on the back of resilient private residential investment, contributing 0.2 percentage point to GDP growth.

Moderately improving machinery orders since late 2004 also supported a turnaround in business capital spending, with private nonresidential investment posting growth of 0.2% (saar) in the fourth quarter, recovering from a contraction of 0.4% in the third. The strength of business investment remains crucial to putting the economy back on the recovery path. Underpinning continued investment recovery through early 2005, Japan's leading exporters posted strong profit gains even as exports slowed from the second half of 2004. Beneath such resilience lie enhanced operational efficiency and financial stability in the corporate sector, after several years of substantial restructuring efforts.

The significant downturn in exports took a heavy toll on business activity. Industrial production fell by 0.7% in the fourth quarter (quarter on quarter), following a decrease of 0.6% in the third. A marked decline in new orders for high-tech equipment corresponding to the cyclical adjustment in the global information technology sector since mid-2004 was primarily responsible for a slowdown in production. There is a glimmer of hope for a production recovery in 2005, as November and December data for machinery orders in manufacturing and shipments of manufacturing goods show a slight improvement on the mild turnaround of exports in the fourth quarter. This is mainly due to robust growth in the economies of the US and the PRC, Japan's major trading partners. However, the weak domestic sector is expected to limit the scope for a swift recovery. Together with a gradual rebound in the export sector, though at a more subdued rate, this suggests only a slight recovery in industrial production for 2005.

On a brighter note, deflationary pressures are slowly easing, with year-on-year growth in the corporate goods price index (which measures

inflation at the wholesale level) settling firmly into positive territory over the course of 2004. CPI inflation also turned positive for 3 consecutive months (until December 2004), for the first time since 1999. Easing deflationary pressures should help the corporate sector sustain profit margins, in the face of high energy costs and slowing sales, both domestic and foreign. However, further deflation remains a considerable downside risk to the recovery, as both the corporate and consumer price inflation rates retreated slightly between December 2004 and January 2005.

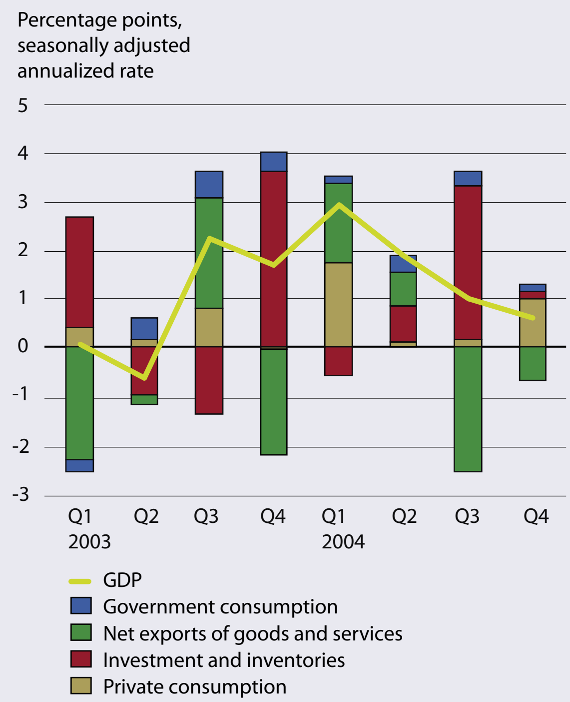
In spite of continued capital spending in the export sector, the near-term outlook remains bleak, with GDP expected to grow at 1.1% in 2005. The lackluster growth projection reflects unfinished business in the reform efforts. While the export sector has aggressively clamped down on excess capacity and has strengthened its financial position on rising global demand, the domestic nonmanufacturing sector—consisting mainly of small and medium enterprises—has made only limited progress in restructuring, thus delaying the recovery process in corporate spending and hiring. Meanwhile, the country's unfavorable demographic profile and related high pension burden suggest that the weakness in the domestic sector will persist, limiting any significant growth gains. GDP growth is projected to rise to 1.3% in 2006 and 2007, buttressed by a mild improvement in exports.

Euro zone

Euro zone GDP grew by 2.0% in 2004, up from 0.5% in 2003. However, final quarter GDP growth in 2004 slid to 0.6% (saar), much lower than the first quarter's 3.0%. A continued appreciation of the euro started to weigh on external trade. Export growth subsided to 5.2% (saar) and to 1.9% in the last 2 quarters, consecutively, from an average growth rate of 8.6% in the first half of 2004. Meanwhile, imports further increased following an improvement in the terms of trade as well as a surge in prices of oil and raw materials, turning the contribution of net exports to a negative 2.6 and 0.7 percentage points, respectively, in the third and fourth quarters, a sharp drop from 1.6 percentage points in the first. A recovery in private consumption remains fragile, with growth falling to 0.2% (saar) in the second quarter (although it has improved somewhat since then) from 3.1% in the first. Rising oil prices appear to be curbing consumption spending by eroding household discretionary income, which was already under pressure from anemic job growth (Figure 1.6).

As external demand softened, some of the larger euro zone economies that relied heavily on exports during the latest rebound slumped over the course of 2004. Germany and Italy, the largest and third-largest economies in the zone, contracted by 0.9% and 1.7% (saar), respectively, in the fourth quarter when the euro, already at its highest level since its launch, further appreciated against the dollar. Other countries—notably France and Spain, where domestic demand strengthened noticeably during 2004 thus exhibiting relative resilience as exports slowed—also remain vulnerable to sustained high oil prices in the face of sluggish job creation. Based on a combination of moderating exports and a slack

Figure 1.6 Contribution to change in GDP, euro zone, Q1 2003–Q4 2004



Source of original data: Eurostat, available: http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/nation/aggs/aggs_gdp&language=en&product=EU_MASTER_national_accounts&root=EU_MASTER_national_accounts&scrollto=0, downloaded 4 March 2005.

domestic economy, euro zone GDP is projected to slow to 1.6% in 2005.

Despite the lackluster performance in the second half of 2004 and weakened near-term outlook, the euro zone economy will likely continue a modest recovery on the grounds of a gradual strengthening of domestic demand over the medium term. In support of the slow, but steady, economic rebound, business investment continues to firm up. Gross fixed capital formation rose by 2.4% (saar) in the final quarter, continuing its rebound from the third. Following years of subdued investment, the corporate sector appears to be in need of replacing old machinery and equipment. Robust export earnings in the past few years have also significantly improved corporate financial positions, underpinning an upward trend in business capital spending. Rising corporate spending should in turn exert a positive influence on the labor market, thus eventually boosting private consumption. Against this backdrop, GDP is projected to grow at 1.8% in 2006, returning to a long-term average growth rate of 2.1% in 2007.

A major downside risk to this scenario is the slow progress in the labor market to date. Jobless rates in the euro zone are persistently high, at an average of 8.8% in 2004. In Germany, the unemployment rate surged to 12.4% in February 2005, while France reported 10.1% the same month. Such a dismal job situation in the euro zone, combined with reductions in unemployment benefits and tighter restrictions on eligibility for benefits that came into effect in January 2005 in Germany, could severely dent the prospects of a recovery in consumer spending over the forecast period. Consumer confidence, which showed a mild recovery in Germany, France, and Italy in early 2005 amid tax cuts and stabilizing oil prices (partly due to the offsetting effect of the strong euro), could also sharply deteriorate as a result of the dim job outlook.

Growth performance remains highly uneven across the euro zone economies, exacerbating the difficulties of harmonizing macroeconomic policies in support of a weak recovery. The dampening effect of continued euro strength notwithstanding, headline inflation remained slightly above the European Central Bank (ECB) target of 2% in 2004 due to sustained high oil prices. Moreover, credit growth has been relatively strong, given the resilient business capital spending and buoyant housing markets in many European economies. While the ECB is likely to maintain the current stance—reasonably accommodative at 2%—for the first half of 2005 in the face of a lagging recovery, a gradual pass-through of higher producer prices could trigger a rate hike later this year, barring any significant slowdown in economic activity. Fiscal policies in many euro zone economies remain largely restrictive, reflecting the target limits of the Stability and Growth Pact (SGP). Although some of the larger countries have introduced tax cuts while pursuing SGP reforms to provide a stimulus to weakening domestic demand, persistently large fiscal deficits and pension burdens limit likely expansionary fiscal spending across the region.

The German economy slowed sharply in the second half of 2004, although it posted decent growth of 1.6% for the year as a whole. The continued appreciation of the euro and a moderating global expansion led to erosion of previous export gains. However, new orders, both domestic and foreign, for manufacturing goods increased in December 2004, by 8.1% and 8.3% respectively, from the previous month, gently brightening the growth outlook for this year. Business surveys also suggested a moderate recovery for industrial production. Nevertheless, a modest turnaround in domestic demand is unlikely to be sufficient to accelerate the economy in the face of moderating foreign demand this year. Ongoing reforms in the labor market, health care, and pensions, although beneficial for long-term growth, will dampen near-term prospects.

In France, the recovery has been more broadly based than Germany and Italy, with domestic demand picking up along with exports. Boosted by income tax cuts, robust consumer spending has been sustained despite the weakness of job growth. The release of pent-up demand in the corporate sector has also lifted business investment. However, a mild cyclical correction is expected this year based on waning fiscal stimulus, continued slack in the labor market, and slowing exports.

The Italian economy ended 2004 on a grim note by shrinking in the final quarter. Exports, which had been the main driver of growth, declined as a result of continued euro

appreciation and slowing external demand, while domestic demand stagnated. Meanwhile, the rigidity in the labor market is further eroding Italy's competitiveness, as well as hampering a consumption recovery. Late in 2004, the Government announced tax cuts for 2005 to support domestic spending. However, without significant reforms in public finances, more measures to curb fiscal spending will be required to keep the government budget deficit from exceeding the SGP limit of 3% of GDP, which leaves the net effect of tax cuts largely ambiguous.

Outside the euro zone, the United Kingdom economy continues to expand on the back of strong consumer spending and business investment. Growth accelerated to 3.1% in 2004, although it will likely moderate to 2.7% in 2005 and 2.6% in 2006. In sharp contrast to the euro zone, past reforms have significantly lifted overall economic efficiency and productivity through enhanced flexibility in both labor and product markets. Productivity gains in turn are reinforcing a pickup in corporate profits, which is passed on to household income and net financial wealth, thus underpinning continued strength in private consumption. However, there are signs that the economy has already reached its potential, pushing labor costs higher, particularly in the buoyant private services sector. Household and corporate liabilities also seem overextended, as reflected in a marked reduction of private savings. Over the forecast period, the pace of private sector spending will soften, which will be partly compensated for by a gradual rise in public spending. Private consumption has already slightly retrenched following stabilization in housing prices coupled with rises in interest rates in the latter half of 2004.

World trade and commodity prices

World trade, as measured by world export volume, grew by an estimated 10.2% in 2004, nearly double the 5.5% rate in the previous year. However, the rapid pace of world trade expansion during the first half of 2004 has eased, as a synchronized global economic recovery largely fell apart in the second half. Strong export growth in major industrial countries all but ground to a halt in the third quarter of 2004, as Japan and some of the large euro zone economies slumped amid rising oil prices. Although relatively resilient US demand and robust industrial production in the PRC continue to provide some support to trade dynamics, several factors—including a moderating world economic expansion, slowing global demand for high-tech equipment, and sustained high oil prices—suggest that world trade will slow to 7.4% in 2005. Growth in world trade is likely to settle at about 6% over the medium term, reflecting a slowdown in world economic growth.

In the midst of rising economic uncertainty, a cyclical downturn in global high-tech industries has started to weigh on the export performance of many East Asian economies, which are leading producers of high-tech and electronic items. The year-on-year growth rate of worldwide semiconductor sales peaked at 40.5% in June 2004, weakening to 14.6% by year-end. After soaring in the first half, memory chip prices have fallen, as a result of softening demand and improved production capacity following tight supply conditions during the upswing in high-tech industries in the latter half of 2003 and the first half of 2004.

Despite the slowing pace of sales into 2005, there are signs that the current slowdown will be relatively mild and short lived. First, inventory buildup during the latest expansion period has been limited by enhanced corporate discipline. Indeed, producers have been quick to trim excess capacity, bringing down capacity utilization rates to 86.0% in the fourth quarter from a peak of 95.4% in the second, according to the Semiconductor Industry Association. Second, a decline in new orders and shipments of semiconductors have been stabilizing since the beginning of 2005 on the back of relatively resilient business capital spending around the world, even as the growth outlook for the world economy has eased. Third, the average price of semiconductors has stabilized since the fourth quarter of 2004, reflecting a relatively benign sales outlook for 2005.

In this context, global production and sales of semiconductors will grow modestly in 2005 after 2004's hefty growth, followed by a cyclical upturn as early as 2006.

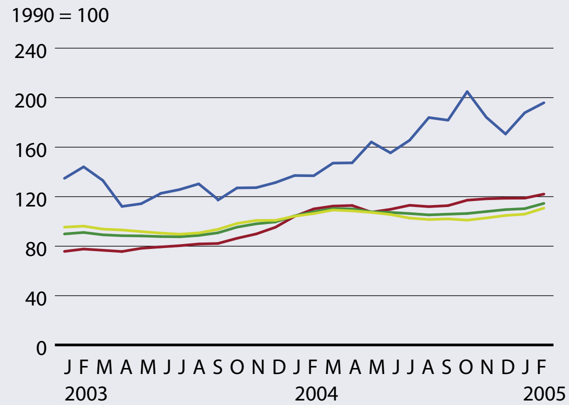
Oil prices surged and remained high at above $40 per barrel for most of the second part of 2004. The price of benchmark Brent crude

averaged $38.3 per barrel for 2004, significantly higher than $28.8 in 2003. With tight market conditions and geopolitical uncertainties, any event that could potentially disrupt oil supplies—such as financial troubles at Yukos (a large Russian oil producer); production delays in the Gulf of Mexico due to a hurricane; an oil rig workers' strike in Norway; and ongoing political unrest in Iraq, Nigeria, and Venezuela—unsettled the market. Last October, the price surged and stayed above $50 per barrel for much of that month. Oil market fundamentals have not improved significantly in the early months of 2005, as strong demand and geopolitical uncertainties continue. According to the February estimate by the International Energy Agency (IEA), global oil demand is 84.0 million barrels per day (mb/d) for 2005, or an increase of 1.5 mb/d from 82.5 mb/d in 2004. Strong demand is expected to continue in the US, the PRC, and the rest of developing Asia, while Japan and the euro zone should see a moderation in oil demand in 2005. Spare capacity of the Organization of the Petroleum Exporting Countries (OPEC) members (excluding Iraq, Nigeria, Venezuela, and Indonesia) remains low, according to the IEA. The growth of non-OPEC supplies, including those from the North Sea, the Gulf of Mexico, and the Russian Federation, is expected to be limited after a number of disruptions in 2004.

Against this background, global oil prices are projected to stay high, with Brent crude averaging $41 per barrel for 2005. Strong demand from developing Asia, especially the PRC, will likely remain supportive of the high oil prices over the forecast period, with the projected prices averaging $39 in 2006 and $37 in 2007.

Prices of nonenergy commodities were up by 10.0% in December 2004 compared with 12 months earlier, following an increase of 12.7% during 2003 (Figure 1.7). The price rally since 2002 stretched into the first half of 2004 on strong food and raw material prices. Prices of agricultural food commodities have generally come down since then, following good harvests of grains including maize, rice, and wheat. After the run-up in 2003 due to drought in major producing countries, prices of fats and oils fell by 17.7% in 2004 on strong production of soybeans. Meanwhile, the prices of beverages are picking up.

Figure 1.7 Commodity prices, January 2003–February 2005



Source: World Bank Commodity Price Data (Pink Sheets), various issues, available: http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html, downloaded 4 March 2005.

Coffee prices soared in the last quarter of 2004 on expectations of lower production in Brazil for 2005, while political instability in Côte d'Ivoire, the world's largest producer of cocoa, is keeping the cocoa price up. Nevertheless, reflecting relatively benign supply conditions, the prices of agricultural food and beverage products will further stabilize closer to their long-term trend in 2005, declining by 1.0–1.5%.

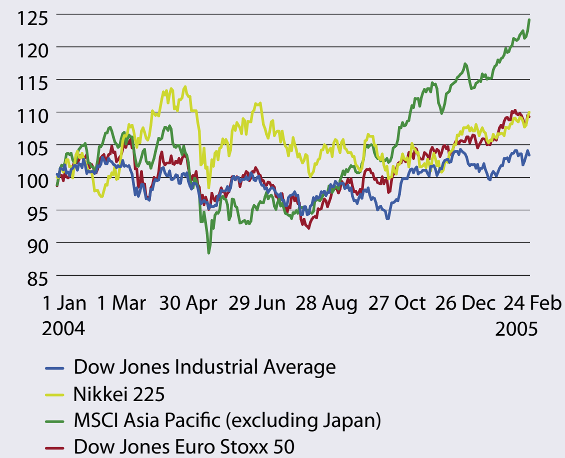
Meanwhile, agricultural raw materials such as rubber and timber sustained strong gains during 2004, reflecting robust industrial demand. Rubber prices (Singapore) rose by 20.4% in December 2004 from the previous year, and timber prices by 9.5%. Cotton prices also appear to be strengthening in early 2005, after hitting a 2.5 year low in December 2004.

Prices of metals and minerals continue to rally, increasing by 24.6% in 2004 on the back of strong demand (particularly from the PRC), low inventories, and ongoing weakness in the dollar. Steel production in the PRC, one of the world's largest producers, remains robust (despite the earlier concerns over a hard landing in the sector). Continued strong demand contributed to the largest gains in steel prices among metals. Prices of other metals such as copper, lead, and tin also

rose significantly, albeit at a slower pace in the second half of 2004 than in the first.

A healthy growth outlook for the PRC in 2005 is positive for the prices of raw materials, particularly metals and minerals. The prices of agricultural raw materials will likely remain strong, although increasing at a much more subdued rate of 1.0–2.0% in 2005, as they will benefit from resilient industrial production in the US and developing Asia. On the grounds of continued—albeit moderate—demand from the PRC, the prices of metals and minerals are also projected to grow at a more modest rate, likely in the range of 4.0–6.0% in 2005. Over the medium term, decelerating world economic growth, including a moderation in the PRC's expansion, suggests further stabilization of prices of nonenergy commodities.

Figure 1.8 Major stock market price indexes, January 2004–February 2005 (1 January 2004 = 100)



Note: Morgan Stanley Capital International (MSCI) is a capitalization-weighted index that monitors performance of stocks from Asia-Pacific, excluding Japan.
Sources: Datastream, downloaded 1 March 2005; Bloomberg, downloaded 1 March 2005.

Financial market developments

Buoyed by generally strong economic growth and a continued low interest rate environment around the globe, international financial markets remained vibrant in 2004. Investor confidence, which was hurt amid surging oil prices and a softening global rebound between July and early August last year, has since recovered. The prospect of continuing global recovery led by still robust economic expansion in much of Asia (including the PRC) and the US—though at a slower pace than in 2004—together with relatively muted inflationary pressures, appears to be underpinning the turnaround in global investment activity. By the end of 2004, both equity and corporate bond prices had climbed higher, recovering most of their earlier losses.

The return of investor confidence was reflected in the rebound of global equity prices (Figure 1.8). Shedding concerns about tight oil supplies, which sent the price of Brent crude beyond $50 per barrel during October last year, international investors quickly resumed the mid-August rally. The focus of investment decisions has been gradually shifted to the resilient growth outlook, as the much-feared inflationary risk from rising oil prices remained largely under control. Strong corporate earnings, despite the sustained high oil prices, also contributed to the revaluation of the international equity markets. In the US, the Dow Jones Industrial Average index rose by 9.9% between its low for the year on 12 August and end-December. The Dow Jones Euro Stoxx 50 index for the European market and the MSCI Asia Pacific index for Asia excluding Japan followed suit by gaining 14.0% and 23.6%, respectively, over the same period. Meanwhile, the faltering economic outlook weighed on Japan's Nikkei 225 stock market index, which remained relatively flat, increasing by only 4.2%.

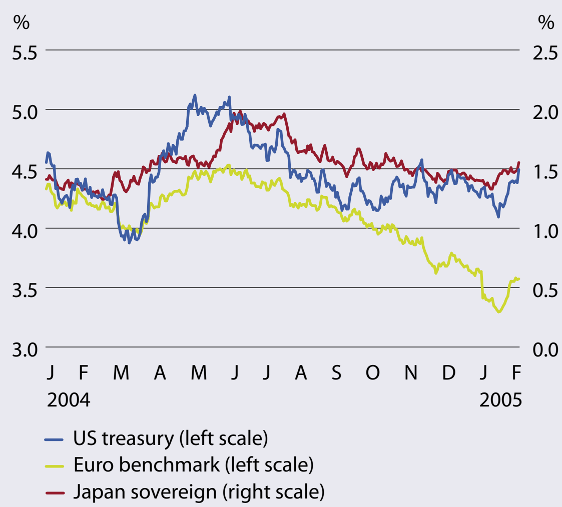
Credit spreads have also been held tight on both investment grade and high-yield corporate bonds since late August. While the credit market remains flush with liquidity from the historically low interest rates of the past few years, the corporate sector, which emerged from credit excesses in the late 1990s with enhanced corporate discipline, has been slow to expand business activities or take new credits in many parts of the world. Overall, such a supply/demand imbalance has kept bond prices high even as the US policy rate has increased. A strengthening of corporate balance sheets on solid profit gains and still soft capital spending have also contributed to improvements in credit ratings of corporate borrowers, thus underpinning the price rally in the corporate bond market.

The gradual increase in optimism regarding the global economic outlook and the pace of ongoing rate movements in the US helped lift investors' risk appetite, which had retrenched significantly during the heavy sell-off of risk assets between April and May prior to the initial Fed decision to raise interest rates on 30 June 2004. Between then and March 2005, the Fed raised the policy rate by a total of 175 basis points. The measured pace of the rate hikes by the Fed (now expected as an increase of 25 basis points at each monetary policy meeting) anchored market expectations, contributing to a significant decline in volatility in the US bond market. At the same time, effective communication by the Fed with the market has nurtured some complacency among investors, as they have perceived the ongoing rate movements as a return to a neutral stance in monetary policy, rather than a tightening. Although the range of a perceived neutral rate differs among investors, there appears to be an increasing consensus that the target Federal Funds rate will not rise higher than 4.0%, which is much lower than the end results of previous tightenings, for example, 6.0% in February 1995 and 6.5% in May 2000.

Underpinning the expectation of relatively low, if rising, interest rates, inflation has remained contained in spite of sustained high oil prices. Given the slack in the labor market, the Fed should be able to continue its measured pace of tightening for the first half of 2005, before gradually settling at a "neutral" rate. The target Federal Funds rate is expected to reach 3.75% by end-2005, with an average of 3.1% for the year as a whole. A considerable upside risk remains, as inflation could significantly pick up on the closing output gap as well as rising input costs. The *ADO 2005* baseline assumptions for the Federal Funds rate are an average 4.2% for 2006 and 4.4% for 2007. The 6-month London interbank offered rate ended last year at 2.78% and is projected to rise to close to 4.0% by end-2005. In the euro zone, the faltering economic outlook has lowered expectations of a rate increase by ECB in the first half of 2005. However, the September futures for 3-month Euribor are priced at a discount rate of 2.4% as of 28 February, suggesting that ECB is expected to raise its policy rates in the last quarter of the year in response to persistent inflation and credit growth. The Bank of Japan is unlikely to shift away from its zero interest rate policy. Deflationary pressures, though easing, remain a sizable threat to the fragile recovery.

The subdued inflation rate has kept long-term bond yields low around the world, with the exception of Japan where easing deflationary pressures have kept long-term interest rates marginally up (Figure 1.9). Even in the face of the Fed rate hikes, yields on the 10-year US treasury note have drifted down since the middle of last year. Falling bond yields at the long end, though mainly attributable to the well-anchored inflationary expectations, have partly reflected the bearish sentiment among investors since mid-2004, weighed down by the prospect of moderating growth in the world economy in the coming years. The yield curves have significantly flattened across major industrial countries since mid-2004. The trend of global flattening was underpinned by the demand for bonds with longer duration, which kept the prices up, thus limiting the yield increase at the long end. The revival of carry trades—investing in long-term securities with higher returns by taking on short-term liabilities with low interest rates—also contributed to the demand. Ongoing excess demand will likely continue to put a lid on long-term bond yields until the middle of 2005. However, with increasing inflationary pressures and solid growth prospects in the US, yields on the 10-year

Figure 1.9 Ten-year government bond yields, January 2004–February 2005



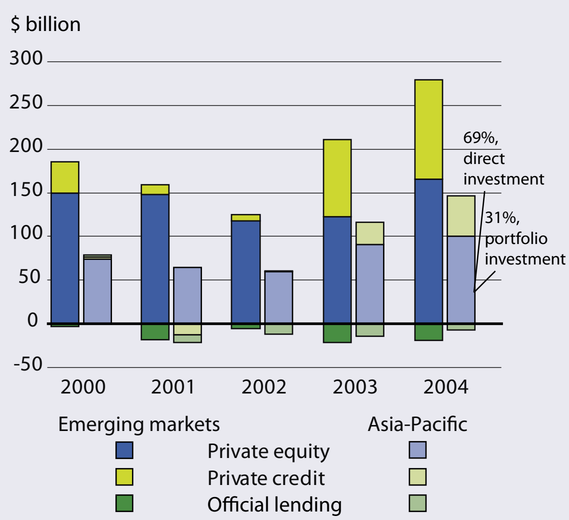
Source: Bloomberg, downloaded 1 March 2005.

treasury note are expected to rise higher in the second half of the year.

Taking advantage of still favorable external funding conditions, emerging market issuers continued to raise significant funds through equities and bonds in international capital markets in 2004. Total equity issuance by emerging Asian market countries amounted to $22 billion, about two thirds of which was offered by the PRC. Bond issuance was also active, with total corporate and sovereign bond issuance of $38 billion, up from $22 billion in 2003.

The comparatively more resilient growth outlook for emerging Asian markets than mature markets, even as moderating growth is expected for the world economy, boosted capital inflows to regional capital markets as well, particularly in the latter half of 2004. Net private capital flows to the region amounted to $146.3 billion in 2004, up from an already high $116.3 billion in 2003, bolstered by continuing FDI flows into the PRC and a surge in syndicated loans (Figure 1.10). According to the Institute of International Finance, Asia-Pacific accounts for nearly 90% of net portfolio equity flows to emerging markets

Figure 1.10 Net capital flows to emerging markets and Asia-Pacific, 2000–2004



Note: Emerging markets and Asia-Pacific follow the definition of the Institute of International Finance, Inc., available: www.iif.com/emr/coverage.quagga.
Source: "Capital Flows to Emerging Market Economies," various issues, the Institute of International Finance, Inc., available: www.iif.com.

Figure 1.11 Sovereign risk spreads, emerging markets, January 2004–February 2005, basis points

Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. Emerging markets and Asia follow the definition of JP Morgan, available: www.utdt.edu/~ely/intro_embig.pdf.
Source: Datastream, downloaded 1 March 2005.

with an estimated total of $31.2 billion in 2004. Net private credit flows in the form of syndicated loans also jumped to $33.5 billion from $13.8 billion in 2003. Such relatively short-term capital flows were particularly strong in the last quarter, driven by increasing speculation on the potential appreciation of regional currencies.

Heightened risk appetite, together with ample liquidity, has also contributed to a decline in emerging market spreads (Figure 1.11). Emerging market bond spreads, which experienced a surge prior to the much-anticipated Fed tightening, subsequently narrowed and ended the year at their lowest level since the 1997–98 financial crisis and subsequent emerging market crises. Falling from a peak of 301.8 basis points during the April–May sell-off, sovereign risk spreads of emerging Asian markets came down to 256.7 basis points by the end of January 2005. Robust, albeit moderating, economic growth, strong trade surpluses, and high levels of foreign exchange reserves, combined with relatively healthy fiscal positions across Asia, have enhanced credit quality and lowered default risk, thus supporting bond prices in the region.

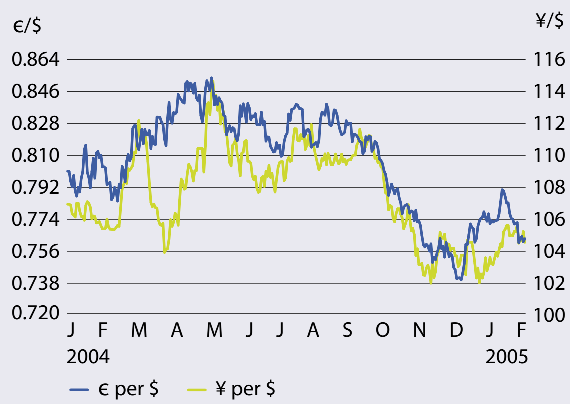
Strong capital inflows—led by significant PRC-bound FDI flows—will likely continue, based on the robust regional economic outlook over the forecast period. The prospect of strong earnings

growth and attractive prices still makes emerging Asian equity markets a top destination for portfolio inflows among emerging markets, while a gradual increase in international interest rates is likely to moderate the pace of private credit flows through bond purchases and syndicated loans. The Institute of International Finance estimate of total net private capital inflows to developing Asia and the Pacific is $125.6 billion for 2005.

Despite the improved outlook for growth in the US, the dollar resumed its decline, falling by more than 11.0% against the euro and 9.0% against the yen from their respective peaks to troughs during the last quarter of 2004 (Figure 1.12). A significant deterioration in the trade balance and the investor perception that the US Government's measures may be inadequate to curb fiscal deficits exacerbated the dollar's slide. However, widening interest rate differentials, as well as macroeconomic fundamentals in the US that remain considerably stronger than those in the euro zone, suggest that the euro/dollar rate may have reached bottom.

Barring any sudden trigger to financial instability, such as higher inflation, another surge in global oil prices, or an unwinding of Asian central banks' dollar assets, the dollar should be able to maintain its current strength vis-à-vis the euro. The pressure on developing Asian currencies to appreciate will likely intensify, on the basis of Asia's relatively robust growth outlook and continuing capital inflows to the region. Against this background, more proactive and concerted regional efforts will be needed to ensure an orderly adjustment among regional currencies in the face of the ongoing global currency movements.

Figure 1.12 US dollar against euro and yen, January 2004–February 2005



Source: Datastream, downloaded 1 March 2005.

Developing Asia: Subregional trends and prospects

In the aftermath of the tsunami disaster that struck some parts of developing Asia on 26 December 2004, the new year began on a somber note. While the human dimensions of the disaster were tragic, recovery is expected to be rapid, with minimal downside effects at the macroeconomic level (Box 1.1).

East Asia

The economies of East Asia performed strongly in 2004, recording aggregate growth of 7.8%, about a percentage point higher than in the previous 2 years (Figure 1.13). As conditions improved during the year, expectations for growth were ratcheted up, and actual aggregate growth surpassed the forecast in *ADO 2004* by nearly a percentage point. The five East Asian economies benefited from strong external demand for their mainly manufactured products. Investment was robust in most of them, joining with generally buoyant consumption spending to lift domestic demand.

Growth in the PRC was expected to decline as the Government introduced a range of controls starting in September 2003 to limit excessive investment in some industries. As it turned out, though, GDP growth edged up to 9.5% in 2004, the highest level in 7 years. Fixed asset investment grew more slowly, but still rose by a steep 25.8%. Actual net foreign direct investment (FDI) reached a huge $60.6 billion (up by 50% in 4 years) as global companies continued to relocate labor-intensive and export-oriented industries to the PRC. FDI in services has also surged since the country joined WTO in 2001 and opened more services to foreign competition. Consumption, driven by rising incomes, grew faster and merchandise trade—both exports and imports—soared by about 36%. Adding to the strong year, the growth rate of agriculture more than doubled.

Box 1.1 The impact on poverty of the tsunami

The 26 December Indian Ocean tsunami killed more than 200,000 people. Despite the huge scale of loss of human life, homelessness, and displaced populations, the macroeconomic impact of the disaster appears limited. This is mainly because the damage is largely confined to rural areas rather than key economic and densely populated urban centers and industrial hubs. Nonetheless, the economic impact will be felt severely at the local and community levels, dragging a significant number of already poor people into deeper poverty. The disconnection between the human costs and the limited macroeconomic impact is considerable with this particular disaster.

Immediate impact on poverty

The poor often subsist in flimsily constructed houses, which are susceptible to destruction by natural disasters. The sudden loss of housing and any other assets, and of jobs, paralyzes their daily activities. The extent and length of recovery depend on the sector affected, and how the recovery process is managed. Incoming aid flows help reconstruct housing and infrastructure. However, the restoration of eroded and salinized fields may take several years. Worse, it can take years for communities to replace the skills lost in a disaster such as a tsunami.

Clearly, the economic recovery does not only depend on supply-side factors such as access to facilities and boats, which is the focus of reconstruction efforts. It also depends on people's recovery from the psychological impact of broken and displaced households, poverty, and health problems. This of course is extremely hard to measure. Assessing the full extent of the loss of life and other effects, therefore, is complex.

This box does two things. First, it assesses the immediate poverty impact of the tsunami by estimating the numbers of poor people who fell below the poverty line as a result of the disaster. Second, it describes two scenarios of recovery—fast and slow—based on a benchmark case of no tsunami.

Box table 1 shows the immediate poverty impact of the tsunami among five of the most affected countries.

In Indonesia, which suffered the highest number of deaths, the poverty impact is geographically concentrated in Aceh and North Sumatra and sectorally in agriculture and fisheries. The disaster has displaced at least 475,000 people, and by taking into account other indirect effects, the number of poor people is estimated to have increased by more than 1 million, adding 0.5 percentage point to the national head count ratio (HCR)—the ratio of the number of poor people to the total population.

In Sri Lanka the disaster hit fishing communities and small-scale traders and other enterprises close to the shore. The associated job losses are significant, especially in the fisheries sector, which accounts for more than 80% of all job losses. The devastating effects of the catastrophe are estimated to have increased the number of poor by around 287,000, raising the national HCR by 1.4 percentage points.

In the Maldives, while the loss of life was fortunately low, the tsunami caused widespread damage to infrastructure. About one third of the country's population of some 300,000 was directly affected. Tourism and fisheries were hard hit. The national HCR of 22% in 2004 is estimated to have risen sharply to 35%, reflecting an increase in the number of poor of about 39,000.

The number of poor in India is estimated to have increased by 644,000 in the affected states of Andhra Pradesh, Kerala, Pondicherry, and Tamil Nadu, and the islands of Andaman and Nicobar. This substantial number does not significantly change the national HCR because of India's very large population.

In Thailand, the likely additional number of poor people as a result of the tsunami is estimated at around 24,000.

The tsunami also has an impact on people in affected areas who were below the poverty line before the disaster struck. Many of them have sunk deeper into poverty because essential goods as well as basic services, such as sanitation and health, are in shorter supply. It will now take an even greater effort to lift these people above the poverty line.

Box table 1 Poverty indicators and poverty impact of the tsunami

Country	Base year	Total population (000)	Number of poor (000)	National HCR (%)	Additional number of poor (000)	New national HCR (%)
Indonesia	2002	212,000	38,584	18.2	1,035	18.7
Sri Lanka	1995	17,280	4,355	25.2	287	26.6
Maldives	2004	300	66	22.0	39	35.0
India	1999	1,001,000	261,261	26.1	644	26.2
Thailand	2002	63,430	6,216	9.8	24	9.8

HCR = head count ratio.

Source: Figures are based on the national poverty lines and ADB staff estimates.

Box 1.1 *(continued)*

Recovery process and its impact on poverty

Over the next 3 years in these five countries, the extent of the poverty impact is estimated on two recovery scenarios, fast and slow, based on a time frame of recovery used in a Citigroup study (Citigroup 2005). The recovery speed and its poverty impact depend on several factors such as the extent of the damage, sectors affected, responses of governments, and other aspects including political stability and macroeconomic management. For example, the scenarios assume that Thailand, where damage is concentrated in part of the tourism sector, recovers faster than other countries. India, Maldives, and Sri Lanka could take longer to recover, and Indonesia even longer.

Box table 2 describes the total number of poor in the fast and slow recovery scenarios and the benchmark case of no tsunami. The scenario analysis suggests that if recovery is fast, the additional poverty due to the tsunami would be eliminated by 2007 in all of the countries except Indonesia, where the additional number of poor would still be around 345,000 compared with the benchmark number. If the recovery process is delayed, the additional poverty in the affected countries would still be 1.1 million in 2007. Of this number, 621,000 would be in Indonesia, 322,000 in India, 144,000 in Sri Lanka, 20,000 in Maldives, and 8,000 in Thailand.

An economy-wide impact would be felt in the Maldives, where the additional poor in the slow recovery scenario in 2007 is still about 44% above the benchmark level. For other countries, the national impacts are relatively smaller, yet the impact in the affected regions would be substantial.

Effective and quick responses are crucial to minimize the poverty impact of a natural disaster of this magnitude. Central and local governments as well as the international community need to work together to overcome immediate and longer-term problems. At the macro level, governments should commit to sound macroeconomic management in an attempt to produce a V-shaped recovery since the longer the recovery process, the worse will be the effect on the poor. At the sectoral level, local participation in decision making will help identify and prioritize the most needed programs. Also, efforts to establish independent authorities to ensure transparent use of recovery funds—such as the Specific Authority Board for Aceh Reconstruction in Indonesia—can speed recovery because they enable better implementation of programs, despite time lost initially.

Well-targeted programs by governments are needed to achieve, among other things, employment generation and provision of schools and health centers. Employment generation through public works programs, for example, can provide income, build socially useful infrastructure, and resume the growth process.

More broadly, the inflow of aid and the engagement of governments in tsunami-affected countries in the planning and implementation of rehabilitation programs provide an opportunity to reinvigorate a general push to build infrastructure, to develop regional cooperation on an early warning system on earthquakes and tsunamis, and to pull out of poverty not only those who were made poor by the 26 December disaster, but also those who were already poor.

Sources: Asian Development Bank staff; Citigroup. 2005. "Economic Impact of the Tsunami," available: http://www.asia.citibank.com/asia/index/hm_index/1,3800,5~5-en-genCont-345-7365,00.html. January.

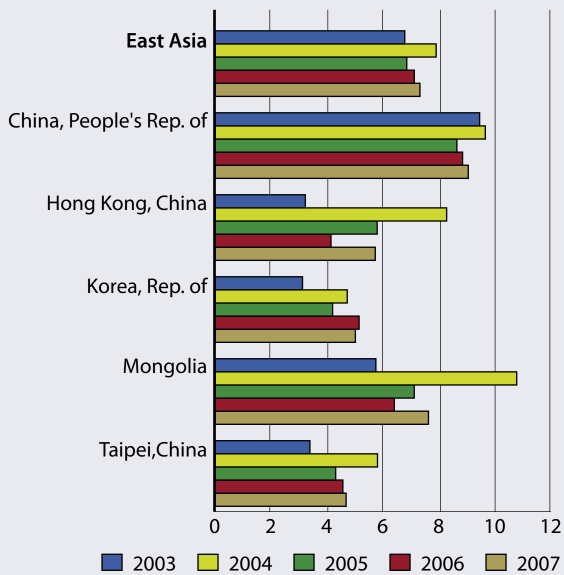
Box table 2 Number of poor (000)

Country	Benchmark (without tsunami)			Fast recovery scenario			Slow recovery scenario			Additional poor people due to tsunami, 2007	
	2005	2006	2007	2005	2006	2007	2005	2006	2007	Fast recovery	Slow recovery
Indonesia	37,777	37,508	37,239	38,812	38,198	37,584	38,812	38,336	37,860	345	621
India	175,837	161,600	147,363	176,481	161,922	147,363	176,481	162,083	147,685	0	322
Sri Lanka	4,248	4,236	4,224	4,535	4,380	4,224	4,535	4,452	4,368	0	144
Maldives	65	55	45	104	74	45	104	84	65	0	20
Thailand	6,011	5,943	5,875	6,035	5,943	5,875	6,035	5,959	5,883	0	8
Total	223,938	209,342	194,746	225,967	210,517	195,091	225,967	210,914	195,861	345	1,115

Note: The fast recovery assumes that the recovery process in Thailand is 1 year, India and Sri Lanka 2 years, and Indonesia 3 years; similarly, for the slow scenario 3 years in Thailand, 4 years in India and Sri Lanka, and 5 years in Indonesia. As for the Maldives, which is not available in the Citigroup report, it is assumed to follow Sri Lanka and India given the extent of damage and sectors affected.

Sources: ADB staff estimates; Citigroup 2005.

Figure 1.13 GDP growth, East Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

Growth in Taipei,China and Hong Kong, China rose sharply, the former by 2.4 percentage points to 5.7% and the latter by nearly 5 percentage points to 8.1%. The recovery of the information technology industry was of particular benefit to Taipei,China. As production and export shipments rose, so did the need for further investment in this important industry. Domestic demand, mainly private consumption and investment, was the driver of growth. Services such as tourism and retail trading had been hit hard in 2003 by the outbreak of SARS in Taipei,China; PRC; and Hong Kong, China, so that a services sector rebound in 2004 contributed to growth in these three economies. Hong Kong, China had suffered 3 years of weak growth until 2004, so its bounce was particularly marked. The economy's property market recovered from a prolonged slump, helping drive consumption and investment.

In Korea, a surge in global demand for electronic products and motor vehicles pushed up manufacturing output and exports, and helped lift investment slightly. However, private consumption fell for a second year in a row because of high household debt levels, acting as a drag on GDP growth. For the year, GDP growth picked up by 1.5 percentage points to 4.6%, which was the lowest rate of increase in the subregion. In contrast, Mongolia, from a much lower level of economic development than elsewhere in East Asia, recorded growth of 10.6%, nearly double the 2003 pace and the strongest since the country began its economic transition in 1991. Mongolia's economy got a lift from the expansion of mining and a milder winter, which allowed the livestock industry to expand rapidly.

Several East Asian economies have battled deflation in recent years. That was not a problem in 2004. A combination of stronger economic growth, together with much higher prices for imported fuel and raw materials plus price increases in domestically produced food in the PRC and Mongolia, revived inflation. Consumer price inflation averaged 3.3% for the subregion, up by 2.0 percentage points from 2003. In the PRC, inflation rose to above 5% in the third quarter, prompting the first increase in interest rates since 1995. Inflation moderated later in the year to leave the PRC's full-year average rate at 3.9%. In Mongolia, inflation hit 10.6% for the year. Korea's inflation rate was unchanged from 2003 at 3.6%. Taipei,China recorded 1.6% inflation after almost 3 years of deflation. In Hong Kong, China the CPI recorded year-on-year increases from July, which still left the price index down by 0.4% on average for the year.

East Asia's growth will slow in 2005, but economic activity will remain robust in most economies. Aggregate growth for the subregion in 2005 is forecast to decline by about 1 percentage point from 2004's high rate, to 6.7%, before rising to 7.0–7.2% in the following 2 years. All of the subregional economies are expected to see easing growth rates in 2005. One reason is an expected halving of the expansion in subregional merchandise exports, from 2004's unsustainably rapid rate of 28.0%. Demand for high-tech products started to soften in late 2004, though the cyclical downturn is expected to be mild and relatively brief. In the PRC, growth is projected to decline to 8.5% in 2005, but this would still put the economy on a higher growth track than other subregional economies. Mongolia is projected to grow by 7.0% in 2005, and the other three economies in the 4–6% range.

A key to this scenario is a soft landing of the PRC economy. The authorities have used

administrative, fiscal, and monetary controls to cool investment in industries considered overheated, including cement, steel, and real estate. They are expected to rely more on market-oriented pricing measures from this year. But there are risks on both sides: substantial investment under way will not be stopped and large pools of funds are still seeking new investment outlets. Any relaxation of the investment controls could spark another round of overheating, which eventually could end in a very hard landing. At the same time, there are reasons to think that economic growth could slow more sharply than expected in the medium term. Administrative controls have had some unintended adverse effects, mainly on SMEs, which are struggling to secure working capital loans. That could hurt employment creation. Rapid increases in farmers' incomes may be unsustainable if prices of agricultural products fall, which would reduce consumption spending. Additionally, the PRC financial sector faces a big challenge over the next 2 years when it is opened to foreign banks as the country meets its WTO commitments. A heavy flow of funds out of the state-owned commercial banks to competitors would further strain these major lenders.

On expectations that the country will make a soft landing, fixed asset investment growth in 2005 for the PRC is projected to be near 20%, with exports growing at this same high rate, and consumption likely maintaining double-digit growth rates. As imports will outpace exports, economic growth will depend on consumption and investment. In Taipei,China, private consumption is forecast to keep rising. Growth in private investment will slow from 2004's high levels, but government spending on infrastructure will support overall investment.

Hong Kong, China's more moderate growth rate, too, will be driven by consumption and investment, rather than net exports, with a revival of construction bolstering investment. Mongolia is set to continue to benefit from the PRC's demand for minerals and expansion of the livestock industry (depending heavily of course on weather conditions). In Korea, the prolonged slump in consumption appears to be ending as household debt and credit card delinquency rates stabilize. Expansionary macroeconomic policies and stronger corporate balance sheets provide a favorable backdrop for investment. However, these factors will take some time to lift Korea's growth rate.

The expected sharp fall in the growth rate of subregional merchandise exports will be matched by a drop in merchandise import growth rates as GDP expansion slows. Moreover, growth of both exports and imports is projected to slow further through 2006–2007. Trade surpluses run by the PRC and by Taipei,China are forecast to fall significantly over the next 3 years, and Korea's surplus will be little changed. The subregional current account surplus will slide to 1.7% of GDP by 2007, from 4.2% in 2004, mainly because the PRC's small current account surplus will move to a deficit over 3 years. International reserves are high and rising in the major subregional economies.

Although most East Asian economies are major importers of oil and other commodities that shot up in price last year, consumer inflation rates are expected to be moderate in 2005. Indeed, average inflation for the year will slow in some economies and hardly move in others. For the subregion as a whole, annual consumer inflation is likely to be about 3.0% over the next 3 years. In the PRC, smaller price rises for grains and overcapacity in many industries will offset much of the upward impact of imported inflation, to put inflation in the 3.2–3.6% range in the forecast period. Higher exchange rates in Korea and Taipei,China will help counterbalance imported inflation in those economies. Hong Kong, China will record inflation of 1.5% in 2005, its first full year of price rises since 1998. Even Mongolia, which is susceptible to bouts of double-digit inflation, is expected to keep price increases to around 5.0%.

With subregional economies generally growing at a reasonable pace, fiscal policy is being tightened in the PRC and Hong Kong, China. The PRC, as part of its effort to cut investment in overheated industries, is sharply reducing issuance of long-term bonds that are used to finance fixed assets. Taipei,China aims to narrow its fiscal deficit over the medium term by broadening the tax base, raising some tax rates, and selling stakes in government-owned companies. However, resistance to these revenue-raising measures within Parliament, labor unions, and some companies has so far frustrated that goal. Mongolia has

reduced its fiscal deficit over the past 2 years, although the gap will widen a bit in 2005. Korea, though, still is operating a budgetary policy that aims to stimulate sluggish economic growth.

Monetary policy, too, is being tightened in most of East Asia. Historically low interest rates were no longer considered appropriate as 2004 progressed; inflationary pressures built up, economic activity was robust, and US rates were raised. The People's Bank of China increased rates in October and indicated that it will use them to help control inflation and investment. The Bank of Mongolia sharply raised rates on its benchmark bills to damp inflationary pressures. Taipei,China moved up its official discount rate three times between September 2004 and March 2005, the first increases since mid-2000.

In March 2005, banks in Hong Kong, China lifted rates. The banks had been able to keep rates steady in the second half of 2004, despite the currency's link to the US dollar that usually requires parallel rate moves, because of flush liquidity in the domestic banking system. Again, Korea went against the trend because of its below-potential economic performance. The Bank of Korea cut its policy rate in August and October and this accommodative stance is expected to be maintained while the financial position of households and small businesses remains weak.

Major challenges for East Asia in the medium term include the PRC guiding its economy to a more sustainable growth path, and its neighbors standing ready to handle any disruptions that may occur if the PRC's efforts overshoot. The economic links between the PRC and other East Asian economies have become much more extensive in recent years.

Another challenge is to strengthen financial systems. The PRC has injected huge amounts into state-owned commercial banks to repair their balance sheets, has plans to sell stakes in some banks to investors, and is shaking up the management of banks, but action on all these fronts needs to be accelerated, since the PRC's banks will face greater competition in the next few years as the country opens the sector to meet its WTO commitments. Taipei,China is pushing consolidation and privatization in the banking industry to build some bigger, stronger institutions. Finally, Korea needs to complete work started on restructuring its troubled credit card companies and to improve risk management in the financial sector.

Southeast Asia

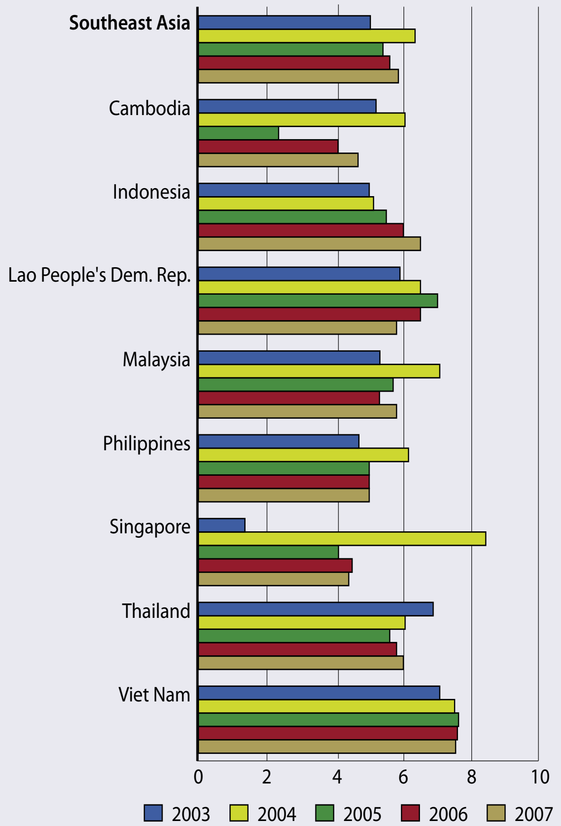
The economies of Southeast Asia expanded on aggregate by 6.3% in 2004, with Malaysia, Singapore, and Viet Nam the fastest growing (Figure 1.14). In spite of some improvement, Indonesia, the third most populous country in Asia, continued to perform well below potential, a matter of concern. Based on their level of per capita income, the economies of Cambodia and the Lao PDR fell further behind relative to the rest of Southeast Asia.

The economic performance of the Southeast Asian economies in 2004 rested on three pillars: robust consumption growth, a strong revival of business investment, and an unusually favorable external environment. Private consumption expenditures continued to contribute significantly to overall growth. With inflation relatively subdued for most of the year, macroeconomic policies, both monetary and fiscal, remained generally supportive.

The most remarkable feature of the 2004 performance was the upsurge in investment in many subregional economies and its large contribution to overall growth. In all countries except Cambodia, investment-to-GDP ratios increased in 2004. *ADO 2004* projected a revival of business investment in most of the subregion, but the outcome turned out much stronger than expected. A combination of factors contributed to the surge in investment: reduced political uncertainties following peaceful elections in Indonesia, Malaysia, and Philippines; reform measures in several countries to improve investment climates and reduce the cost of doing business (e.g., Singapore); much reduced excess capacity; and continued improvement in FDI flows to the subregion.

On the external front, the subregion experienced its best environment in many years, as major industrial countries grew rapidly and the rest of Asia, in particular the PRC and India, also experienced solid economic growth. The result was that exports shot up in 2004 by an average of 20.2%, compared with a 12.8% rise in 2003. The outcome was well above the expecta-

Figure 1.14 GDP growth, Southeast Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

tions of early 2004. The pickup in exports was particularly robust in Cambodia, Malaysia, Singapore, Thailand, and Viet Nam. Increased demand for electronic products as investment spending strengthened in major industrial countries benefited many subregional countries. But the strong performance of exports was broad based. Cambodia's merchandise exports were boosted by garments and rubber, while petrochemicals and pharmaceuticals contributed significantly to the growth of Singapore's exports. At the same time, buoyant world prices for oil and agricultural products boosted Viet Nam's export revenues by 30.3%.

Given high income growth in the subregion over the past few years, imports also rose very fast in 2004, on aggregate by 23.6%, up from 12.1% growth in 2003. With the exception of the Philippines and Singapore, net exports subtracted from growth. Developments in the external sector also helped lower the aggregate current account surplus, to 7.1% of GDP in 2004 from 7.8% in 2003.

Finally, a notable feature of the 2004 outcome is that in spite of a robust economic performance and high oil prices throughout the year, inflation remained relatively subdued in most countries, with the exception of the Lao PDR and Viet Nam. Inflation averaged 4.2% for the subregion, up from 3.3% in 2003. In some countries, appreciation in exchange rates helped keep inflation under control, notably in the Lao PDR and Thailand. As the year advanced however, inflationary pressures increased in several countries, prompting Thailand's monetary authorities, for instance, to start raising interest rates. Inflationary pressures will be an important variable to watch over the forecast period.

GDP growth in Southeast Asia is forecast to remain robust in 2005–2007, albeit at a slower pace than in 2004. Average GDP growth is forecast at 5.4–5.9% over the medium term. In a welcome development, and in spite of the negative impact of the Indian ocean tsunami, somewhat faster expansion is projected for Indonesia, mainly in 2006 and 2007 when GDP could expand at an average of 6.2%. In Cambodia, however, a less favorable external environment due to the termination of the Multifibre Arrangement (MFA) in January 2005 is expected to lead to a significant slowdown. In the Philippines, a weak fiscal situation and hesitant investment could lead to growth below potential, at rates of around 5.0%.

The outlook remains optimistic both with regard to private consumption expenditures as well as investment, which are projected to be the main contributors to GDP growth over the forecast period. However, the forecast depends critically on inflation remaining moderate. This would mean that monetary policies could remain generally supportive, with low interest rates, although some monetary tightening is expected in most countries. In some countries, fiscal support to private consumption can be expected to abate because the economies are on a firmer footing. This is the case in Singapore and to a lesser extent Thailand, as well as in the Philippines where fiscal consolidation will be a policy priority.

In Singapore, Thailand, and Viet Nam, and to a somewhat lesser degree, Indonesia and Malaysia,

robust investment, both public and private, will be the most dynamic variable in the economy. While in Viet Nam, strong investment spurred by FDI inflows will remain part of the economy's transition and its catching-up process, in Singapore and Thailand, higher investment will be focused on restructuring of the economies to raise productivity and maintain their competitiveness in the regional and global context. In Singapore over the past few years, government policies, including tax policy, have been strongly oriented toward making the economy more competitive by reducing business operating costs and attracting new forms of FDI.

In Thailand, the Government intends to pursue active policies over the next few years to spur investment in small and medium enterprises. It has also announced a major infrastructure development plan, which focuses on large-scale investments in transport and energy, which could push up GDP by 0.2 percentage point annually. In Indonesia, the Government is struggling to make the legal and regulatory environment for investment more transparent and to open new sectors to foreign investors. Subject to satisfactory progress in the reforms, the country's natural resources and its large domestic market are expected to spur domestic and foreign investment over the forecast period. In a similar manner, policy reform measures to improve the investment climate and reduce the cost of doing business are being enacted in Malaysia. Public investment, though, is expected to be scaled back in a drive for fiscal consolidation.

In the Philippines, there is a need to significantly raise the investment-to-GDP ratio, a major challenge if economic growth is to improve in the medium term. Some positive developments are expected, but a tight fiscal situation will limit the scope of public policy. Reviving private sector investment will be the main challenge over the next 3 years.

In the external sector, while global prospects remain relatively bullish, the exceptional performance of exports in 2004 cannot be sustained in 2005 and beyond, as already presaged in many countries over the last quarter of 2004. Export growth is projected at around 7.9–9.1% over the next 3 years, down from 20.2% in 2004 and 12.8% in 2003. The downturn in the electronics sector evident at the end of 2004 is projected to be relatively mild and short lived. While exports to industrial countries are likely to expand more slowly in 2005, before leveling off in 2006–2007, intraregional trade should remain dynamic as only a mild slowdown is projected in the PRC, while India's economy is expected to continue its solid expansion. Both developments should boost trade opportunities for the economies of Southeast Asia, which are in between the two regional growth poles. The PRC absorbs 6% of Southeast Asian exports, and these exports to the PRC have been growing at rates of about 37% over the past 2 years. Exports to India have been growing at rates of about 26% over the same period, accounting for about 2% of Southeast Asia's exports.

Over the forecast period, South Asia is likely to emerge as a growing and dynamic market for Southeast Asia. Already several countries, such as Indonesia, Malaysia, Thailand, and Singapore, are negotiating preferential trade arrangements with India and other South Asian countries. A moderation in growth will damp import growth, which is forecast to be 10.6% in 2005, less than half the rate of 2004, and about 10% in the following 2 years. Southeast Asia will continue to exhibit a sizable—albeit reduced—current account surplus of about 6.2% of GDP in 2005 and about 5% on average in 2006–2007.

The need for fiscal consolidation in most subregional economies has been noted in recent *ADO*s. Budgets, at least for 2005, show mixed outcomes. In the Philippines, where fiscal problems are most acute, a progressive reduction in budget deficits is projected over the forecast period as new revenue measures are introduced and as expenditures are curtailed. In Malaysia, too, the Government has indicated its intention to rein in the fiscal deficit by selectively cutting expenditures and improving revenue collection. Gasoline subsidies are being phased out, and changes in the tax structure and the introduction of a goods and services tax in January 2007 are expected to narrow the deficit by half by 2007. In Indonesia, the fiscal deficit is expected to be brought down further over the next 3 years, to below 1% of GDP.

In Singapore, tax reforms will continue to support the restructuring process but the need

for large fiscal stimulus packages will no longer exist. Significant surpluses of around 3% of GDP are projected. Thailand, which posted a surplus in 2003–2004, expects a balanced budget in 2005. In Viet Nam, the budget deficit will widen to around 5% of GDP as expansionary fiscal policy continues to support implementation of economic reforms and development of infrastructure. Planned cuts in import tariffs will also affect revenues. In Cambodia and to a lesser extent the Lao PDR, fiscal deficits are projected to remain substantial, threatening macroeconomic stability.

While the forecast remains optimistic for the economies of Southeast Asia, the high global and regional risks in the outlook could affect this group of countries more severely than others. First, what happens to inflation globally and in the subregion, and as a consequence, to interest rates, will be of paramount importance. In this context, the subregion is highly sensitive to further increases in oil prices, particularly as there is a need to further rein in rising subsidies (Box 1.2). While damping consumer demand, a sharp rise in interest rates also could derail the recovery in investment that is needed to support high long-term growth. In addition, some countries such as Indonesia, the Philippines, and possibly Thailand, where public or household debt stocks are larger, could be significantly affected by high interest rates.

As they are extremely open, a second main concern in subregional economies is what happens to the value of the US dollar. Should it fall precipitously, the upward pressure on the subregion's currencies would increase substantially. While this would contain inflation somewhat, it would damage the important export sectors and exacerbate competition from the PRC. Obviously, if a further weakening of the US dollar and higher world interest rates led to a major slowdown in the world economy, the impact on Southeast Asia would be very severe. Hence the importance of sound macroeconomic policies, in particular fiscal restraint. At the same time these policies need to be complemented by microeconomic reforms to continuously enhance the competitiveness of the economies of the subregion. In part, this means keeping investment rates high.

Finally, the subregion remains particularly vulnerable to the impact of epidemics. The continued resurgence of avian flu should not be underestimated. Governments and the international community need to significantly enhance collaborative efforts to ensure that risks of transmission of the virus are kept to the absolute minimum and prepare contingency plans in case it becomes transmissible among humans.

South Asia

South Asia's aggregate GDP is estimated to have expanded by 6.4% in 2004, substantially slower than in 2003 (7.8%), and below the 7.0% expansion projected for the subregion in *ADO 2004* (Figure 1.15). The divergence in performance stems from developments in India, which accounts for nearly 80% of the subregion's output, as all countries except Afghanistan and Sri Lanka grew more rapidly in 2004 than in 2003.

Indian GDP growth is estimated at 6.5%, 2 percentage points below 2003, with the marked change in outcome mainly due to the vagaries of the monsoon that sharply depressed agriculture sector growth from its normal rate in 2004 while a recovery from an earlier poor monsoon inflated it in the previous year. Developments in the industry and services sectors remained buoyant on the grounds of strong consumer and investment demand. The 26 December tsunami, which affected the coastline of some mainland southern states as well as the Andaman and Nicobar Islands, led to heavy loss of life and great destruction; however, the impact was localized and has not significantly affected national economic activity.

Pakistan saw GDP growth accelerate to 6.4%, the highest rate in 7 years. Investment in key large-scale sectors picked up and consumer demand was energetic, even as the fiscal position strengthened, the balance of payments remained in surplus, and foreign exchange reserves touched new highs.

Growth in Bangladesh, at 5.5%, was only slightly higher than a year earlier, as a strengthening in export-oriented manufacturing was in part offset by weakness in crop production. Though larger imports outweighed larger exports and increased the trade deficit, further gains in large workers' remittance inflows, which markedly boosted domestic incomes, kept the current account at a small surplus.

Box 1.2 Oil subsidies as fiscal liabilities

Oil subsidies are widespread. Government price controls, which hold prices below the economic cost of supply, remain the most common means of providing subsidies for equity purposes. Rising oil prices in recent years, however, have prompted several developing countries that grant heavy subsidies to reduce the size of the subsidies. Still, as oil prices remain high, the fiscal costs and associated opportunity costs continue to soar. This box illustrates the different forms of subsidies for petroleum products implemented in India, Indonesia, Malaysia, and Thailand.

Government intervention for redistributional and environmental reasons is justifiable only when the social gain or the environmental improvement exceeds the economic cost. Nonetheless, the existing practices in these four countries appear ineffective since the subsidies are poorly targeted and often distort resource allocation. Further, the distorted pricing encourages an excessive use of oil products, and the resulting deadweight costs can be substantial. Efficient use of oil products requires correct price signals. Aligning the underpriced markets with international prices would lead to more efficient use of oil, force productivity improvements, and increase competitiveness over time. The message that emerges is that continued oil subsidies can be justified neither on equity nor efficiency grounds.

In Indonesia, except for unregulated liquefied petroleum gas (LPG), the Government sets the price ranges for refined oil products, which are far below the production costs at Pertamina, the state-owned oil and gas company. Although all prices, except for household kerosene, were finally increased substantially by 29% in February 2005, the after-subsidy prices of oil products have been set at only 20–60% of their internationally traded prices.

Consequently, the rise in international oil prices over the past year compelled the Government to quadruple the oil subsidy budget to about \$6.8 billion in 2004, or 3% of GDP. Despite the recent price increase, the subsidy might balloon again in 2005 because of high world oil prices. Any future move to eliminate subsidies may be frustrated by a constitutional court decision in December 2004, which supported price controls on goods sold to the poor.

Similarly, the Malaysian Government has, since 1993, controlled prices of petroleum products under the “managed market approach” by setting ceiling prices or manufacturer list prices. The production cost above the controlled prices is subsidized or given tax exemptions. A total of \$1.3 billion or about 4% of total budget expenditure was used in 2004 to keep retail petroleum prices low. With the rising pressure on the budget, the Government finally took the first step in reducing the subsidies in March of this year by increasing the diesel price, which accounts for almost 70% of total subsidies. Yet \$0.8 billion is still allocated in the 2005 budget, as the scaling back of subsidies is expected to move only gradually.

In India and Thailand, subsidies on oil products, with a focus on specific products such as diesel, LPG, and kerosene, are also fairly common, and are mainly for social welfare purposes. These subsidies are characterized by off-budget expenditure in principle, but may incur fiscal liabilities in practice.

In India, the Government has historically maintained heavy subsidies through the public distribution system on the two principal household fuels, LPG and kerosene. Rising oil prices have severely dented the profitability of public sector oil-marketing companies as the retail prices have not increased in line with international prices. Consequently, subsidy spending of over \$3 billion was estimated for FY2004. The scheme would ultimately create a fiscal liability once the public sector oil-marketing companies no longer prove viable. Several remedies adopted in FY2004 include requiring profit-making upstream companies to share the burden, and reducing customs duties on petroleum and excise taxes on diesel and LPG. However, as such remedies are palliative and temporary, the Finance Ministry’s declaration in December 2004 that these subsidies would end in 3 years is a welcome move. Accordingly, during FY2005, the subsidy will be reduced to 33% of the previous year’s level.

Thailand utilized its Oil Stabilization Fund on gasoline and diesel to maintain the stability of domestic commodity prices and transportation costs. As tax revenues on oil products finance the Oil Stabilization Fund, the fund is in principle not a subsidy. However, as the fund’s deficit continued to increase to B40 billion, or about \$1.0 billion, in October 2004, the stabilization scheme began to signal a possible fiscal liability. The Government responded by removing the price cap on gasoline in October 2004 so that gasoline’s tax revenues generate revenue for the fund. As

Box 1.2 *(continued)*

for diesel, which accounted for 47% of petroleum consumption in 2004, the subsidy remains. Although the subsidy has been reduced gradually in the first quarter of this year, the cost of the diesel subsidy will continue to put pressure on the Oil Stabilization Fund as the international price of diesel is expected to stay high in 2005.

All the recent measures taken by the four governments will lessen some of the pressures on their budgets; however, it should be remembered that increasing the prices to another level will not solve the distorted market incentives. The appropriateness of the subsidies should be measured by assessing their impact on economic efficiency and equity as well as their economic costs, i.e., the fiscal costs. However, convincing evidence for environmental and equity improvements, or for and dampened price fluctuations—the very objectives of subsidies—hardly exists.

Past studies suggest that, in many instances, overall social welfare would be higher without subsidies (von Moltke et al. 2004) and oil subsidies are not associated with less volatile price movements (Terada-Hagiwara and Pardo 2004). In India, where subsidies on LPG and kerosene are meant to help the poor, the United Nations Development Programme and World Bank (2004) find that the use of these products by the poor is limited. As for the impact on the environment, it may not always be negative as the subsidies on kerosene and LPG discourage the use of firewood for cooking and lighting needs to some extent. However, the more pressing environmental cost relates to the health impact of air pollution, as in the case of India and Indonesia.

The opportunity costs of the subsidies are substantial—mispricing of oil products discourages efficient use of the products and delays investments in cost-effective energy. Moreover, such a cost would include the spending forgone that could have been directed to other social welfare programs, such as direct income-support payments for the poor. Thus, scaling back the existing subsidies to reflect rising oil costs is critical, while efficiency and equity should be improved through better targeted and practical subsidy programs.

Examples might include temporary support for new renewable and energy-efficient technologies to overcome market barriers, and measures to improve poor or rural households' access to modern commercial forms of energy. Limited duration, preferably set at the outset, is important—among other reasons so that consumers and producers do not take the subsidies for granted, and the cost of the program does not spiral out of control.

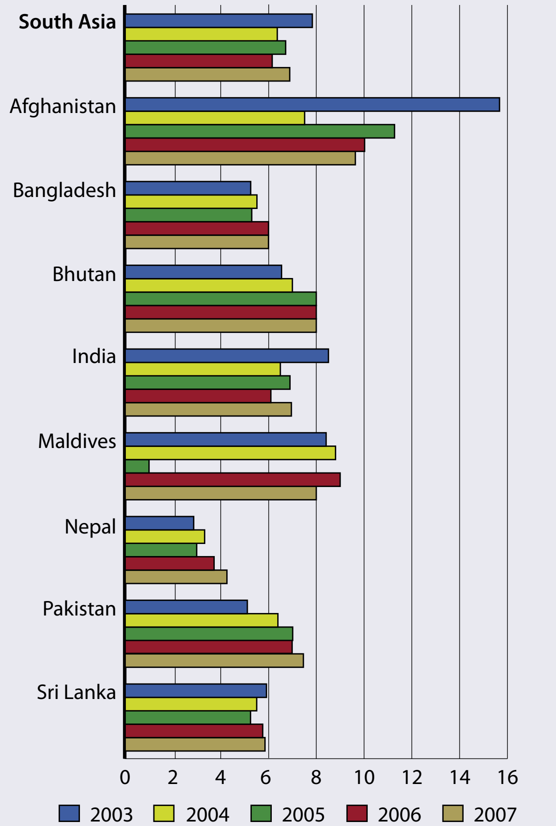
In practice, public resistance to removing subsidies can be very strong, particularly during times of volatile oil prices, as seen in Indonesia. While great attention should be paid to mitigating a reform's excessive negative impacts on the poor who may initially bear the brunt of the change, current market conditions should be taken as an excellent reason to push through with reform, as the fiscal costs rise and as the escalation in the oil price may be more than just transitory.

Sources. This box draws heavily on *Energy Subsidies: Lessons Learned in Assessing their Impact and Designing Policy Reforms*, edited by Anja von Moltke, Colin McKee, and Trevor Morgan, published in 2004 by the United Nations Environment Programme and Greenleaf Publishing, Sheffield, United Kingdom. Other sources are: Terada-Hagiwara, Akiko and Aludia Z. Pardo. 2004. "Are Petroleum Products Priced Right?—Case of the Selected Asia." Asian Development Bank; and United Nations Development Programme and World Bank. 2004. "Access of the Poor to Clean Household Fuels in India," available: http://lnweb18.worldbank.org/SAR/sa.nsf/Attachments/InHHFuel-full/$File/Access+of+the+Poor+to+Clean+Household+Fuels+in+India.pdf.

After 2 years of double-digit GDP growth, estimates for Afghanistan indicate that recovery of its war-racked economy slowed to 7.5% in 2004 as another drought lowered cereal production by 25%. The year, however, was marked by considerable progress in that the first ever presidential election was held and economic structural reforms continued to advance at a good pace, especially with respect to budget implementation. Rapid growth of the opium economy, however, has emerged as a major issue in development.

Sri Lanka saw its GDP growth moderate slightly to 5.5%, which remained driven by domestic consumption and fast-growing exports, with performance underpinned by the continuing cease-fire. With two elections—for parliament in April that resulted in a change in government and for provincial councils in July—most progress on the previous government's structural reform policies stalled and awaits determination of a new direction. The year ended in tragedy with the tsunami.

Figure 1.15 GDP growth, South Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

In the Maldives, tourist arrivals and hotel capacity utilization expanded at a strong pace to reach record levels, where the economy grew by 8.8% in 2004. While loss of life from the tsunami was less than in most other affected countries, the damage to the economy was substantial. Economic growth may fall to as low as 1.0% in 2005 as the high tourist season was lost, and there will be a substantial widening of the fiscal and balance-of-payments deficits. However, most resorts were unaffected and 2006 should see a marked economic rebound.

In 2004, the economy in Nepal continued to recover from the downturn of 2 years earlier. Improved performance in agriculture and services marginally raised GDP growth to 3.3%. The economy has performed weakly since the second half of 2001 as a result of a worsening insurgency and political instability, while the royal proclamation of emergency rule in February 2005 has increased political and economic uncertainties.

Bhutan's economy continued its steady growth at 7.0% during the year, reflecting sound economic management and further development of its hydropower resources.

South Asian growth is projected to move up to 6.7% in 2005, dip to 6.2% in 2006, and then recover to 6.9% by 2007. While Afghanistan, Bhutan, India, and Pakistan are projected to have somewhat stronger growth in 2005, the rest of South Asia is likely to experience slower growth—Bangladesh because of serious flooding, Maldives and Sri Lanka due to the tsunami and its aftermath, and Nepal as a result of weaker paddy production. The subregional slowdown in 2006 reflects a slowing in India's growth, which will rebound in 2007. Although Afghanistan's growth is expected to slow marginally after 2005, other subregional countries are expected to match or exceed the 2005 growth performance in the 2 subsequent years. The South Asia forecasts assume continued cooperative efforts between India and Pakistan and no deterioration in the security situation in Afghanistan, Nepal, and Sri Lanka.

India's growth outlook is buoyant—6.9% in 2005, 6.1% in 2006, and 7.0% in 2007. Agriculture is projected to recover in 2005, and expand at normal rates subsequently, though expansion in the industry and services sectors will slow. The industry slowdown in 2005 is attributable to cost-smoothing behavior of firms to tide themselves over an anticipated cost escalation. In 2006, GDP is projected to decline on account of a further deceleration in growth of the industry and services sectors, but these sectors should experience a revival in 2007.

In Pakistan, with sound macroeconomic fundamentals achieved and key sectors strengthened by reforms of recent years, the projection is for stronger growth of 7.0% in 2005 and 2006, nudging up to 7.5% in 2007. Notably, private investment is on the rise and fiscal consolidation and structural reforms have made space for increased social and infrastructure expenditures that underpin this upbeat outlook.

Growth in Bangladesh is projected to slow only slightly to 5.3% in 2005 despite widespread and destructive flooding, as activity is to be

sustained by donor-supported reconstruction efforts and continued expansion in export-oriented production and greater workers' remittances. Growth may reach 6.0% in the following 2 years; however, it is necessary that strong economic reform efforts be continued and that downside pressures associated with a loss of MFA quotas and current confrontational domestic politics be kept to a minimum.

Afghanistan's economic prospects are good, with growth expected to recover to 11.3% in 2005, on the assumption of better rainfall, and then moderating slightly in 2006–2007. This outlook assumes continued support by the international community in economic assistance and in security efforts, as well as continued strong efforts in structural reform.

Sri Lanka's growth is expected to tail off only a little to 5.2% in 2005, as the tsunami did not damage areas of major economic activity, though there was great loss of life. Assuming that reconstruction plans are implemented smoothly, growth should pick up to just under 6.0% in the following 2 years. The major risk to the outlook, as in the past, is uncertainty in the peace process. Also, it will be important for the new Government to define its plans for economic and structural reforms needed to achieve a high, sustainable growth path.

Economic growth in the Maldives is expected to drop sharply in 2005 to 1.0% due to extensive damage to the fishing fleet, hotel closures, and the loss of tourism during the high season. A recovery in tourist arrivals could bring GDP growth to 9.0% in 2006 and 8.0% in 2007.

Growth in Nepal is projected to fall to 3.0% in 2005 due to weather-related weaker performance in agriculture and a deterioration in other activities, especially those connected to tourism, due to the insurgency. Growth is expected to slowly strengthen to 3.7% and 4.3% in the subsequent 2 years, on the basis of no further deterioration in the security situation. However, the outlook is highly uncertain and depends crucially on how parties respond to developments in the period of emergency rule. Bhutan's economy is projected to grow by 8.0% over 2005–2007, reflecting the steady expansion in the power sector and the country's new economic strategy for poverty reduction.

Exports in 2004 surged by 20.8% in South Asia, on top of the strong 18.3% gain in 2003, with almost all countries bettering their earlier performances. At the same time, imports shot up by 33.5% due in the main to continued strong growth in domestic demand and in part to the steep increase in global oil prices and the subregion's import dependence. The subregion's current account balance moved to a deficit of 0.7% of GDP in 2004 from the solid 1.9% surplus recorded in 2003. The main player in this swing was India, which recorded a deficit of 1.0% of GDP during the year, the first since 2000, in marked contrast to a 1.8% surplus recorded in 2003.

For 2005, South Asia's current account deficit is expected to widen further to 1.2% of GDP, with every country but Nepal recording a deficit and India maintaining a deficit of 1.0% of GDP. These deficits are moderate and are readily financed. Exchange rates against the dollar appreciated modestly in 2004 in most countries in the subregion and all countries but Sri Lanka recorded gains in gross international reserves.

Average inflation for South Asia rose to 5.9% in 2004, up from 5.1% a year earlier, reflecting increases in all countries except Afghanistan, Bhutan, and Nepal. In response to growing price pressures, monetary polices were tightened during the year in Bangladesh, India, Pakistan, and Sri Lanka. Moreover, many countries took measures to delay and not fully pass through the cost of global oil price rises.

Central Asia

Economic growth in the six Central Asian republics (CARs) as a group is estimated at 10.4% in 2004, higher than the 8.1% projection made in *ADO 2004*, and representing a continuation of the very strong performance of recent years (Figure 1.16). Nearly all of the countries in the subregion performed better than expected. A notable and welcome feature was unexpected strength in the Kyrgyz Republic, Tajikistan, and Uzbekistan, countries that have the lowest per capita incomes in the CARs and that had seen various economic difficulties in recent years. Higher than expected commodity prices for the region's main exports, not only oil and gas but also for gold, cotton, and aluminum, were the

principal stimulus underlying the strong gains made during the year.

Indeed, exports surged by about 38.9% for the subregion as a whole in 2004, up from 25.0% growth in 2003, at country rates that varied from 9% to 54% in dollar terms. Kazakhstan, where substantial FDI has developed the oil and gas sector in recent years, recorded the highest export gain of 53.7%, with expanded oil volume boosting the steep rise in export prices. Kazakhstan now accounts for about 60% of aggregate CAR exports.

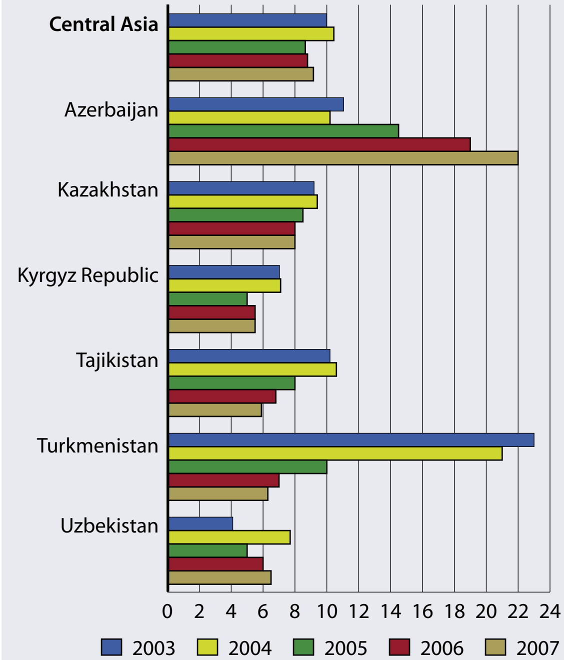
An upturn in domestic consumption demand as well as continued investment boosted the CARs' imports at essentially a matching pace of 38.1%, again well above the 2003 expansion (19.0%). Consequently, as a group, the CARs' current account deficit at 1.9% of GDP was only slightly improved from a year earlier. Kazakhstan and Uzbekistan recorded a surplus on the current account. Deficits were fully financed by FDI and other capital flows to allow all countries to post moderate increases in official reserves. Both Azerbaijan and Kazakhstan, which saw particularly heavy FDI inflows in 2004, are experiencing upward pressure on their exchange rates.

The medium-term outlook for the CARS is quite favorable, pointing to a moderate slowing in growth for the subregion as a whole to 8.7% in 2005 but then a mild advance to 8.8% and 9.2% in the following 2 years. Even though the oil and gas sector will continue to drive growth for the region, some change is foreseen in the country pattern.

In Azerbaijan, growth is expected to accelerate sharply to 14.5% in 2005 and to 19.0% and 22.0% in 2006 and 2007, respectively. This impressive outlook reflects the phasing in of production from investments in oil and gas fields and pipeline facilities. Conversely, growth in Kazakhstan is projected to moderate to 8.5% in 2005 and 8.0% in the following 2 years as additional petroleum sector production in this period builds on a larger base. Since Kazakhstan is the bigger economy, the differing outlooks in the two countries are largely offsetting for aggregate CAR growth.

In Turkmenistan, a large producer of natural gas, the outlook is underpinned by long-term export contracts with the Russian Federation and Ukraine. GDP growth is projected to be strong at 10.0% in 2005, but then to slow to 6.3% in 2007.

Figure 1.16 GDP growth, Central Asia, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

Any assessment of the country outlook is difficult, however, because of the limited information available.

The outlook for Kyrgyz Republic, Tajikistan, and Uzbekistan is for a slight easing in growth in 2005 as circumstances are expected to be generally less propitious. In the Kyrgyz Republic, GDP growth is expected to decelerate to 5.0% in 2005, reflecting depleting reserves and consequent declining production at the Kumtor gold mine, though growth may be lifted to 5.5% in subsequent years as deposits elsewhere are developed. The March 2005 uprising and apparent change of government appear related mainly to governance issues rather than to economic policy. However, it will take some time to assess the full impact of these events on the economic outlook.

In Tajikistan, growth is expected to slow to 8.0% in 2005 and then to 5.9% by 2007 because of capacity limits on expansion in aluminum and cotton production, the two main economic activities. With cotton and gold prices less favorable in 2005, a moderate deceleration in Uzbekistan's growth to 5.0% is expected; however, growth is projected to pick up to 6.0% and 6.5% in the

following 2 years, on the assumption that policy reforms are adopted, which would boost agricultural, manufacturing, and trade activity.

Inflation is not a central policy issue in the CARs. However, in Turkmenistan and Uzbekistan subsidies and controls keep official inflation rates lower that what would be determined by the operation of fully free market forces. Implementation of more effective monetary polices sharply reduced Tajikistan's average inflation to 6.8% in 2004 from 17.1% a year earlier. Azerbaijan and Kazakhstan experienced some price pressure during the year and as a result tightened monetary policy. Average inflation in the subregion in 2004 was 6.0% with little country variation. This rate is likely to be maintained in 2005 and is projected to moderate slightly to about 5.0% by 2007.

As countries in transition to market economies, the CARs have made varying degrees of progress in their reform efforts. Kazakhstan (per capita GNP of $1,780) and Azerbaijan (per capita GNP of $810) have attracted by far the bulk of FDI made in the subregion and have built substantial oil and gas sectors that have buttressed very rapid rates of growth. Both countries, however, are struggling to deepen economic diversification to expand employment opportunities that have grown only slowly because of the capital-intensive nature of their resource-based growth. To this end, Kazakhstan adopted its Innovative-Industrial Development Strategy while Azerbaijan has drawn on its State Program on Poverty Reduction and Economic Development. Whether the two countries can avoid "Dutch disease," which could stymie broad-based rapid growth, is a major concern.

Among the other countries, the Kyrgyz Republic (per capita GNP of $330) and Tajikistan (per capita GNP of $190) have developed medium-term poverty reduction and growth strategies supported by International Monetary Fund economic programs and development assistance. Heavy external debt burdens and a limited resource base make rapid growth an arduous process, despite very substantial macroeconomic and structural reforms that the countries are undertaking.

Recently, Uzbekistan (per capita GNP of $420) has tightened economic policies and maintained current account convertibility, and is in the process of developing a wide-ranging framework to accelerate broad-based growth. Its longer-term outlook depends on whether it adopts a substantially reinvigorated structural reform program or continues with its present policies.

Turkmenistan is relatively wealthy (per capita GNP of $1,120) based on energy production and exports that will underpin reasonable rates of growth in the medium term. Central planning and management of the economy persist and a substantial change in policies would be required to move from growth that relies primarily on exploitation of natural resources to broader-based growth that would reduce exposure to volatility in the energy markets.

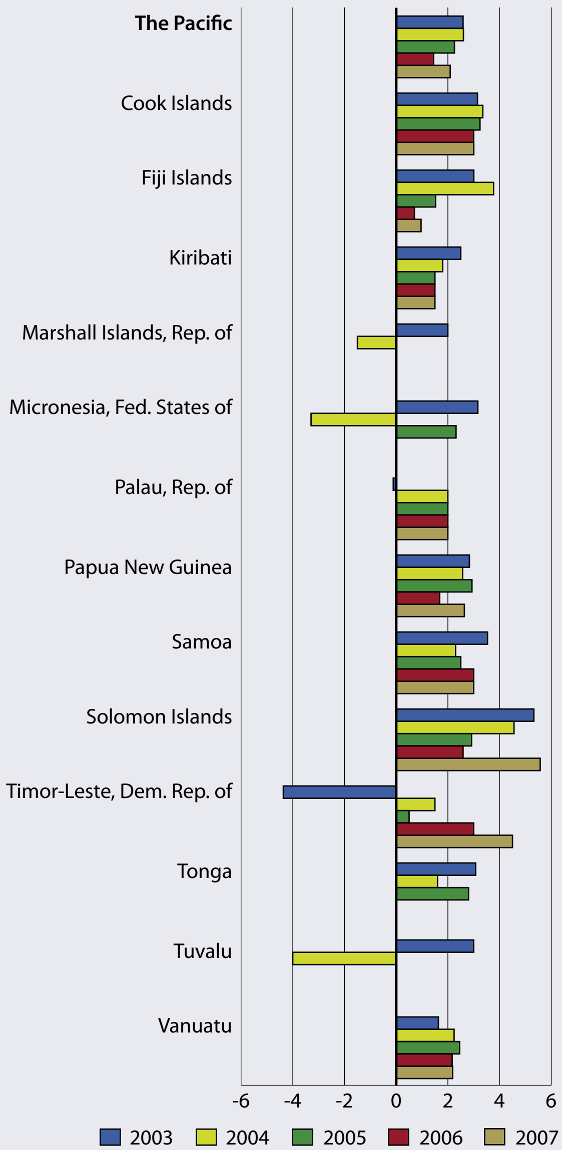
The Pacific

Aggregate GDP growth of the Pacific DMCs was unchanged at an estimated 2.6% in 2004 (Figure 1.17). Increases in GDP ranged from 1.5% (Timor-Leste) to 4.6% (Solomon Islands). The Federated States of Micronesia, Republic of the Marshall Islands, and Tuvalu registered contractions because of reductions in public sector activity.

The maintenance of high international prices for primary commodity exports benefited those economies with relatively large natural resource endowments. Solomon Islands' second year of relatively rapid growth was led by agriculture, forestry and fisheries, though this entailed harvesting of the natural forest at an unsustainable rate. Primary production also led a mild acceleration of growth in Vanuatu and contributed to a pickup in growth in the Fiji Islands, the second-largest economy. The agriculture and mining sectors of the largest economy, Papua New Guinea, expanded at around 3.0%, but the oil and gas subsector contracted significantly because of the depletion of oil reserves. As a result, growth decelerated slightly to 2.6%, from 2.8% in 2003.

Tourism continued to grow across the subregion, partly because of lower airfares that resulted from increased competition in airline services to several destinations. Consequent stimulation of the services and construction sectors was important to the economies of Cook Islands, Fiji Islands, Samoa, and Vanuatu. In contrast,

Figure 1.17 GDP growth, The Pacific, %, 2003–2007



Sources: Asian Development Outlook database; staff estimates.

tourism contracted in the Federated States of Micronesia where the lack of sustained competition in airline services provision left airfares at a high level compared with other subregional destinations. The recovery in international capital markets improved returns for the long-established Kiribati and Tuvalu trust funds and for the newly established trust funds in the Federated States of Micronesia and the Republic of the Marshall Islands.

Economic growth at modest rates generated an increase in employment levels across the subregion, but growth in labor supply continued to outpace labor demand. Inflation decelerated to an average 3.6% in the subregion, largely because of a sharp drop in inflation in Papua New Guinea. Inflation fell in the majority of other Pacific DMCs, the notable exceptions being Samoa and Tonga, which both registered double-digit rates.

Fiscal outcomes improved in most Pacific DMCs plus Palau during 2004. In Papua New Guinea, the budget balance moved from deficit in 2003 to surplus in 2004 as total revenues and grants exceeded budget projections and fiscal management improved with assistance under an Enhanced Cooperation Program with Australia. The fiscal deficit exceeded the budget estimate in the Fiji Islands because of unanticipated expenditures, but was lower than the 2003 deficit. Public financial management in Solomon Islands demonstrably improved with the continued assistance of the Australian budget stabilization team. Budget outcomes worsened significantly in the Federated States of Micronesia and the Republic of the Marshall Islands as "bump-up" funding under the previous Compact of Free Association with the US ended; and Palau continued to fund a large budget deficit by drawdowns from its Compact trust fund.

External accounts generally improved in 2004 as export growth accelerated faster than import growth and tourism earnings strengthened.

Political uncertainty continued to be a concern in a number of Pacific DMCs, most conspicuously in Vanuatu; and corruption and poor governance remained as major obstacles to improving development outcomes in the subregion. On the positive side, Nauruan voters rejected the leadership that had mismanaged the economy for years and elected a reformist government.

Some progress was made in 2004 in formulating and implementing economic and public sector reform strategies aimed at improving public service delivery and the enabling environment for private sector development. However, reforms needed to be extended and consolidated. For most Pacific DMCs, physical infrastructure development and creation of an effective legal and regulatory environment for business (including property rights) remained major challenges. Rela-

tively large civil services still needed rightsizing and refocusing on performance, and the importance of public enterprise reform was underlined by the bankruptcy of Royal Tongan Airlines.

At the regional level, Pacific Island Forum leaders decided in 2004 to create a Pacific Plan for Strengthening Regional Cooperation and Integration. This will potentially strengthen the contribution of regional institutions to achievement of sustainable development, good governance, and regional security.

In the context of a weaker international economic environment, economic growth in the subregion is forecast to slow slightly to around 2.0% in 2005–2007, while inflation is expected to be in the 3.4–4.0% range. Papua New Guinea is forecast to grow at an average annual rate of 2.4% as depletion of mineral reserves continues and logging is curtailed. A major growth slowdown is forecast in the Fiji Islands, as the garment industry loses concessionary access to export markets and the sugar industry confronts structural adjustment.

Modest growth is expected in most other Pacific DMCs. This aggregate growth outcome will mean that a substantial proportion of the annual net increase in labor market entrants will continue to flow into the pool of the under- and unemployed, increasing hardship in both rural and urban areas. The main downside risk to the growth forecasts is that governments will fail to implement the structural reforms necessary to stimulate private sector development.

Risks to the outlook, and challenges for developing Asia

While developing Asia continues to add a strong impetus to the world economic expansion, the risk of global imbalances looms greater than ever. As discussed in *ADO 2004*, developing Asia has been an intrinsic part of the global imbalances, by producing large current account surpluses and financing a significant share of the US twin deficits, mainly through large purchases of US securities. Ongoing weakness in the US dollar suggests that the adjusting forces for such imbalances might already be at work. As Asia is increasingly expected to share the burden in the adjustment process, Asian currencies may experience proportionately larger appreciation over the forecast period.

The other risks identified in *ADO 2004* and *ADO 2004 Update* are still very relevant: the risk of epidemics, the threat of terrorism, the growing interdependence of regional economies, and sustained high oil prices. As evidenced by the recent resurgence of avian flu in Viet Nam and Cambodia, the risk of broader and more life-threatening epidemics remains a very serious concern to the region. In addition, the disastrous tsunami (Box 1.1 above) that struck the countries bordering the Indian ocean and its impacts—including the huge loss of human life and a sharp increase in poverty in the affected areas—underscore the need to reinforce regional cooperation in Asia to effectively deal not only with the aftermath of such natural disasters but also the continuing threat of terrorism—and all the more so in the context of increasing economic linkages across the region.

Global economic risks

Forces of global rebalancing unfold. The risk of global disruption stemming from large external imbalances in the US has been on the radar screen for some time, but the timing and impact of the inevitable adjustment process remain uncertain. Prior periods of adjustment and resultant weakness in the dollar have proved quite painful for the world economy. In the early 1970s following the collapse of the Bretton Woods system, exchange rate volatility, inflation, and oil price shocks presented major economic challenges to policy makers around the world. In the late 1980s, the dollar's decline contributed to the stock market crash in the US and financial turbulence. Moreover, overinvestment in Japan led to a decade of recession there, limiting that country's contribution to global growth, while structural problems in the EU have played a similar role with regard to its contribution to global growth.

With US growth outpacing that of other major industrial economies, its current account deficit is expected to rise further. On the back of robust domestic demand and considerable fiscal outlays, the US current account posted another deficit of $665.9 billion, or about 5.7% of GDP, in 2004, up from $530.7 billion in the previous year. Although

the budget deficit came in smaller than expected at $412.1 billion in 2004, as a result of ongoing efforts by the US government to curb fiscal spending, the deficit is still up by $34.5 billion from $377.6 billion reported in the previous year.

Behind the sustained increase in the US twin deficits has been strong reserves accumulation by Asian central banks. At the end of 2004, developing Asia's foreign exchange reserves were about $1.6 trillion, with the majority held in dollar assets; including Japan, the figure is estimated to amount to more than $2.4 trillion. According to estimates by the Bank for International Settlements, the reserves accumulation of Asian central banks financed more than 70% of the US current account deficit in 2003. However, the increasing exposure to a weaker dollar may prompt Asian central banks to consider rebalancing their reserves portfolios. Corroborating this view, a recent survey of central bank reserves managers published by Central Banking Publications—a London-based private think-tank—indicated a tendency of shifting reserves away from dollar assets into euro assets.

Two main implications for developing Asia flow from this. First, the dollar could depreciate faster and more sharply than assumed in the baseline scenario, deeply eroding the value of dollar reserves, while constraining Asia's exports before its domestic demand reaches firmer ground. Second, US interest rates could rise rapidly to break the dollar's fall and ensure the financing of the US budget deficit, thus triggering a major adjustment in international financial flows. Combined, these two factors pose a significant risk to the regional outlook.

Developing Asia will have to play a key role in bringing about a smooth adjustment without incurring too steep an economic cost, both for the region and the rest of the world. Reducing the US current account deficit requires faster growth in US savings. While the US Government must take the necessary steps to contain an unsustainable rise in the fiscal deficit, US income growth should also exceed growth in private consumption. The only way this will occur without a major slowdown in consumption and investment spending is with increased net exports. Such an outcome can be attained only if domestic demand in the rest of the world—particularly Japan, EU, and developing Asia—grows much faster. An orderly adjustment in Asian currencies along with strengthening regional demand could help achieve this result. Thus a major agreement among the key players would be needed to ensure a smooth and orderly adjustment of global imbalances.

A sharp increase in US interest rates could have negative impacts. The ongoing weakness of the dollar, the gradual working off of slack in the labor market, and sustained high oil prices all point in one direction—a bout of inflation in the US. With inflationary pressures building up, US interest rates could rise significantly higher in 2005. A sharp acceleration in these rates can exert significant influence on both the US and global financial markets.

Over the past few years, a low interest rate and high liquidity environment have nurtured investors' risk appetite, thus tightening credit spreads for both sub-investment grade and emerging market corporate and sovereign borrowers. Increasing carry trades have been also undertaken, reflecting a significant flow of funds into risk assets. A weakening of such international capital flows, in the event of a steep rise in US interest rates, could jeopardize generally heightened prices of risk assets around the world. Housing prices may also come under pressure in some industrial countries, including the US and the United Kingdom. More importantly, abrupt changes in financing conditions might expose emerging market economies in the region to some disruption. The wave of unwinding speculative positions and rising cost of international borrowing could also have negative impacts on emerging economies with large fiscal deficits and external debts.

High oil prices pose an added threat to the financial risks. While the economy of developing Asia appears to have gained considerable growth momentum to avoid a major slowdown from currently high oil prices, another steep rise in oil prices in combination with inflation and high interest rates could add significant strains on the regional as well as global outlook. Brent crude is projected to average $41 per barrel in 2005, much higher than its post-1990 long-term average of $20–25. However, as of 16 March, the Brent

crude price surged again to $53.8 per barrel, exceeding last year's peak of $51.4. This current price run-up beyond $50 per barrel is a vivid reminder that high oil prices remain a major risk for the region, given Asia's high dependence on oil imports. (As reported in *ADO 2004 Update*, a $10 increase in oil prices for 1 year could shave an estimated 0.8 percentage point off growth in Asia excluding Japan.)

Regional risks

Greater regional exchange rate coordination is necessary. The rapid depreciation of the US dollar has put Asian foreign exchange policies in the spotlight. With increasing risks of global imbalances, pressure on the region's currencies is rising. Equally important is the increasing cost of maintaining a dollar peg, due to a rapid accumulation of foreign exchange reserves across the region and upward pressure on inflation. Reflecting these factors, some Asian currencies—including the baht, New Taiwan dollar, Singapore dollar, won, and yen—have already appreciated in the last quarter of 2004.

As de facto US dollar pegs become more difficult to maintain, varying degrees of exchange rate flexibility across the regional economies pose a risk to currency and financial stability. Regional economies currently exhibit a wide range of foreign exchange policies, from fixed exchange rate regimes to managed floats and flexible exchange rates. Nevertheless, by keeping local currencies relatively stable against the dollar, these economies have been able to achieve stable cross-currency exchange rates within the region. However, without concerted efforts among regional economies to maintain intraregional currency stability while introducing more flexibility vis-à-vis the US dollar, the recent divergence in exchange rates may lead to greater volatility of regional currencies against each other.

Contrary to popular belief, the US economy is no longer developing Asia's largest trading partner—developing Asia itself is. Increasing regional integration implies that greater volatility in cross-currency exchange rates could widen trade and financing gaps within the region, putting undue pressure on certain countries during the course of international currency adjustments. The challenge lies in further strengthening regional cooperation to address and contain such volatility while extending support to an agreement for the orderly adjustment of global imbalances (as noted in the previous section, "Global economic risks").

Meanwhile, look out for speculation. Speculation on regional currency appreciation has already triggered substantial private capital inflows to the region. Relatively short-term flows, such as portfolio equity investment and commercial bank lending, were particularly high in the last quarter of 2004. With the majority of such capital flows destined for the PRC, the increasing volatility of capital flows compounds the difficulties of sterilization, exacerbating the overinvestment problem. The speculative capital flows also increase the risk of a sharp unwinding, if US interest-rate increases accelerate as inflation takes off or if investors simply change their expectations.

Although ample official foreign reserves and strong macroeconomic fundamentals limit the risk of a financial crisis recurring, sound management of capital flows is particularly important for these countries to arrest excess volatility in their currency and financial markets. To this end, regional diversification and specialization can help underpin the efficient allocation of financial resources for more productive uses across the region. Alleviation of financial risks may result from enhanced dynamic competitiveness of individual countries in the region and from intraregional trade—through greater diversification and specialization in goods and services—which will not only broaden the use of increasing capital inflows across the region, but also reinforce regional economic growth and integration.

Overheating in the PRC is still a possibility. *ADO 2004* warned against the risk of overinvestment in some sectors and the related increase in nonperforming loans in the banking sector. The PRC Government has taken a series of steps to slow investment and credit growth in some sectors, which include tightening liquidity and employing administrative measures to contain overheating in the concerned sectors. Despite such measures to engineer a soft landing, the

PRC economy is still performing strongly, growing by 9.5% in 2004. Fixed asset investment rose by 25.8% that year, only 1.9 percentage points lower than in the previous year. Although there are signs that government policies have been effective in reining in inflationary pressures and generating more balanced growth, the latest growth figures suggest that more austere measures of tightening may be necessary to curb overinvestment and achieve a soft landing. Failure to do so in the near future may increase the risk of a hard landing at a later date.

Epidemic outbreaks remain a very significant risk. Strong regional cooperation is absolutely vital in mitigating the risk of various epidemics. The tsunami that devastated coastal areas of the Indian Ocean left these areas vulnerable to epidemics. While the immediate economic consequences remain under control in many affected countries, poor sanitary conditions alongside the lack of sound health systems are risk factors for epidemic outbreaks of typhoid, hepatitis, diarrhea, and cholera across the region.

The outbreaks of avian flu in 2004 reportedly killed 29 people out of 37 affected in Viet Nam and have affected some parts of Asia. The risk of an avian flu pandemic cannot be ignored, as the persistent fear that the virus could mutate into a form that can spread efficiently from human to human remains. The threat of diseases is significant, and the region still remembers the grim impacts of SARS on overall economic activity, let alone the loss of human life. In order to avert another disease-related disaster, strong regional cooperation, together with help from international aid agencies, is needed to ensure early detection of outbreaks, effective treatment of the affected, protection of the public against contagion, and minimization of the spread across borders.

Challenges to developing Asia's policy makers

Developing Asia has exhibited remarkable resilience while continuing to adjust to the emergence of the PRC as a major economic power, and more recently to the rise of India. Taking advantage of enormous opportunities that these potential economic powerhouses should bring to the region, developing Asia is expected to continue rapid and robust growth in 2005–2007 and beyond. Nevertheless, Asian policy makers face significant challenges to maintain sound macroeconomic fundamentals while nurturing domestic demand conditions to sustain strong growth momentum. Overall, the downside risks are considerable, particularly as some external factors—such as the moderation of the world expansion, the downturn of global information technology industries, and sustained high oil prices—weigh on the regional outlook over the forecast period.

Sound macroeconomic policy is integral to sustaining high growth. There are growing concerns that the basis of sound macroeconomic conditions needs to be reinforced.

First, headline inflation has picked up across the region. Higher food and energy prices have been mainly responsible for the rise in CPI inflation. Although supply-side pressures have yet to trigger a full-blown price effect through a wage-price spiral, a pickup in CPI inflation complicates the monetary policy decisions of Asian central banks. Some countries, including the PRC where strong consumption and investment growth is already stoking inflationary pressures, have taken tightening measures. In other countries where domestic demand continues to be a concern, monetary policy remains flexible, providing necessary support to underpin a nascent recovery in domestic consumption and investment demand. However, the monetary authorities face increasingly limited room to maneuver, as the region has been flush with liquidity due to strong private capital inflows, thus building greater external reserves and further exacerbating the difficulties of sterilized interventions. In these countries, the central banks need to closely monitor monetary and financial conditions over the rest of this year. As the domestic demand recovery reaches a firmer footing, the eased monetary policy should gradually reverse to keep price stability.

Second, behind the modest inflation (despite Asia's high dependence on oil imports) have been policy efforts to contain the price pass-through of high oil prices. Many Asian governments have increased oil subsidies, strengthened price controls, or cut import duties on oil during the price run-up. While protecting consumers from higher global oil prices, the incomplete pass-

through has led to a deterioration in the fiscal position in these countries, particularly in India and Indonesia where budget conditions have been an ongoing problem (Box 1.2 above). As noted in *ADO 2004 Update*, heavy debt burdens—which will become heavier if international financing costs rise—continue to be a threat to the medium-term outlook for many countries in the region. Large fiscal deficits have been a persistent problem in South Asia and the Pacific for many years. Many countries in Central Asia and some in Southeast Asia also run high levels of external debt. With the cost of international borrowing rising and inflation picking up, these economies are vulnerable to rising debt-servicing burdens. Taking stock of ongoing economic strength, these regional governments should continue their efforts to enhance their fiscal position by consolidating the budget deficit and promoting effective public debt management. Phasing out oil subsidies, along with deregulation in energy prices, also needs to be considered as part of the fiscal reforms.

Successful implementation of structural reforms remains a priority. Looking ahead, Asia's growth strategy needs to focus on balancing domestic growth and enhancing resilience to external shocks for long-term sustainability. To this end, policy priority should be given to the following: creating a positive investment climate for enhancing competitiveness (see *ADO 2003*, Part 3: "Competitiveness in developing Asia"); generating sustainable increases in domestic demand across the region; and further strengthening regional economic cooperation to improve the region's resilience against adverse external conditions. The following points are worth noting in this respect.

First, broadening intraregional trade and investment underpins strong regional dynamics to allow extra resilience against adverse shocks from the rest of the world. Along these lines, recent initiatives to increase regional economic integration through Asian bond market development and regional trade agreements are welcome, to the extent that these efforts help strengthen cooperation within the region as well as broaden its economic linkage to the rest of the world.

Second, Asian economies should continue to strengthen their financial systems to underpin the efficient use of financial resources. Financial sector weaknesses, coupled with lack of prudential oversight, have often led to credit and asset price booms during the era of liquidity in Asia, only to be followed by painful corrections. In order to strengthen its financial sector, developing Asia needs to enhance risk management, strengthen prudential oversight, establish healthy credit systems, and improve governance. Continuous progress in financial sector reforms combined with sound macroeconomic management will be key to ensuring currency and financial stability in the region, as some large economies such as the PRC and Korea are experiencing increasing capital inflows. To channel such resources to productive uses, the sound management of private capital flows is crucial, to be achieved by broadening financial markets, strengthening market infrastructure, building a sound legal and regulatory framework, and enhancing market transparency.

Third, it is imperative for the region to increase domestic absorption by nurturing local investment conditions (see Part 3: "Promoting competition for long-term development"). In line with the above financial sector reforms, further comprehensive structural reforms should follow to improve overall economic efficiency and competitiveness. Such reforms include the successful implementation of corporate and financial sector restructuring through strengthening the balance sheets of companies in these sectors, while creating an investment-friendly environment through minimizing unnecessary regulatory barriers in business activities, encouraging private incentives toward more dynamic market economies, opening domestic markets to international competition, and creating a level playing field across all sectors. Over the forecast period, strong growth in Asian demand is not only important for more balanced and resilient regional growth, but is also essential for alleviating the pressure of global imbalances.

Export or domestic demand-led growth in developing Asia?

In recent years, some developing Asian countries claim to have started shifting emphasis from export-led to domestic demand-led growth policies with a view to achieving a more balanced growth strategy. This part of ADO 2005 *evaluates empirically how far this shift has gone. The evaluation—based on an analysis of five countries—finds no evidence that the last decade has been marked by such a shift at the expense of a decline in net exports. It also finds that periods of expansionary domestic demand and deteriorating net exports signaled an ensuing crisis.*

Introduction

Since the Asian financial crisis erupted in 1997, countries in the Asia-Pacific region have been immersed in a search to identify what policies led to the crisis and subsequent recession, and what alternative set of policies would lead them back to a path of sustained and higher growth (Felipe 2003). The majority view has been that the crisis was the consequence of a fundamental flaw in precrisis financial policies, which led to currency overvaluation, overborrowing, and overlending for the domestic economy, and speculative bubbles in the nontradable sectors that eventually burst (for an overview see Jomo 1998, Seguino 2000, and Lim 2004).

As part of the "package of solutions" to reinvigorate these economies, a number of policy makers in the region (some of them more openly, e.g., in Thailand, and some others less so, e.g., in Malaysia) proposed shifting to a "new development paradigm" based on *domestic demand-led growth*. This way, it is argued, the Asian countries hit by the crisis are making efforts at diversifying their economic base away from overreliance on external trade, the basis of the so-called *export-led growth model*. During the last 4 years, articles in the press have analyzed and followed this alleged shift.[1] Thailand's Prime Minister Thaksin Shinawatra, for example, announced upon taking the helm of government in January 2001 that he was determined to move the country away from mass manufacturing for exports into domestic demand-led growth through a series of policies. The country's policy makers are making big efforts toward shifting economic policy in an attempt to reduce the country's overdependence on external demand and foreign capital. The high growth rates achieved by Thailand in recent years seem to vindicate the new approach. However, Mr. Thaksin's approach is not, strictly speaking, just a transformation from export-led growth into domestic demand-led growth, if by the latter a series of policies to boost domestic demand is meant (this will be properly defined in the section "Definition of domestic demand- and export-led strategies," below).

His policies are based on what has been referred to as a "dual-track" strategy (Lian 2004) of relying on external demand (first track) and simultaneously developing domestic demand and supporting domestic enterprises (second track). Though it is true that his policies emphasize private consumption, they try to boost the demand of domestically produced goods and services (Box 1.3).

Since becoming prime minister in 2001, Mr. Thaksin's objective has been to alter Thailand's production structure with a view to reducing the country's dependence upon exports. The key is to create demand among households and businesses

Box 1.3 What is *Thaksinomics*?

In August 2004, the Government of Thailand published a white paper entitled "Facing the Challenge: Economic Policy and Strategy." This explains clearly the economic agenda that Prime Minister Thaksin has been trying to implement since January 2001. The message is that his policies try to balance past excessive dependence on external demand, urban-based mass manufacturing, and unproductive asset-building, with structural development in domestic demand, traditional sectors (e.g., agriculture, small and medium enterprises, and rural households) and entrepreneurs, and improvement in the pricing power of Thai goods and services. Thus, Mr. Thaksin intends to revive domestic demand (by boosting private consumption and by developing the traditional sectors), in addition to exports. This is what has been referred to as a dual-track strategy, as opposed to the single-track model followed by many countries in the region, namely, production for export. Mr. Thaksin's dual-track strategy is five-pronged:

- *Revitalizing growth at the grassroots level*. The key policy initiatives are embodied in the following programs: "one *tambon* [village] one product," SME and entrepreneur promotion, farmers' debt suspension, Village and Urban Community Revolving Fund, the People's Bank of the Government Savings Bank, SME loans, venture capital, and asset capitalization.
- *Jump-starting key sectors*. The paper contains ideas for the key sectors of the economy. With regard to agriculture, for example, it argues that it is crucial to identify new demand for Thai agricultural products both domestically and abroad. For manufacturing, the Government has set up a new Entrepreneurs Promotion Board to create 50,000 new SME businesses. In tourism, the policy sets out to promote Thailand aggressively and to capture the upper middle classes of Chinese, Indians, and Europeans. In terms of real estate, the Government has disregarded the standard prescriptions of "fire sales" and driving asset prices to their true bottom. Instead, it has promoted asset reflation. Finally, in the financial sector, the Government has put in place a financial sector master plan to create a more efficient and competitive financial system.
- *Enhancing economic efficiency and long-term competitiveness*. The Government has identified a series of industries to promote, namely automobiles, tourism, software, food, fashion, health care services, hospitality, rubber, and furniture.
- *Providing a stable and supportive macroeconomic environment to facilitate growth while maintaining overall policy discipline*. The Government has raised tax revenues, consolidated spending, balanced the budget, and retired public foreign debt.
- *Promoting the external sector through market expansion and fostering financial stability through regional and global cooperation*. Under the dual-track strategy, the external sector is as important as the domestic. Thus, exports remain a cornerstone of the strategy.

Source: Asian Development Bank staff.

without creating another bubble (i.e., to avoid a household-led spending boom fueled by borrowing such as in the US). Moreover, Mr. Thaksin's strategies aim at boosting domestic demand and strengthening local enterprises as well as developing indigenously owned production capacity.[2]

Malaysia is also making an effort at diversifying its economic base. The Republic of Korea is reported to have gone into a debt-led consumption binge after the Asian financial crisis, which led to the 2003 crisis of credit card defaults and weak consumption demand that is the cause of low growth.

It is therefore important to analyze whether the empirical evidence indicates that a shift from export-led growth to domestic demand-led growth is indeed taking place across Asia, and the consequences of this shift. In particular, do the data appear to confirm this move toward a domestic demand-led growth strategy? More precisely, this part of *ADO 2005* attempts to answer the following three questions:

(i) Does the evidence indicate that countries are switching from export-led growth to domestic demand-driven growth?
(ii) Did the export-led strategies partly contribute to the Asian financial crisis?

(iii) What lessons can be drawn from the different country experiences?

Structure

In order to address the three questions, this part of *ADO 2005* analyzes growth from the point of view of the aggregate demand components. The approach is very simple, based on the analysis of the information provided by the basic demand-side macroeconomic accounting identity, according to which output equals the sum of consumption, investment (i.e., domestic demand), and net exports.

The section after this, "Export-led growth strategy," offers a summary and discussion of the strategy as well as a summary of some recent critiques of it. These have led (at least in the view of some authors) to the theoretical rationale for the alleged need to shift to a domestic demand-led growth approach. The next section, "Definition of domestic demand- and export-led strategies" defines the two types of growth strategies for purposes of the subsequent discussion.

The empirical work is carried out in the form of three complementary analyses (the sections "Demand-side growth-accounting exercise," "Decomposition analysis," and "Comparing expenditure shares"). Since the objective of this part is limited to an ex post, factual, and descriptive analysis of whether a shift to domestic demand-led growth is taking place, the methodology used is very simple. Output (GDP) from the demand side is looked at. This way, the latter is made up of the domestic demand components—consumption and investment—and net exports (exports less imports); and this is seen from the point of view of an accounting identity, i.e., there is no attempt at *modeling* in the sense of understanding *ex ante*, *causal*, or *behavioral* relationships. The first of these three sections, "Demand-side growth-accounting exercise" presents the results of such an exercise performed on the aggregate demand components of a selected group of Asian countries, namely, People's Republic of China (PRC), India, Korea, Philippines, and Thailand. Growth accounting apportions overall GDP growth to the contribution of each component of demand. Thus, overall growth of output is the sum of the growth rate of each component multiplied by its share in GDP. For example, the contribution of private consumption growth to overall GDP growth is calculated as the product of the growth rate of consumption times the share of consumption in GDP. Expressed as a percentage of the overall growth rate, it is the ratio of this product to the growth rate of GDP. The exercise provides a long-run view of these five countries in terms of the contribution of growth in domestic demand components and net exports to overall growth.

The second of these three sections, "Decomposition analysis of stances in the private, government, and trade sectors," broadens the analysis of the five countries by looking at the expansionary versus nonexpansionary (or even contractionary) stances or positions of the private sector, government or fiscal sector, and external trade sector over the last 20 years, in terms of aggregate demand "injections" (private investment, government spending, and exports) versus "leakages" (private savings, taxes, and imports) of the three sectors. Over the last three decades, there have been substantial changes in demand-side parameters, such as import coefficients, tax efforts, and savings rates, along with jumps in flows such as annual exports, investments, and government spending. The analysis in this section looks at how output has responded to these shifts, using a simple decomposition of demand injections versus leakages. The discussion helps identify whether the component of demand in question has an expansionary or nonexpansionary contribution to aggregate demand (naturally, ex post, total injections must equal total leakages).

It should be pointed out that, while the growth-accounting exercise provides a long-run picture over three decades (1973–1983, 1983–1993, and 1993–2003) in terms of the growth contribution of each demand component to overall growth, the stances provide an annual graphical picture over 20 years of the different phases of growth of the five countries by identifying expansionary and nonexpansionary factors (private, government, and external sectors) in effective demand.

The last of these three sections, "Comparing expenditure shares," completes the empirical analysis with a comparison of the shares of aggregate demand components for a large number of Asia-Pacific countries—classified according to

three income groups—with the shares of a group of small open European economies. Since it is impossible to carry out the growth-accounting and stance analyses for all Asia-Pacific countries, the analysis of the demand shares provides an overall picture.

The last section of this part of *ADO 2005* provides a summary and some conclusions.

Methodology

Some words on methodology are important. First, the demand-side growth-accounting and stance exercises are not, strictly speaking, an economic model in itself (nor based on a model), so no causal inferences should be drawn. The former is simply a device to split and apportion, ex post, the growth of output from the demand side. The latter also provides an ex post classification of how the private, government, and trade sectors contribute to expansions or contractions in output, where, by definition, the sum of the three is zero. Second, the analysis does not take into account any supply-side considerations (e.g., the relationship between exports and technology upgrading, often brought up in the discussions of the benefits of export-led growth). Third, although the analysis is an exercise in positive economics, it leads naturally to the normative observation that the problem being considered should not be an either/or choice between domestic demand-led growth and export-led growth, but a need to actually give both domestic demand growth and net export growth due importance and proper balance. This is especially crucial since developing countries need precious foreign exchange for their economic development, which net export earnings provide. Finally, it is virtually impossible to clearly discern a structural change from export-led growth into domestic demand-led growth with 3-year data. If this is happening, it will take years, perhaps a decade, for the data to show. Hence, the analysis covers three decades and unveil episodes of the two strategies mentioned.

Synopsis of conclusions

The analysis leads to the conclusion that the more successful phase of development of the selected countries has been associated with significant investment increases and capital accumulation, as well as with significant export growth that brought about trade surpluses or reductions in trade deficits. For the countries badly hit by the Asian crisis in 1997–98, the instabilities were preceded by unbalanced growth in demand components, with domestic demand highly expansionary, and increasing trade deficits. This was the result of currency overvaluations, overborrowing and overlending in the domestic private sector, and rise of speculative bubbles that most economists agree triggered the loss of confidence, substantial currency depreciation, and capital flight during the crisis. The harsh adjustments during the crisis resulted in the collapse of domestic demand (especially investments) as net exports recovered sharply. Thus, it was not the export-led strategy that contributed to the crisis—it was the promotion of debt-financed domestic demand growth at the expense of net exports that precipitated it.

The analysis suggests that the best periods seem to be those when both domestic demand and net exports exhibit significant and continuous growth or improvements, as in the case of the PRC and India today, or in postcrisis Thailand. This was also the case of the post-Plaza Accord period of the second half of the 1980s in Korea and Thailand, when the reputation of the “Asian miracle” reached its peak. Periods when domestic demand was highly expansionary at the same time that net exports deteriorated signaled an ensuing crisis, as the experiences of Korea, Philippines, and Thailand show.

The comparisons between the upper-medium and low-income Asia-Pacific countries show that, during the last decade, 1993–2003, the high-performing Asian countries outpaced the European countries in terms of growth in both exports and net exports. The Asia-Pacific middle-level and low-income countries, on average, improved their trade deficits during the last decade. However, the low-income countries still have very high trade deficits that need to be reduced (or, alternatively, the gap between aggregate domestic demand and domestic production has to be narrowed). But there is no evidence that countries in the Asia-Pacific region have recently been exhibiting growing domestic demand shares at the expense of net exports.

Inasmuch as the analysis suggests that healthy growth for developing countries should be the

result of growth in both domestic demand and net exports, the last section includes a general discussion about how the international trade system should be more responsive to the needs of poorer countries with a view to allowing them to benefit from international trade. It is proposed that, to provide developing countries with the proper environment in which to achieve improvements in their net exports, the international trade system should provide them with mechanisms to reduce their large trade deficits. This requires (i) a more open international trade system—richer and trade-surplus countries can contribute by opening up their agriculture, industry, and services markets to the developing world; and (ii) use of price and non-price mechanisms by poorer and deficit-ridden countries to improve their productivity and competitiveness in the world market.

Export-led growth strategy

Overview

Export-led growth is a term used loosely to refer to a strategy comprising the encouragement of and support for production for exports. The rationale lies in the belief of many economists that trade is the engine of growth, in the sense that it can contribute to a more efficient allocation of resources within countries as well as transmit growth across countries and regions. Exports, and export policies in particular, are regarded as crucial growth stimulators. Exporting is an efficient means of introducing new technologies, both to the exporting firms in particular and to the rest of the economy, and exports are a channel for learning and technological advancement. Moreover, the growth of exports plays a major part in the growth process by stimulating demand and encouraging savings and capital accumulation, and, because exports increase the supply potential of the economy, by raising the capacity to import.

Mercantilist economists believed that the wealth of a country should be measured by the extent of the accumulation of precious metals and placed a great emphasis on achieving trade surpluses. Classical economists, on the other hand, argued that trade was welfare improving because it led to an efficient use of resources in each country, in the sense that countries would produce and export the products in which they have a comparative advantage, and import the products in which they have a comparative disadvantage. It could even be said that the purpose of trade, from a classical point of view, is imports. Exports are simply the way to pay for imports. In this sense, there is also an emphasis on the importance of exports, although of different nature.

As a development strategy, the classical belief was that development could be transmitted through trade. Classical economists justified the benefits of exports with the traditional argument of comparative advantage. Accordingly, opening up a country's market to the international markets allows a country more efficient production and allocation of resources as the country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. Thus, world trade markets allow producers and consumers of the participating countries to benefit from lower prices, higher-quality products, more diverse supply of goods, and higher growth. The export-led growth model seemed initially to have been vindicated with the success of Asia's miracle countries, which achieved extraordinarily high growth between the 1970s and mid-1990s, supposedly through export promotion. Since the eruption of the Asian crisis, however, some sectors have expressed increasing doubts as to the feasibility of export-led growth for many developing countries (Felipe 2003).

Recent decades have brought about other important justifications for export promotion. Some of these are:

- Participating in trade, especially export production and promotion, exposes a country to the latest and most advanced production and marketing techniques, and a "learning-by-doing" process that brings about dynamic innovation and technological diffusion into the economy. It also drives a country to higher production and to economies of scale, which lead to increasing returns (Felipe 2003).
- Many development economists use the "two-gap or three-gap" models of Taylor (1993) to justify the need to earn foreign exchange via exports. According to these models, the investment-savings gap and the foreign exchange gap are major obstacles to the

growth and development of many developing countries. Since countries need precious foreign exchange for their development needs (capital goods, industrial raw materials, oil, and food), export earnings are a more efficient means to finance these needs than foreign debt since the latter is vulnerable to adverse exogenous shocks and currency risks that may lead to debt defaults.

- A similar argument (McCombie and Thirlwall 1994) claims that large balance-of-payment deficits, spurred by large import propensities or elasticities, may be a hindrance to growth for many developing countries. Thus, moderate trade deficits, or trade surpluses, are more desired. This, of course, implies that export growth should be in pace with, or ahead of, import growth.
- Felipe (2003) also argues that export-led strategies allow an expansion of aggregate demand without much inflationary pressure and without the danger of a wage-price spiral, compared with strong domestic demand injections. This partly stems from the real appreciation of the currency that results from large export earnings, which tame inflation and allow real wages to rise.

A rationale for domestic demand-led growth?

It is important to mention that while the literature on growth and development considers the export-led growth strategy, the "domestic demand-led growth strategy" is not a term defined and used (hence it has to be defined here, in particular for purposes of empirical implementation—see "Definition of domestic demand- and export-led strategies," below).[3] Therefore, it is not straightforward to place the "debate" between export-led and domestic demand-led growth strategies in a theoretical context.

In recent years, however, a series of economists have hypothesized that, the Asian crisis had very different roots and that after several decades of being presented as the optimal growth strategy, the export-led growth model that the Asian countries followed ultimately gave in and even harmed the growth prospects of developing countries. These economists have put together a critique of the export-led growth model and proposed a shift toward domestic demand-led growth.

Palley (2002), for example, has argued that the emphasis on export-led growth of most Asian countries had a series of negative effects. First, it prevented the development of domestic market growth. Second, it put developing countries in a "race to the bottom" among themselves. Third, it placed workers in developing countries in conflict with workers in industrial countries. Fourth, there is a relationship between export-led growth and financial instability through the creation of overinvestment booms. Fifth, due to the emphasis placed on global goods and commodity markets, this model has aggravated the long-trend deterioration in developing-country terms of trade. And finally, and most important, export-led growth has reinforced the dependency of developing countries on industrial countries, thus rendering them vulnerable to slowdowns in industrial-country markets (e.g., as in the slowdown of the semiconductor world market in 1996–97 right before the Asian crisis). Export-oriented economies are dependent on foreign (mostly Western) demand. The problem is that recessions in Europe, US, or Japan translate into slow growth in the developing world. Summing up, Palley (2002) argued that the export-led growth model that the Asian countries followed for several decades is no longer an optimal strategy.

Blecker (2002, 2003) has also contended that the adoption of a development strategy that relied on high rates of growth of manufactured exports is the root cause of the problems that led to the crisis, for such a strategy led to growing excess capacity, intensified competitive pressures, and disappointing growth performance. In a similar vein, Kaplinsky (2000) and Erturk (2001–2002) have suggested the possibility of *immiserizing growth* as a result of the creation of excess capacity in export-oriented manufacturing industries. During the 1990s, too many developing countries entered the more advanced product categories, thus creating excess capacity and fostering falling prices.

Blecker (2002, 2003) has also argued that reliance on export growth suffers from a "fallacy of composition." The reason is that, if too many countries try simultaneously to rely on export-led growth policies to stimulate growth in a given set of global demand conditions, the market for developing countries' exports is limited by the

capacity of the industrial nations. If demand in the industrial countries stagnates, it translates into overinvestment and excess capacity in developing countries. As Asian countries plunged into the crisis, the first policy option they all considered as a means of resuming growth was the export-led strategy. However, the difficulty with this strategy is that the fallacy of composition problem has been exacerbated, since during the last decade the PRC has been added into the equation. Export-led growth operates through a hierarchical process with less-developed newcomers replacing more maturing export economies as their wages grow. The PRC poses an entirely different problem for it has a fairly large supply of labor so that it can keep wages very low and, seemingly, for a long time.

Blecker summarizes his views as follows: "the current emphasis on export-led growth in developing countries is not a viable basis on which all countries can grow together under present structural conditions and macroeconomic policies" (Blecker 2003). Palley (2002) has gone further and contends that the export-led growth model followed by many developing countries during the last few decades was part of the "Washington consensus" emphasis on trade liberalization.[4] As a solution, Palley proposes a new development paradigm based on domestic demand-led growth.[5]

Definition of domestic demand- and export-led growth strategies

The analysis is performed in terms of the macroeconomic accounting identity:

$$GDP \equiv Y \equiv C_p + C_g + I + X - M \quad (1)$$

where GDP stands for gross domestic product, C_p is private consumption, C_g is government consumption, I is gross domestic investments or gross domestic capital formation (GDCF), and X and M are exports and imports, respectively, of goods and services. An export-led growth strategy is referred to as one that results in:

high export growth, accompanied by high GDP and income growth;

and

improvement in net export growth, i.e., higher export growth than import growth.

Conversely, growth is *strictly speaking* domestic demand-led if domestic demand is growing, accompanied by GDP and income growth.

The share of each component in output is defined as: (C_p/Y) is the share of private consumption, (C_g/Y) is the share of government consumption, (I/Y) is the share of investment, and $((X-M)/Y)$ is the share of net exports.

A convenient way of categorizing the different possibilities for the two strategies is as follows. The first three terms on the right-hand side of identity (1)—consumption of the private and government sectors plus investments—are the domestic demand components, while $(X-M)$, or net exports, is the other component of aggregate demand. Thus, the following cases can arise:

- Domestic demand is growing and net exports are deteriorating (becoming a smaller positive number or larger negative number). If GDP growth is positive, then growth must be domestic demand-led. This is the only case where one can, *strictly speaking*, refer to domestic demand-led growth.
- Domestic demand and net exports are growing. Thus, growth is due to both domestic demand and net exports. Which one is contributing more to growth is simply an empirical issue. If domestic demand is growing faster, it can be said that growth is demand led, but *weakly speaking*.
- Domestic demand is deteriorating and net exports are increasing. If growth is positive (which is often not the case since domestic demand is usually a much larger component of GDP), growth must be net export led. If growth is negative, the recession is due to a decline in domestic demand.
- Both domestic demand and net exports are decreasing. Obviously, there is an economic recession and negative growth rates are due to declines in both domestic demand and net exports.

It must be pointed out that, as GDP is separated into the domestic demand and net export components, the share of domestic demand will be much larger than the net export share,

usually constituting more than 90% of GDP when net exports are positive. (When net exports are negative, the share of domestic demand will be more than 100%.) This is because much of the export earnings will go to import purchases, and since net exports track the difference between these two trade variables, the magnitude becomes quite low compared with domestic demand. This is true even in the most successful export-led growth cases where export growth is in double-digits.[6]

Demand-side growth-accounting exercise

In this section, a growth-accounting analysis on the components of demand is performed. As indicated above, the objective of this exercise is to apportion overall growth between domestic demand and net exports. Technical details are shown in Box 1.4.

The five countries chosen—PRC, India, Korea, Philippines, and Thailand—provide a relatively wide spectrum of experiences and results. The first two are the oft-touted Asian success stories of the most recent decade due to their opening up to international trade, and the latter three were countries affected by the Asian financial crisis in 1997–98. Table 1.3 gives the shares of the expenditure components of GDP at constant prices for the five countries. Table 1.4 shows the average annual growth rates of GDP and of demand components over the 10-year intervals of 1973–1983, 1983–1993, and 1993–2003. Table 1.5 provides the growth rates of the expenditure components weighted by their shares in GDP. This gives, in growth rate terms, the contribution of each component to the growth rate of GDP. Finally, Table 1.6 displays, as a percentage, the contribution of each aggregate demand component to overall GDP growth.

Box 1.4 Demand-side growth accounting

Real output from the demand side is given by the national income and product accounts as:

$$GDP \equiv Y \equiv C_p + C_g + I + X - M \qquad (1)$$

where GDP stands for gross domestic product, C_p is private consumption, C_g is government consumption, I is gross domestic investments or GDCF, and X and M are exports and imports of goods and services, respectively.

In growth rate terms:

$$\hat{GDP} \equiv (C_p/GDP) \times \hat{C}_p + (C_g/GDP) \times \hat{C}_g + (I/GDP) \times \hat{I} + (X/GDP) \times \hat{X} - (M/GDP) \times \hat{M} \qquad (2)$$

where the symbol ˆ denotes growth rate of the variable.

The above simply states that the growth rate of GDP is the sum of the products of the shares in GDP times the growth rates of private consumption, government consumption, gross domestic investments and exports, less the product of the share of imports and its growth rate.

Real values were derived for 1973, 1983, 1993, and 2002 using the United Nations Statistics Division data, which have a continuous series of expenditure component measures from 1973 to 2002 in constant 1990 prices. Data for 2003 were derived from the 2002 data above and the latest growth data from ADB's *Key Indicators 2004* or the latest IMF *International Financial Statistics*. For the Philippines, the United Nations Statistics Division has a complete continuous series from 1973 to 2003. India did not have data for 2003 at the time of writing (December 2004), so its data end in 2002.

Average annual growth rate of a variable, denoted $\hat{x}$, was derived, say, for 1973 to 1983, as:

$$\hat{x} = (((x_{1983} - x_{1973}) / x_{1973}) * 100) / 10 \qquad (3)$$

For a continuously increasing positive x, the above method will yield a higher annual average growth rate than taking the 10 actual annual growth rates of x from 1973–74 up to 1982–83, and then averaging them.[1]

The method employed here also uses the GDP estimate without taking into consideration the statistical discrepancy between the value-added GDP estimate and the expenditure GDP estimate. That is, the GDP in the denominators of the shares in equation (2) uses equation (1) exactly without including the statistical discrepancy. This allows the expenditure shares to sum up to exactly 100%, and for equation (2) to sum up exactly to the GDP growth rate.

[1] This is because the base year in (3) is always the value of 1973, while averaging the actual annual growth rates uses base years from 1973 up to 1982.

Source: Asian Development Bank staff.

Table 1.3 Shares of expenditure components in real GDP, 1990 prices, %

		Domestic demand (1)=(2)+(3)+(4)	Private consumption (2)	Government consumption (3)	Gross domestic fixed capital formation (4)	Net exports (5)=(6)-(7)	Exports of goods and services (6)	Imports of goods and services (7)
1973	PRC	99.1	55.7	9.4	34.1	0.9	5.0	4.1
1983		100.2	54.3	12.1	33.7	-0.2	13.2	13.4
1993		100.8	49.1	13.1	38.6	-0.8	18.6	19.3
2003		94.2	39.6	12.0	42.6	5.8	24.4	18.6
1973	India[a]	101.6	70.8	9.1	21.7	-1.6	6.7	8.4
1983		103.1	71.8	10.3	21.0	-3.1	6.5	9.6
1993		102.8	68.7	11.9	22.2	-2.8	8.6	11.5
2002		101.1	62.8	12.0	26.4	-1.1	16.7	17.9
1973	Korea	100.5	64.1	15.7	20.7	-0.5	16.4	16.9
1983		96.7	55.1	12.8	28.8	3.3	27.7	24.4
1993		100.2	52.3	10.5	37.4	-0.2	33.9	34.1
2003		94.3	52.9	12.2	29.2	5.7	45.7	40.0
1973	Philippines	100.4	69.0	11.4	20.0	-0.4	19.0	19.5
1983		102.3	63.0	9.8	29.6	-2.3	21.9	24.2
1993		107.2	74.8	10.0	22.4	-7.2	31.3	38.5
2003		105.7	73.8	9.2	22.7	-5.7	39.3	45.0
1973	Thailand	114.4	68.7	10.0	35.7	-14.4	17.1	31.5
1983		109.5	63.5	13.1	33.0	-9.5	19.6	29.1
1993		105.9	55.1	8.7	42.0	-5.9	39.6	45.5
2003		85.3	55.4	8.7	21.2	14.7	65.7	50.9

[a] India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.4 Average growth rates of expenditure components based on constant 1990 prices, %

		Expenditure on GDP	Private consumption	Government consumption	Gross domestic fixed capital formation	Exports of goods and services	Imports of goods and services
1973–1983	PRC	9.0	8.6	14.7	8.8	40.6	52.3
1983–1993		16.1	13.6	18.0	19.8	26.7	27.7
1993–2003		14.2	9.5	12.2	16.7	21.8	13.3
1973–1983	India[a]	5.0	5.2	6.9	4.5	4.4	7.2
1983–1993		5.6	5.0	8.1	6.5	10.9	8.7
1993–2002		8.0	6.4	8.1	11.6	26.0	18.7
1973–1983	Korea	10.6	7.7	6.8	18.7	24.8	19.8
1983–1993		12.2	11.1	8.2	18.9	17.2	21.1
1993–2003		7.3	7.5	10.1	3.5	13.3	10.3
1973–1983	Philippines	6.4	5.0	4.0	14.2	8.8	10.4
1983–1993		1.5	3.6	1.8	-1.3	6.4	8.2
1993–2003		4.7	4.5	3.5	4.9	8.5	7.2
1973–1983	Thailand	8.9	7.5	14.7	7.5	11.7	7.5
1983–1993		13.3	10.2	5.6	19.7	37.0	26.4
1993–2003		3.6	3.7	3.6	-3.1	12.6	5.3

[a] India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.5 Growth rates of expenditure components weighted by their share in GDP, %

		Expenditure on GDP (1)=(2)+(6) =(3)+(4)+(5) +(7)-(8)	Domestic demand (2)= (3)+(4)+(5)	Private consump-tion (3)	Gov-ernment consump-tion (4)	Gross domestic fixed capital formation (5)	Net exports (6)= (7)-(8)	Exports of goods and services (7)	Imports of goods and services (8)
1973–1983		9.0	9.2	4.8	1.4	3.0	-0.1	2.0	2.1
1983–1993	PRC	16.1	16.2	7.4	2.2	6.7	-0.2	3.5	3.7
1993–2003		14.2	12.7	4.7	1.6	6.4	1.5	4.0	2.6
1973–1983		5.0	5.3	3.7	0.6	1.0	-0.3	0.3	0.6
1983–1993	India[a]	5.6	5.8	3.6	0.8	1.4	-0.1	0.7	0.8
1993–2002		8.0	7.9	4.4	1.0	2.6	0.1	2.2	2.1
1973–1983		10.6	9.9	5.0	1.1	3.9	0.7	4.1	3.3
1983–1993	Korea	12.2	12.6	6.1	1.1	5.4	-0.4	4.8	5.1
1993–2003		7.3	6.3	3.9	1.1	1.3	1.0	4.5	3.5
1973–1983		6.4	6.7	3.4	0.5	2.8	-0.3	1.7	2.0
1983–1993	Philippines	1.5	2.1	2.3	0.2	-0.4	-0.6	1.4	2.0
1993–2003		4.7	4.8	3.4	0.3	1.1	-0.1	2.6	2.8
1973–1983		8.9	9.3	5.1	1.5	2.7	-0.4	2.0	2.4
1983–1993	Thailand	13.3	13.7	6.5	0.7	6.5	-0.4	7.3	7.7
1993–2003		3.6	1.0	2.0	0.3	-1.3	2.6	5.0	2.4

[a] India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

Table 1.6 Contribution of demand components to GDP growth, %

		Expenditure on GDP (1)=(2)+(6) =(3)+(4)+(5) +(7)-(8)	Domestic demand (2)= (3)+(4)+(5)	Private consump-tion (3)	Gov-ernment consump-tion (4)	Gross domestic fixed capital formation (5)	Net exports (6)= (7)-(8)	Exports of goods and services (7)	Imports of goods and services (8)
1973–1983		100.0	101.4	52.9	15.2	33.3	-1.4	22.3	23.6
1983–1993	PRC	100.0	101.1	45.9	13.6	41.6	-1.1	21.9	23.1
1993–2003		100.0	89.6	32.9	11.3	45.4	10.4	28.6	18.1
1973–1983		100.0	106.1	73.9	12.7	19.6	-6.1	5.9	12.1
1983–1993	India[a]	100.0	102.3	63.2	14.8	24.4	-2.3	12.5	14.8
1993–2002		100.0	98.8	54.7	12.0	32.1	1.2	27.9	26.7
1973–1983		100.0	93.2	46.6	10.0	36.5	6.8	38.3	31.5
1983–1993	Korea	100.0	103.1	50.0	8.6	44.5	-3.1	39.0	42.1
1993–2003		100.0	86.3	53.7	14.6	18.0	13.7	61.9	48.1
1973–1983		100.0	105.3	53.6	7.2	44.5	-5.3	26.4	31.7
1983–1993	Philippines	100.0	140.4	154.5	11.8	-25.8	-40.4	94.6	135.0
1993–2003		100.0	102.4	71.7	7.4	23.3	-2.4	56.4	58.8
1973–1983		100.0	104.0	57.6	16.5	29.9	-4.0	22.5	26.5
1983–1993	Thailand	100.0	103.2	48.8	5.5	48.8	-3.2	54.7	57.9
1993–2003		100.0	28.6	56.0	8.6	-36.1	71.4	137.3	65.9

[a] India's 2003 data not available as of December 2004.

Sources: United Nations Statistics Division; Asian Development Bank. 2004. *Key Indicators 2004*.

People's Republic of China

The tables show that the PRC registered high domestic demand growth in the first two decades, 1973–1993, while its net export position deteriorated and was negative.[7] This happened even as the growth of exports posted annual averages of more than 20% (since imports increased more than exports). The last decade, 1993–2003, however, saw not only continuing large growth in domestic demand components, but also a strong shift from negative net exports (or trade deficits) to high positive net export (or trade surplus) positions, as export growth accelerated and import growth decelerated. Thus, the PRC's growth experience during the last decade points to high growth in both the domestic demand components and in the net export component. Domestic demand contributed around 90% to the double-digit GDP growth of the PRC in 1993–2003, while net exports contributed around 10% (Table 1.6). It is also important to point out that, in all three decades, investment growth outpaced consumption growth (Table 1.4), so that the last decade saw a larger contribution of investment than consumption to GDP growth, an increase in the share of capital formation (to more than 40%), and a continuing decline of the share of private consumption. It must be emphasized that in the last decade the share of net exports in GDP grew substantially—reflecting the transition from a negative contributor to growth to a high positive contributor.

India

India registered positive average annual GDP growth during the three decades, but lower than the PRC. The first two decades (1973–1993) were marked by growth in domestic demand as net exports deteriorated. During the last decade, when India opened up to the international market, the country exhibited even higher growth, with higher growth in the domestic demand components, but now the trade deficits improved so that net exports contributed slightly to overall GDP growth. During this decade, the growth rates of exports and imports more than doubled, with exports outpacing imports, leading to the decline in the trade deficits (net exports became a smaller negative number). As in the PRC, investment increased more than consumption in the last decade, with the consequence that the share of capital formation increased, while that of private consumption fell. But the high share of consumption still made this component of demand the largest contributor to growth in the last decade. Finally, the last decade saw an increase in the share of net exports to GDP (actually a decline of its negative share to GDP) and a slight decline in the share of domestic demand to GDP.

Korea

The high-growth decade for Korea was 1973–1983, when it started being touted as an "Asian tiger." During this decade, the domestic demand components of GDP grew very fast. Export growth exceeded 20% annually and surpassed import growth such that the country registered net export growth. At the same time, there was strong domestic demand growth. The trade surplus position reversed during 1983–1993 as the country began exhibiting trade deficits in the early 1990s, even if exports continued growing at a very high rate. The very high GDP growth during this decade, therefore, was due to high growth of domestic demand, with net exports deteriorating and turning negative toward the 1990s. Trade deficits continued until the Asian crisis. The last decade, 1993–2003, reversed the trade deficits, and the country returned to positive net exports starting in 1998, at the height of the Asian crisis. Because of the significant contraction of the economy in 1998, the growth rate of the last decade was lower than those registered during the last two decades, though still respectable. The last decade saw a slower growth of consumption and investment than in the previous decades, with investment actually losing share of GDP (reflecting the investment collapse of 1998). Net exports contributed to GDP growth in this last decade, and increased its share in GDP, while the share of domestic demand fell.

Philippines

The Philippines exhibited respectable growth during 1973–1983, with domestic demand growing significantly. The decade 1983–1993 was a difficult period for the Philippines, marked by the economic collapse of 1984–85 and 1991–92. Average annual growth was low during this

decade, which saw a decline in investment and low growth in consumption. Trade deficits also worsened, contributing to the low growth. The decade, therefore, was characterized by stagnation, with net exports not improving by the end of the decade (1993). The last decade (1993–2003) saw an improvement in growth rates, but net exports continued to be negative and did not improve in absolute terms, though they did improve as a percentage of GDP. The Philippines, therefore, is the only case among the five countries analyzed where all three periods, including the last one, were marked by growth in domestic demand and deterioration in net exports, although there was an improvement in terms of the share of net exports to GDP (to a smaller negative number).

Thailand

Thailand registered very high growth in the first two decades, 1973–1983 and 1983–1993, with both investment and consumption growing very fast. This was accompanied by deteriorating net exports in the two decades.[8] The deterioration of net exports during 1983–1993 was accompanied by spectacular growth rates in both exports and imports. The last decade saw a significant fall in the GDP growth rate, as a consequence of the Asian crisis, which hit Thailand in 1997–98, and resulted in steep GDP and investment declines. Because of this, investment fell during the decade while consumption grew slowly and net exports turned from negative to largely positive. Thailand's GDP growth in 1993–2003 stemmed largely from improvements in net exports, which contributed 71% of the country's overall growth. Thus, Thailand's post-Asian crisis improvement in net exports was the main contributor to growth during the last decade, rather than domestic demand.

Summary of results

Table 1.7 summarizes the results of the growth-accounting exercise. The overall picture that emerges from the analysis of the selected countries indicates that during the first two decades, but more especially during the second, domestic demand was the main driver of growth, as net exports deteriorated. The last decade of 1993–2003, on the other hand, was accompanied by significant improvements in the net exports position of the selected group of countries (with the exception of the Philippines). This is true for countries experiencing continuous growth (PRC and India) and for the countries hit by the Asian crisis (Korea and Thailand). The PRC and India registered high domestic demand growth in the last decade, simultaneously with net export growth (and very high export growth). Korea and Thailand saw net exports swing from negative to highly positive and contribute significantly to growth, as the domestic demand components grew more slowly.

In the Asian tigers such as PRC, Korea, and Thailand, export growth actually decelerated in the last decade relative to the second decade, but export growth was still in double digits. On the other hand, the growth rate of imports decelerated more with the consequence that all three countries saw improvements in their net export positions.

Export growth accelerated very strongly in

Table 1.7 Phases of domestic demand- and net export-led growth in selected Asian countries: A summary

Period	PRC	India	Korea	Philippines	Thailand
1973–1983	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD increasing, NE positive and improving	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating
1983–1993	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD increasing, NE negative and deteriorating	DD stagnant, NE negative and deteriorating	DD increasing, NE negative and deteriorating
1993–2003	DD increasing, NE positive and increasing	DD increasing, NE negative but improving	DD increase slows, NE positive and improving	DD growing moderately, NE negative and deteriorating	DD growing slowly, NE positive and improving

DD = domestic demand, NE = net exports.
Source: Asian Development Bank staff.

India during the last decade, much more than imports, leading to the reduction in the country's trade deficit. The Philippines had the slowest growth in exports in the last decade, and was the only country with deteriorating net exports.

The net export share to GDP improved in all five countries. Even countries with negative net exports (or trade deficits) improved their positions. India was able to reduce its trade deficit in terms of magnitude. Trade deficits increased in magnitude in the Philippines, but declined in terms of the share in GDP. Tables 1.3 and 1.6 show that the share of domestic demand and its contribution to growth decreased during the last decade. Conversely, the share of net exports and its contribution to growth increased.

The conclusion is that there is no evidence that the net export position of the selected countries deteriorated during the last decade. And as a consequence, there is no evidence that growth during the last decade was domestic demand-led and at the expense of the net export position.

Decomposition analysis of stances in the private, government, and trade sectors

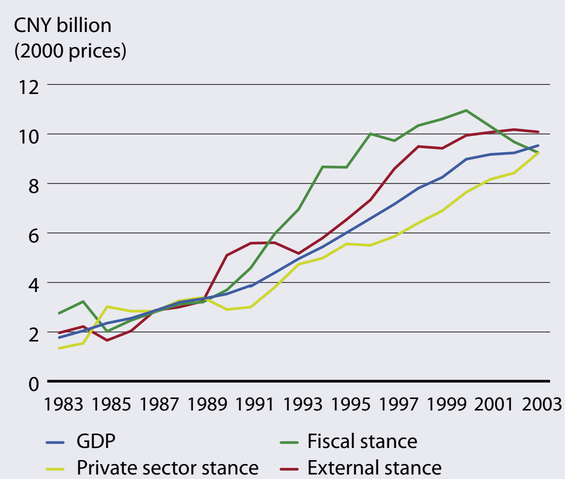
In this section, the stances of the private sector, the government (fiscal) sector, and trade sector for the five selected countries are analyzed. (The technical details of the aggregate demand decomposition analysis are provided in Felipe and Lim, forthcoming.) The private sector stance, or direct "own" multiplier on output, is given by (I_p/s_p) where I_p denotes gross private investment and s_p is the savings rate out of GDP. If (I_p/s_p) is larger than GDP, then private investment is larger than private savings (or, alternatively, private disposable income is smaller than private spending, composed of private consumption and private investments). Under these circumstances, the private sector is exhibiting an "expansionary stance" on aggregate demand, i.e., demand injections are larger than demand leakages. The government or fiscal stance is (G/t) where G is government spending and t is the tax effort out of GDP. If (G/t) is larger than GDP, then government spending is larger than tax revenues, and the government exhibits an expansionary stance on aggregate demand, i.e., it exerts positive net injections on aggregate demand. Finally, the external sector stance is (X/m), where X denotes exports of goods and services and m is the propensity to import out of GDP. If (X/m) is larger than GDP, exports exceed imports, and the trade or external sector is exhibiting an expansionary stance on aggregate demand, i.e., export injections exceed import leakages. The period covered in this analysis is 1983–2003, using real values in the national income accounts for aggregate demand components.

The results are presented in Figures 1.18–1.22, which plot the stances of the three sectors vis-à-vis GDP.

People's Republic of China

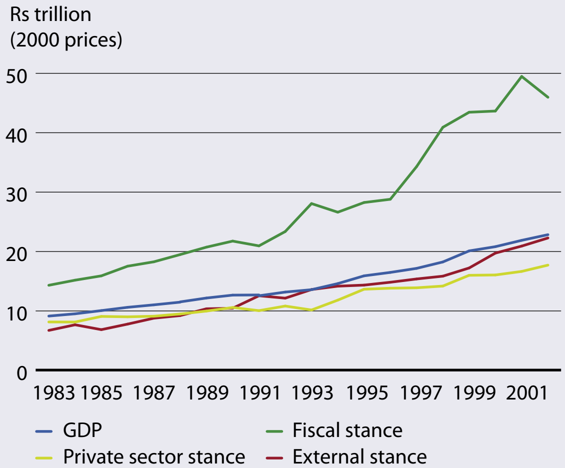
The PRC's slow transformation into a market economy and its participation in world trade has brought almost uninterrupted high growth to the country from the late 1970s until the present. The very high private savings rates (above 35%) have allowed the private sector "stance" to be nonexpansionary throughout most of the second and last decades, while maintaining a very high share, as well as growth, of GDCF (Figure 1.18). Since the early 1990s, the fiscal stance has been expansionary. The external stance became expansionary in 1990 and has remained positive until

Figure 1.18 Private sector, fiscal, external stances relative to real GDP, People's Republic of China, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.19 Private sector, fiscal, external stances relative to real GDP, India, 1983–2002



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

now. The major expansionary stances in the last decade came from the government and external sectors.

In recent years, the PRC Government has reduced the expansionary fiscal stance in an attempt to avoid overheating of the economy. This explains why the external sector has emerged as the leading expansionary sector in recent years.

India

As in the PRC, relatively high private savings rates for a low-income country have allowed a nonexpansionary private sector stance and, at the same time, have supported a GDCF of around 20–25% of GDP during most of the second and last decades. Figure 1.19 shows the consistent nonexpansionary stance of the private sector. This sector's stance falling below GDP seems to be widening in recent years as the private savings rate is close to 30% of GDP.

Imports have been increasing since the 1990s but at lower rates than in the other countries. Export growth, however, has outpaced import growth in recent years leading to smaller negative net exports and to a small nonexpansionary external stance.

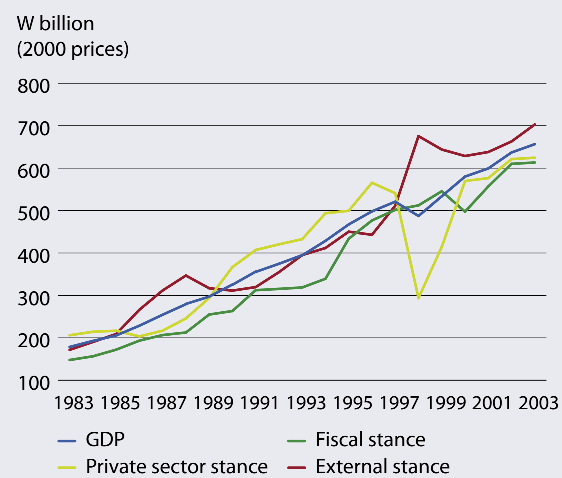
The very low tax effort (below 10% of GDP during most of the 1983–2003 period) and high government spending have made the government the only sector with an expansionary stance. This impact of the fiscal expansionary stance on aggregate demand, though large and increasing in recent years, is moderated both by the growing gap between GDP and the private sector stance and by the improvement in the external stance.

Korea

Figure 1.20 shows that an expansionary private sector stance and nonexpansionary external stance during 1983–1985 were reversed in the second half of the 1980s. This shift to an expansionary external stance took place at the time the optimism about the Asian miracle was at its height. This high foreign exchange-earning capacity of the country was an important component of the country's success.

The appreciation of the won, high short-term capital inflows, speculative bubbles, and the fixed exchange rate regime of the 1990s, however, brought back an expansionary private sector despite the country's very high private savings rates. This was accompanied by a reversal to a nonexpansionary (and at times contractionary) external stance between 1990 and 1997. This contributed to a loss in confidence in Korea in the period right before the Asian crisis.

Figure 1.20 Private sector, fiscal, external stances relative to real GDP, Korea, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

As Korea became enmeshed in the crisis, the deep recession and sharp currency depreciations in late 1997 and throughout 1998 effected a sharp reversal, with the private sector stance shifting sharply from expansionary to highly contractionary, and vice versa in the case of the external stance. This situation continues, though is quite subdued compared with the situation in 1998–1999. In recent years, Korea has experienced difficulties in increasing its GDP growth rate due to weak consumption demand. The fiscal stance has historically been nonexpansionary except in 1998–1999 as a result of the Asian crisis. Therefore, the only expansionary sector in Korea in the post-Asian crisis period has been the external sector, as net exports remain significantly positive.

Philippines

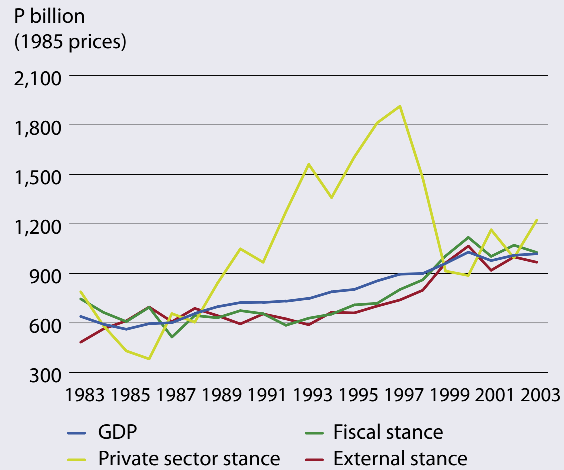
The Philippines' economic history since the 1980s has been marked by alternate periods of growth and recession. The sharp recession and crisis in the mid-1980s caused a sharp reversal in the private sector stance from highly expansionary in 1983 to highly contractionary. Correspondingly, the contractionary external stance in 1983 turned expansionary in 1985–1988.

Economic recovery in the late 1980s brought the private sector increasingly back to very positive territory in the 1990s, even though 1990–1993 were years of stagnation. The most expansionary period of the private sector was 1993–1997. Accompanying the high expansionary stance of the private sector were increasingly negative net exports, which returned in 1989 and rapidly increased in the 1990s (reaching more than 10% of GDP).

The Philippines was also hit by the Asian crisis in the second half of 1997 and throughout 1998. The sharp currency depreciation, initial high interest rates, and a slight recession tamed the high expansionary stance of the private sector (making it briefly contractionary in 1999 and 2000) and brought net exports to positive territory in 1999 and 2000.

The ensuing economic recovery (though weak and slow) returned the private sector to expansionary territory and the external sector to a contractionary position in recent years (2001 to 2003), but at much lower levels than before the Asian crisis.

Figure 1.21 Private sector, fiscal, external stances relative to real GDP, Philippines, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

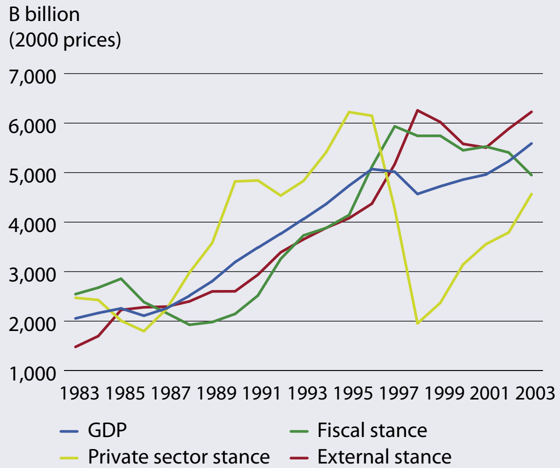
High government injections and deficits in the mid-1980s were met with fiscal austerity in 1987–1992 due to debt overhang as the country joined the decade-long debt crisis that afflicted most Latin American countries during 1982–1992. Philippine fiscal deficits remained high in 1987–1992, but this is not reflected in Figure 1.21 because much of the government spending was due to debt payments, and net lending and bailouts of government corporations. Fiscal surpluses were attained in 1994–1997 but these were reversed in 1998 due to the crisis. The Philippines now faces another fiscal crisis as the tax effort has continued its decline since the crisis, and as debt payments and failing government corporations (especially the National Power Corporation) are absorbing much government spending. The fiscal stance turned expansionary in 1999, but weakly so for the reasons given just above.

Summing up, recent years in the Philippines have been marked by an expansionary stance in the private and fiscal sectors, and a contractionary one in the external sector—but even then, these levels are much lower than before the Asian crisis.

Thailand

Like Korea, Thailand's private sector stance

Figure 1.22 Private sector, fiscal, external stances relative to real GDP, Thailand, 1983–2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

moved from expansionary to nonexpansionary in 1985–1987, and its net exports turned from negative into positive in 1986–1987 (Figure 1.22). Net exports turned slightly negative in 1988–1989. Thus, like Korea, Thailand was at its most "miraculous" during the second half of the 1980s, when its net exports were either positive or in slightly negative territory, and its private sector was not too expansionary.

Also like Korea, currency overvaluation, high short-term capital inflows, speculative bubbles, overlending and overborrowing, and a fixed exchange rate regime made the private sector's stance significantly expansionary from 1989, which continuously strengthened during 1990–1996. Correspondingly, its external stance was significantly contractionary throughout the 1990s, especially in the few years before 1997, the year of the outbreak of the Asian crisis (which, of course, originated in Thailand).

The fiscal stance was largely nonexpansionary during 1987–1995. More so than in Korea, there were very severe private sector and trade sector adjustments during the Asian crisis and its aftermath. The private sector became very highly contractionary, especially in 1999 and 2000, and it remains significantly negative. The external stance turned very highly expansionary, especially in 1998 and 1999, and has remained that way.

The fiscal stance was expansionary (with fiscal deficits) during 1997–2000 because of a decline in the tax effort and social and economic spending due to the Asian crisis. These were restrained in 2002 and 2003 as tax efforts improved (unlike in the Philippines, where the tax effort has continued to decline).

Thailand has shown a continuous and increasing import propensity from the mid-1980s to the present, with a short respite in 1998 (because of the Asian crisis), but since then export growth has outpaced import growth. Thus, as in Korea, 2002 and 2003 saw the trade sector as the only one providing a significant expansionary stance to aggregate demand. Nevertheless, the reduction in the nonexpansionary stance of the private sector during the last few years is, to some extent, the result of Prime Minister Thaksin's policies. For the time being, the private sector stance is still nonexpansionary. However, if it becomes overexpansionary, then the authorities must be cautious that the situation does not revert to that of the precrisis period, that is, a highly expansionary private sector stance leading to significant trade deficits financed by large foreign borrowings (making the economy very vulnerable to interest and exchange rate shocks).

Therefore, despite the attempts of the prime minister at switching from export-led to domestic demand-led growth, net exports still provide a key ingredient to Thai growth, while the private sector and fiscal stances—the domestic demand sectors—have actually been nonexpansionary in recent years. If anything, Mr. Thaksin's policies must be seen as an attempt at increasing aggregate output vis-à-vis aggregate demand (domestic absorption). If one thinks of net exports (X-M) equivalently (through the national accounts) as the difference between aggregate output (GDP) and domestic absorption (the sum of consumption plus investment and plus government expenditures), it seems that the Government's five-pronged strategy (Box 1.3) aims to boost the former rather than the latter.

Summary

The three questions posed at the beginning of this part of *ADO 2005* can now be answered.

(i) Does the evidence indicate that countries are switching from export-led growth to domestic demand-driven growth?

The answer to this question is a clear "No."

The external sector is the one with the strongest expansionary stance in recent years in three out of the five countries studied, namely, PRC, Korea, and Thailand. For Korea and Thailand, it is the only sector providing an expansionary stance. For the PRC, the Government is very consciously reducing its expansionary stance to avoid overheating. Since its private sector has historically exhibited a nonexpansionary stance (due to the country's high savings rate), the trade sector provides a major force in the expansion of aggregate demand.[9]

In India, the high fiscal expansionary stance is growing, but growing nonexpansionary and offsetting pressures from the private sector and improving net exports (though still negative) are reducing this expansionary domestic demand pressure on aggregate demand.

In the Philippines, the post-Asian crisis years saw a return to expansionary stances in the private and fiscal sectors, and negative net exports, though the expansionary stance of the private sector and negative net exports are substantially lower than before the Asian crisis.

(ii) Did the export-led strategies partly contribute to the Asian financial crisis?

Again, the answer to this question is a clear "No."

Korea, Philippines, and Thailand followed a growth strategy characterized by a bias against exports during the years before the Asian crisis. This bias has been well documented and consisted of overvaluation of the currency, overlending and overborrowing in the domestic private sector, and creation of speculative bubbles in the nontradable sectors. This resulted in highly negative net export positions, and the exaggerated expansionary stance of the private domestic sector. For Korea and Thailand, this hurt the strong Asian miracle image they had achieved in the second half of the 1980s. The Asian crisis and its aftermath have been a painful reversal of the earlier situation in these three countries.

These results directly contradict the arguments of Palley (2002) presented earlier—namely that the export-led growth strategy was partly to blame for the Asian crisis and led to biases against the domestic demand sector. In fact, the above simple analysis has shown that it was an overexpansionary stance in the private sector and growing trade deficits that marked the immediate period before the Asian crisis for Korea, Philippines, and Thailand.

(iii) What lessons can be drawn from the different country experiences?

The most obvious result coming out of the above analysis is that the "best" periods for the selected countries have been those when both domestic demand and net exports exhibited impressive growth. This corroborates the earlier justifications for export-led growth, especially the argument that developing countries need precious foreign exchange to finance their import needs. It must be pointed out that this corresponds to the definition of domestic demand-led growth weakly speaking (both domestic demand and net exports are increasing).

The PRC has demonstrated that this kind of growth can be sustained for long periods. India adopted this type of strategy in the late 1990s, and as a result its high domestic demand growth is accompanied by impressive export growth and improvements in its trade deficits. Thailand and Korea followed this strategy in the second half of the 1980s, when their reputation as Asian tigers was at a peak. A deviation from this strategy seemed to have led them toward the Asian crisis. The above analysis indicates that they actually have reverted to the earlier strategy of promoting both domestic demand and net export components of the economy during this postcrisis period.

Comparison of expenditure shares of open European countries and selected countries in the Asia-Pacific region

For comparison purposes, the expenditure shares of a group of small open developed economies in Western Europe (Belgium, Denmark, Netherlands, Sweden, and Switzerland) are analyzed and

compared with those of the developing countries of Asia-Pacific.

The Asia-Pacific countries are divided into three groups: upper-income economies (UA), middle-income countries (MA), and low-income countries (LA). The LA group coincides with the World Bank's latest categorization of low-income countries.[10] The MA group coincides with the World Bank's countries in Asia-Pacific that are categorized as lower-middle-income countries. The UA group comprises those economies in Asia-Pacific that are above the income brackets for the lower-middle-income countries as categorized by the World Bank.[11]

Figures 1.23 and 1.24 show the average shares of exports and imports, respectively, in GDP for the European countries, UA economies, MA countries, and LA countries.

Figure 1.23 indicates that the European and UA economies have significantly higher shares of exports in GDP than the MA and LA countries. The UA economies have by far the highest share of exports among all countries and their export share increased the most between 1983 and 2003. For all categories of countries, the shares of exports and imports grew fast between 1983 and 2003.

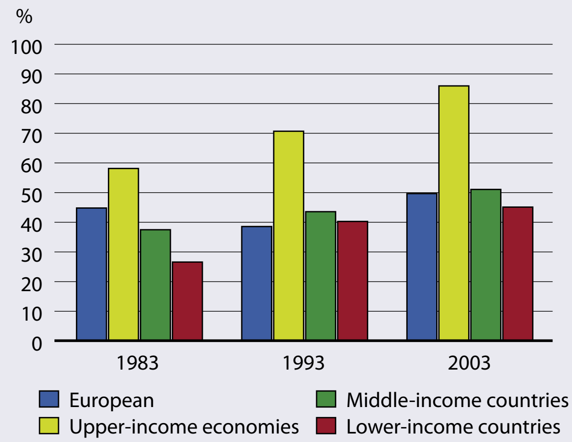
Changes in the import share are quite different (Figure 1.24). The European countries had higher import shares than the MA and LA countries in 1983, but in 1993 both the MA and LA countries had exceeded the import share of the European countries. In 2003, the MA countries' import share still exceeded that of the European countries, but the share of the LA countries fell again below that of the European countries. The UA economies again have had the highest share of imports since 1983, and their import share is also growing the fastest.

Figure 1.25 indicates that net exports (exports less imports) as a share of GDP are positive and growing for the European and UA economies. On the other hand, net exports are negative for both the MA and LA countries in three periods analyzed. But the net export position of the MA countries had clearly improved in 2003 (almost zero on average). The LA countries still had large negative net exports in 2003, of around 8% of GDP on average.

It must be stressed that the UA economies improved their net export share considerably between 1993 and 2003. In 2003, it was almost twice as large as the net export share of the European countries.

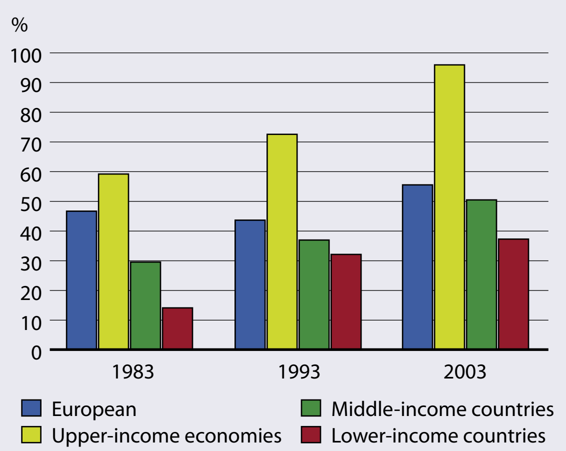
Domestic demand—defined as consumption (private and government) plus GDCF—and net exports sum to GDP. Thus, Figure 1.25 also indicates that the share of domestic demand has

Figure 1.24 Average share of imports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.23 Average share of exports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

been decreasing significantly in the European, UA, and MA economies.

The above analysis shows that the UA and MA economies—where most of the emerging markets in the Asia-Pacific region are categorized—on average improved their net export position between 1993 and 2003, and that the UA and MA economies' share of domestic demand also declined. The UA economies even outperformed the European countries in terms of exports and net export shares.

The decreasing share of the domestic demand components in the UA and MA economies is borne out in Figures 1.26 and 1.27, which graph the average shares of consumption (private plus government) and GDCF (or gross domestic investments), respectively, in GDP.

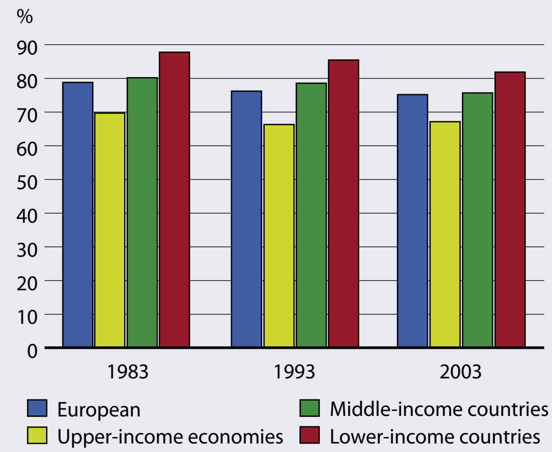
Figure 1.26 indicates that consumption shares fell in all groups of countries between 1983 and 2003. It is clear that, although the MA and LA countries have higher consumption shares than the European and UA economies, the shares are decreasing more quickly over time in the first two groups of countries. The UA economies have the smallest share of consumption, even lower than that of the European countries.

For GDCF, Figure 1.27 shows that all of the categories of Asian countries have had, since the early 1980s, higher shares of investment to GDP than the European countries. The latter have very stable gross investment shares of between 18% and 19% of GDP. The UA economies had the highest investment share in 1983 and 1993. But this share, as well as that of the MA countries, fell during the 1993–2003 decade, with the UA economies' investment share losing almost 10 percentage points. The LA countries, on the other hand, increased their investment share in this decade.

Thus, on average, there is no indication that strong domestic demand-led growth or consumption-led growth has been taking place in the developing countries of Asia-Pacific during the last decade. The shares of consumption and GDCF declined during the last decade in the UA and MA economies (i.e., the share of domestic demand declined, which means that the net exports share improved). The LA countries' consumption share also fell, but their GDCF share increased. This is a positive indication that the lower-income countries, which are capital scarce, are accumulating capital at a faster rate than the other groups.

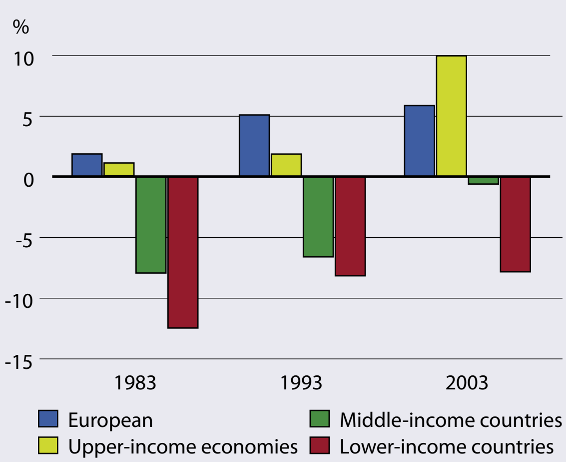
The outstanding performance of the UA economies in terms of exports and net exports reinforces the general perception that these four

Figure 1.26 Average share of consumption in nominal GDP: 1983, 1993, 2003



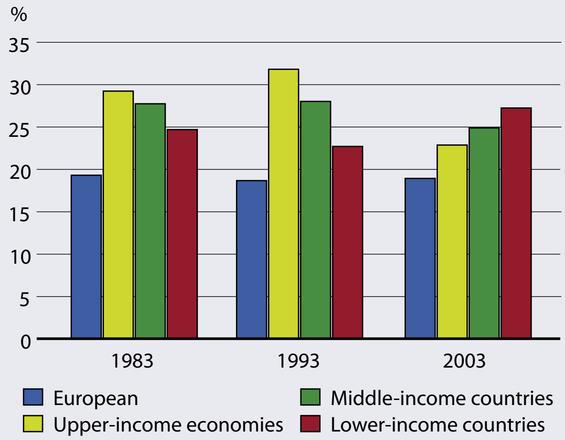
Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.25 Average share of net exports in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

Figure 1.27 Average share of gross domestic capital formation in nominal GDP: 1983, 1993, 2003



Sources of original data: Asian Development Bank, *Key Indicators* (various issues); International Monetary Fund, *International Financial Statistics* (various issues); United Nations Statistics Division.

economies are some of the strongest export performers in the world.

What is worrisome is the very large negative net exports still plaguing the low-income Asia-Pacific developing economies. This is discussed further in the following section.

Summary and conclusions

In brief, the main conclusions of the growth-accounting and stance analyses are as follows:

(i) There is no evidence that the 1993–2003 decade was marked by domestic demand-led growth at the expense of net exports. On the contrary, the countries hit by the Asian financial crisis, such as Korea and Thailand, lessened domestic demand expansion and strengthened net export growth. Domestic demand and net exports have been growing in countries not hit by the crisis, such as the PRC and India.

(ii) In general, the Asia-Pacific countries were able to reduce their trade deficits during the 1993–2003 decade, so that the share of net exports increased vis-à-vis that of domestic demand.

(iii) There is no evidence that the export-led strategy contributed to the Asian crisis. On the contrary, the export-led strategy, as defined in this discussion, was not implemented during the period right before the crisis. This period was marked more by overexpansion in domestic demand, and deterioration of net exports.

(iv) Periods when domestic demand was highly expansionary at the same time that net exports deteriorated signaled an ensuing crisis. The periods when the countries analyzed performed the best were those when both domestic demand and net exports exhibited impressive growth. This corresponds to what was defined above as domestic demand-led growth weakly speaking.

Two more conclusions, of a normative nature, may be added.

(v) There should be no conflict between growth in exports and in domestic demand: successful and sustained growth requires growth in both domestic demand and net exports.

The demand-side growth-accounting exercise and the decomposition analysis of stances from the private, government, and trade sectors provide some useful lessons for appraising the discussion of domestic demand-led versus export-led growth.

Growth of successful countries such as the PRC, and to a lesser extent India, is based on a combination of both domestic demand components—especially GDCF—and exports. It is clear that developing countries should have adequate investment levels in order to grow and develop. There also has to be appropriate growth in consumption so that the population's welfare improves. These can be achieved at the same time that the country succeeds in developing and improving its export sector. In fact, in terms of technology deepening and "learning by doing," growth in both sectors will be complementary and mutually reinforcing.

It is when one strategy is overemphasized at the expense of the other that the growth strategy becomes unstable. Clearly, the growth strategies of Korea, Philippines, and Thailand in the 1990s (before the Asian crisis) overemphasized expansionary tendencies in domestic private sector demand at the expense of net exports. This is reflected in the frequently discussed roots of the Asian crisis: currency overvaluation as well as overlending or overborrowing—spurred by inflows of short-term speculative capital—that

brought high growth to the domestic and nontradable sectors, and deterioration in the net export positions.

Conversely, the harsh adjustments undertaken by the three countries during and after the Asian crisis saw recessions and a collapse of gross investment as net export positions improved. There are prominent economists (e.g., Stiglitz 2002) who believe that the adjustments and policies imposed on the Asian countries hit by the crisis were overly harsh, especially on domestic demand, and contractionary. Whatever side one takes, it is clear that the sacrificed growth and resulting decline in the growth of productive capacity in the crisis-affected countries constitute a harmful consequence of the strategy that they followed (currency overvaluation, overlending, and overborrowing), which reversed the healthy balance and the desirable progression that both domestic demand (and the capital goods sector) and the tradable sectors achieved during the second half of the 1980s.

(vi) Countries with high trade deficits, mostly low-income countries, will benefit from a more open international trading system, and from promotion of their exports through price and non-price competitiveness.

Now, finally, is addressed the question posed by Palley (2002), Blecker (2002, 2003), and those who contend that not all developing countries can achieve successful export-led growth, inasmuch as positive net exports and trade surpluses correspond to trade deficits in other countries, and as the markets of the weaker countries (mostly in industrial countries) are gobbled up by the richer, high-performance countries.

It must be pointed out that Figure 1.25 shows that even if the LA countries had high negative net exports in 2003, this position had not, on average, deteriorated from that in 1993, despite the high export growth of countries such as the PRC, India, and other large countries that strengthened their export sectors in the 1990s. This is one encouraging sign, at least in the Asia-Pacific region. It must be added, however, that the net export position of many countries may not have deteriorated very much due to the very large and growing trade deficits of the US. Expected adjustments, especially through the depreciating US dollar, may correct this situation in the medium term.

There are some other encouraging signs. The fast growth and expansion of the PRC has quickly opened up a potentially large export market for other developing economies. This will benefit many Asian economies, and has already benefited Korea; Malaysia; Taipei,China; and Thailand. The task now is to extend the benefits to the middle- and low-income countries in Asia-Pacific. India is another country that has been growing fast in the last decade. Its opening up to the world trade market has also opened a large export market.

The conclusion is that, for an export-led development strategy to cover as many countries as possible, a more balanced and equitable growth in exports and imports across the world is required.[12] This in turn requires the following two main "pushes":

- all countries, including richer and trade-surplus nations, must open up their markets to poorer countries; and
- the poorer and latecomer countries need to make extra efforts both to promote their export sector via price and non-price competition, and to develop the necessary technological, physical, and human infrastructure to be competitive.

The first obviously requires the cooperation and participation of rich and trade-surplus countries so that developing countries can access the large world markets and reduce their trade deficits with the surplus countries. Trade liberalization of poor and trade-deficit countries alone (without the opening of the markets of the first group of countries) will obviously lead to perverse results. The second requires twin growth in the domestic demand and tradable sectors inasmuch as a high level of this infrastructure building will be part of domestic demand.

A more balanced and equitable international arrangement in world trade should therefore lead to smaller trade surpluses and smaller trade deficits across countries in the world, since more developing countries will be able to share in the benefits of international trade.

Endnotes

[1] See, for example, Patrick Smith. 2002. "From Exports to Domestic Demand-Led Growth: A New Model of Economic Growth?" *International Herald Tribune*. 8 November; and articles in *The Economist* (5–11 February 2005), "Heading back" (p. 9) and "Thaksin's way" (pp. 22–24).

[2] In fact, this is part of a very ambitious agenda (stimulus package) laid out by the prime minister, which includes lowering the cost of medical care; debt relief and microcredits for farmers; and the "local enterprise initiative" e.g., the encouragement of the production of wine out of exotic fruits.

[3] What the literature discusses is the import-substitution strategy, often presented as the "opposite" of the export-led growth strategy (Felipe 2003).

[4] The term "Washington consensus" was coined by Williamson (1990). In its original formulation, the idea encompassed fiscal discipline, reorientation of public expenditures, tax reform, interest rate liberalization, unified and competitive exchange rates, trade liberalization, openness to FDI, privatization, deregulation, and securing of property rights.

[5] Palley certainly acknowledges that developing countries need to export. What he argues is that "the global trading system must be made the servant of domestic development, and domestic development must not be forgone for the sake of international competitive advantage" (Palley 2002, p. 4). For him, domestic demand growth rests on four pillars: improved income distribution, good governance, financial stability, and a fairly priced supply of development finance. The policies needed to put these pillars in place are labor and democratic rights; financial reform; and a combination of debt relief, increased foreign aid, and increased development assistance through the expansion of special drawing rights.

[6] Another important point is that domestic demand is made up of consumption and investments. Growth dominated by consumption may have a very different impact and implications from growth led by investments. This topic is not tackled in this discussion.

[7] Actually, the PRC's net exports turned positive in 1990. The negative net exports position in 1993 was an aberration, since it was the only year in the 1990s when the country registered a trade deficit.

[8] In fact, Thailand's net exports improved in the second half of the 1980s, as will be shown in the next section, but deteriorated again in the 1990s.

[9] It must be added that high GDCF growth also provides a strong force in expanding aggregate demand in the PRC, despite a nonexpansionary private sector stance.

[10] Available: http://www.worldbank.org/data/countrydata/countrydata.html.

[11] The four UA economies are Hong Kong, China; Korea; Malaysia; and Taipei,China (Singapore was not included since it did not have separate data for exports and imports in the national income accounts). MA countries comprise People's Republic of China, Fiji Islands, Kazakhstan, Philippines, Sri Lanka, Thailand, and Vanuatu (Maldives was not included because it was such an outlier in some of the indicators that it distorted the averages). LA countries are Azerbaijan, Bangladesh, Bhutan, Cambodia, India, Indonesia, Kyrgyz Republic, Lao People's Democratic Republic (Lao PDR), Mongolia, Nepal, Pakistan, Papua New Guinea, Tajikistan, and Viet Nam. The World Bank categorizes the countries according to 2002 gross national income (GNI) per capita using the *World Bank Atlas* method. LA countries have GNI per capita of $735 or less; MA countries have GNI per capita of $736–2,935; and UA economies have more than $2,935 GNI per capita. All the selected European countries fall into the World Bank's category of high-income countries, with $9,076 GNI per capita or more. For the following countries, 2002 data were used due to lack of 2003 data: Bhutan, Fiji Islands, India, Lao PDR, Papua New Guinea, Tajikistan, and Vanuatu. Sources of data were ADB *Key Indicators*, IMF *International Financial Statistics*, United Nations Statistics Division, and World Bank country profiles.

[12] The breakdown of trade talks in Cancun, Mexico at the end of 2003 also points to the strong need to push for trade reforms in industrial countries to allow more agriculture, industry, and services sector imports from the developing world.

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ASIAN DEVELOPMENT

Outlook 2005

Part 2

Economic trends and prospects in developing Asia

East Asia

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

People's Republic of China

Despite macroeconomic tightening measures that cooled overheated sectors in 2004, economic growth was stronger than forecast. A more balanced development strategy and continued macroeconomic controls are expected to slow growth by about 1 percentage point in 2005. There are challenges to achieving this soft landing from both sides—investment could surge again and spark overheating, or growth could slow more abruptly than planned if potential problem areas are not addressed.

Macroeconomic assessment of 2004

Gross domestic product (GDP) growth in the People's Republic of China (PRC) accelerated from 9.3% in 2003 to 9.5% in 2004, the highest level since 1997, even though the Government took several steps to damp sectors that it considered overheated. On the supply side, the growth rate of industry fell to 11.1% in 2004 from 12.7% in 2003. Supply shortages were still experienced in coal, electricity, petroleum, and transport. For example, 26 out of 31 provinces suffered power outages. The growth rate of agriculture more than doubled to 6.3%, supported by subsidies to grain growers and a cut in agricultural taxes. Grain production recovered from a 4-year decline to increase by 9% to 469.5 million tons. The services sector grew by 8.3%, a percentage point faster than in 2003, when services were hurt for a while by the outbreak of SARS.

In the breakdown of demand, fixed asset investment grew by 25.8% in 2004, which was marginally slower than 2003's rate of 27.7% because of the macroeconomic controls. Investment grew faster in manufacturing than in agriculture, services, and small and medium enterprises (SMEs). When the growth rate of fixed asset investment shot up to 43% in the first quarter of 2004, the Government implemented a combination of monetary, fiscal, and administrative measures to cool it, especially in the overheated steel, cement, aluminum, automobile, and real estate subsectors. As a result, growth of investment in manufacturing eased for the full year to 38.3% from 46.3% in 2003. Investment in agriculture rose by 20.3%, a turnaround from 2003 when investment fell.

Total consumption increased faster in 2004 than in 2003, driven by improving rural and urban incomes. Due to rising grain prices and subsidies to farmers, real rural incomes grew by 6.8% in 2004, the highest rate since 1997. Urban incomes increased by 7.7%, helping push up retail sales by a fast 10.2% in 2004, though retail sales growth in rural areas still lagged that in urban areas.

In spite of the stronger growth in total consumption, private consumption has declined as a share of GDP in recent years (Figure 2.1). In the past 3 years, private consumption has expanded at a slower rate than government consumption and fixed asset investment. Also, growth of consumption in rural areas has been slower than in urban areas. Private consumption as a share of GDP in the PRC is below the 60% average seen in other countries with a per capita GDP of around $1,000. An increase in the share of private consumption to GDP would help smoothen fluctuations in economic growth caused by swings

in investment and would reduce the imbalance between supply and demand in some industries.

External trade maintained its robust uptrend on strong domestic and external demand, with the result that the PRC overtook Japan to become the world's third-largest merchandise trader, after the United States (US) and Germany. Merchandise exports rose by 35.4%, with production at foreign-funded enterprises estimated at about 58% of exports. Merchandise imports grew by 36.0%. Most of the increase came from energy products and raw materials. Factors behind the import surge were booming investment-led domestic demand, rising international oil prices, and the reduction in import tariffs and removal of nontariff barriers following the PRC's accession to the World Trade Organization (WTO) in 2001. The PRC played a more important role in interregional trade; bilateral trade between the PRC and countries in the Association of Southeast Asian Nations (ASEAN), for instance, grew by 36% to over $100 billion in 2004. Overall, the trade surplus on goods increased from $45 billion in 2003 to about $58 billion in 2004, and the current account maintained a surplus of about 3.3% of GDP.

The PRC continued to be a favored destination for foreign investment. Actual foreign direct investment (FDI) rose by 13.3% to $60.6 billion in 2004. Investors come partly for unskilled labor, which is about 4% of the cost in the US and one third of the cost in, for example, Malaysia. Moreover, the country's infrastructure continues to strengthen, and its business environment has improved significantly since it joined WTO. Multinational enterprises have accelerated their relocation of labor-intensive and export-oriented industries to the PRC. WTO membership has prompted an opening of services to more foreign participation, so that FDI in services during 2002–2004 on average grew slightly faster than in agriculture and manufacturing. FDI in steel and cement slowed significantly in the second half of 2004 as those industries faced government curbs. A combination of strong FDI inflows, the trade surplus, and fund inflows pushed higher by speculation that the yuan would appreciate led to a 51% surge in foreign exchange reserves, to $610 billion by year-end. Total external debt amounted to $229 billion, equivalent to 14% of GDP. The yuan was kept steady at CNY8.28/$1.

Table 2.1 Major economic indicators, People's Republic of China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	9.5	8.5	8.7	8.9
GDI/GDP	45.6	44.7	43.8	41.0
Inflation (CPI)	3.9	3.6	3.3	3.2
Money supply (M2) growth	14.6	14.1	13.7	14.6
Fiscal balance/GDP	-1.5	-0.9	-0.7	-0.2
Merchandise export growth	35.4	20.4	14.8	12.5
Merchandise import growth	36.0	22.1	19.6	14.1
Current account/GDP	3.3	1.2	0.4	-0.2

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

Sources: National Bureau of Statistics of China, available: www.stats.gov.cn/english/index.htm, downloaded 9 March 2005; People's Bank of China, available: www.pbc.gov.cn/english, downloaded 9 March 2005; staff estimates.

Fiscal revenues expanded considerably in 2004, rising by 21.4%, driven by high levels of economic and trade activity and strengthened tax collection. Fiscal expenditures rose by 15.1%. Priorities in public spending shifted from infrastructure to agriculture, social security, and health care as part of government efforts to better balance economic growth and social development. The fiscal deficit narrowed to an estimated 1.5% of GDP from 2.5% in 2003. However, if off-budget obligations, including the implicit pension debt and costs related to nonperforming loans (NPLs) in the banking sector were considered, the fiscal deficit would be much higher.

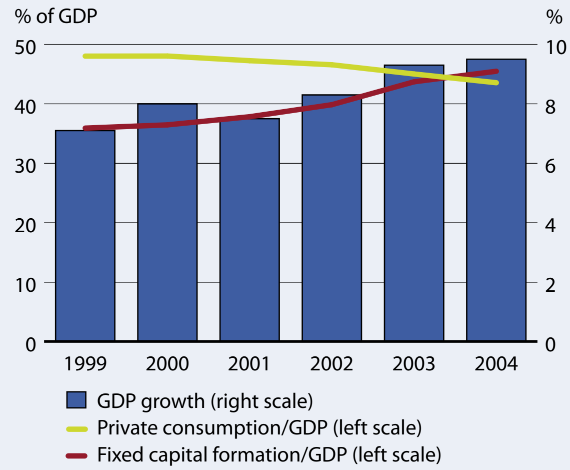
The growth of broad money (M2) moderated to 14.6% at end-2004 from 19.6% in 2003. Growth of total bank deposits slowed in the third quarter due to negative real deposit rates. Deposit growth picked up, though, after the People's Bank of China (PBC), the central bank, raised interest rates in October. The macroeconomic controls were expected to curb medium- and long-term lending to state-owned enterprises (SOEs) and to major investment projects. Instead, much of the impact fell on SMEs, when banks pulled back on short-term lending that SMEs use mainly as working capital, which affected their operations.

Inflation measured by the consumer price index (CPI) picked up to 3.9% in 2004 from 1.2% in 2003. During June–September, inflation

exceeded 5%, prompting the October interest rate rise. Food, which accounts for around one third of the CPI basket, was the main cause of higher inflation. A better than expected grain harvest helped bring down inflation to 2–3% late in the year. However, ex-factory industrial prices, regarded as comparable to a producer price index, rose by 6.1% in 2004, the fastest rate in 8 years. Rising prices for oil and raw materials were the main reason. There were also signs that labor shortages in coastal manufacturing regions, such as the Pearl River delta, were causing factory managers to increase wages and benefits to attract workers, thereby stoking inflationary pressure.

Unemployment edged down to 4.2% of the urban workforce from 4.3% in 2003. However, this does not include laid-off SOE workers or those who migrate to cities looking for work. The number of urban employees went up by 9.8 million, 800,000 more than the Government's target. In addition to the labor shortages in some manufacturing regions, many college graduates are finding it difficult to get work in their professions. The number of rural poor with per capita incomes below CNY668 (the official poverty line) decreased from 29 million to 26 million as rural incomes increased and as more budget resources were applied to poverty reduction.

Figure 2.1 GDP, private consumption, and fixed capital formation, People's Republic of China, 1999–2004



Source: National Bureau of Statistics.

Macroeconomic policy developments

The long-term goal of the Government is to raise per capita GDP to $3,000 by 2020, from $840 in 2000, and to quadruple GDP in this period, which requires growth of at least 7.2% annually. Although continued rapid expansion looks achievable, challenges need to be overcome. Rapid growth and structural changes, while resolving many problems, have created new ones: increasing income inequalities, weaknesses in the social security system, rising regional disparities, and environmental pressures. At the National People's Congress (NPC) in March 2004, the Government affirmed that sustaining strong economic growth would remain a priority, but it also started to address some of these problems to achieve more balanced and equitable development.

The latest NPC, in March 2005, set out the following targets for 2005: GDP growth of around 8%; 9 million new jobs for urban residents and keeping the registered urban unemployment rate under 4.6%; inflation held to 4% or less; and a sound balance of payments.

Fiscal policy will be tightened further, now that pump priming is not needed to maintain economic growth. The issuance of long-term government bonds was limited to CNY110 billion in 2004, a reduction from the budgeted amount of CNY130 billion, partly so that there would be less available for capital construction. Issuance will be reduced further this year, to CNY80 billion. The budget deficit target for 2005 is CNY300 billion, narrower than CNY319.8 billion in 2004.

Expenditure priorities were shifted in 2004 from infrastructure construction to agriculture, education, health care, and social security. Poorer central and western regions received greater attention, as did rundown industrial locations, and areas where ethnic minority groups live. The Government speeded up a trial of a change in the value-added tax (VAT) for some enterprises, to allow those in Jilin, Liaoning, and Heilongjiang provinces to claim tax deductions when buying new machinery. The trial will be expanded to more provinces. To assist farmers, the Government decided in March 2004 to abolish agricultural tax within 5 years. By end-January 2005, 23 out of 31 provinces and municipalities had done this. The aim now is to end the tax throughout the country in 2006.

Administrative measures taken in 2004 to rein in investment in sectors considered to be overheated included an order to curb credit expansion and investment in the overheated subsectors; restrictions on the transfer of arable land to nonagricultural use; and addition of industries to the restricted-investment list. The Government is expected to adopt more market-oriented pricing measures to control and direct investment from this year.

Since the second half of 2003, PBC has taken steps to tighten monetary policy, including: curbing real estate lending by raising the proportion of capital that developers must contribute to a project to 30%, and raising the cost of loans for investment in second houses; raising commercial banks' reserve requirement ratio from 6% to 7.5%; removing the ceiling on most commercial lending rates; and increasing the benchmark interest rate on 1-year loans from 5.31% to 5.58% and the rate on 1-year deposits from 1.98% to 2.25%. As the first rate rise since 1995, this October 2004 move signaled that the monetary authorities will use interest rates to cool the economy when necessary. During its annual meeting in January 2005, PBC announced that it would maintain its tighter stance, pointing to continuing inflationary pressures and a risk that growth in investment might surge again. PBC set its 2005 M2 growth target at 15%, slightly higher than the actual increase of 14.6% in 2004, and committed to using monetary levers such as interest rates to achieve the macroeconomic goals.

Speculation that the yuan may be allowed to appreciate was triggered in 2004 by the weakening US dollar, surging exports to the US and euro zone, and rising foreign exchange reserves. The International Monetary Fund called for greater exchange rate flexibility through a widening of the narrow band in which the yuan can move, and the G7 group of industrial countries said that it also favors more flexible exchange rates for Asian nations. While the Government stated its commitment to a long-term goal for a more flexible system, the current official stance is for a gradual transition to a more flexible exchange rate regime that does not put at risk macroeconomic stability and the financial system.

The PRC's stock markets performed weakly in 2004, even as stock prices rebounded in most other Asian markets. An overhang of nontradable state-owned shares and a relatively opaque stock-pricing system hurt the domestic stock market. In an effort to revive new share issues, the China Securities Regulatory Commission introduced a new pricing system for initial public offerings from January 2005. It also will promote better corporate governance and information disclosure by listed companies.

Progress was made in SOE reform in 2004. The State-owned Assets Supervision and Administration Commission continued its efforts to strengthen its supervision over 178 major central SOE groups and improve the management of SOEs nationwide. The commission tightened policies on management buyouts and stated that privatizations should be carried out through open and competitive bidding. Efforts to repair state-owned commercial banks continued when the Government injected $45 billion of its foreign exchange reserves into the Bank of China and the China Construction Bank to strengthen their balance sheets and prepare them for stock market listings.

For the private sector, the Government issued guidelines to improve the legal, policy, and market environment. More industries and sectors were opened to nonstate capital, and financing channels were widened for private enterprises.

Three years after WTO accession, the PRC has reached its goal in terms of cutting trade tariffs, with the general tariff level lowered from 15.6% in 2001 to 10.1% in early 2005. Nontariff barriers have also come down, with the number of quota-administered commodities reduced to 52 on the export side (from more than 100 in 2001) and eight on the import side (from 26). In services such as banking, insurance, and securities, the PRC has met its WTO commitments on time (Box 2.1). Over the past 3 years, the country has revised more than 2,300 national laws and regulations that ran counter to WTO rules. A series of laws and related regulations on the protection of intellectual property rights, including legislation on trademarks, patents, copyright, and protection of computer software, has been passed or revised. However, enforcement remains difficult.

Box 2.1 Action taken since the People's Republic of China joined the World Trade Organization in 2001

Sector	Commitment	Action
Agriculture	• Reduce the average tariff rate on imported farm products from 22% to 15% before 2010 • Significantly increase the import quota of low-tariff grain and cotton	• Average tariffs on farm products cut to 15.4% in 2004 • Import quotas for grain and cotton increased to 5% of total output in 2003 from less than 3% in 2001
Automobiles	• Cut the tariffs from 70–80% to 30% in 2005, 28% at the start of 2006 and 25% in mid-2006 • Gradually remove quotas on vehicle and spare parts imports and remove them completely in 2005	• Tariffs reduced to 43.8–50.7% in 2002, 38.2–43% in 2003, 34.2–37.6% in 2004, and 30% in 2005 • Tariffs lowered to 30% and quotas on vehicle and spare parts imports removed at start of 2005
Energy	• Gradually open the crude and refined oil sectors to private traders and end the state monopoly on oil trading • Open retail oil distribution 3 years after WTO accession and allow foreign firms at least 30 wholly owned gasoline stations each, and open the wholesale market 5 years after accession	• Import quota management for the three state-owned oil companies—China National Petroleum (CNPC), Sinopec, and China National Offshore Oil—removed on 1 January 2004 • Ten new oil importers ratified in April 2004. In August 2004, all private oil importers ratified. Total joined with Sinopec, and BP signed with Sinopec and CNPC to build gasoline stations in the PRC
Banking	• Allow foreign banks to conduct foreign currency business without geographic limit from the time of WTO accession • Foreign banks can conduct yuan business with domestic enterprises 2 years after WTO entry, with all geographic and customer restrictions to be removed by 2006	• Foreign currency business opened fully to foreign banks in 2001 • From December 2003, foreign banks allowed to conduct yuan business with domestic enterprises • By December 2004, 18 cities in the PRC allowed foreign banks to conduct corporate yuan business • In August 2004, Volkswagen, General Motors, Ford, and Toyota approved to carry out automobile financing • Foreign banks allowed to own 20% of a PRC bank, exceeding a commitment of 15%, from January 2005
Insurance	• Open reinsurance on accession; open health and pension insurance by 2004; and allow foreign nonlife companies to form joint ventures with a stake up to 51% (life companies up to 50%) • All geographic restrictions to be removed by 2004	• Eleven foreign insurance firms have entered the PRC market since accession, bringing total foreign insurers in the PRC to 39, with 70 outlets • A total of 124 foreign insurance companies have opened resident offices in the PRC
Securities	• Allow foreign firms to form joint ventures with local partners to manage investment funds	• Eleven overseas investment institutions granted qualified foreign institutional investor status • China Securities Regulatory Commission has ratified 13 Sino-foreign joint-venture fund management firms
Retailing	• Phase out restrictions on distribution services for most products by 2004 • Lift joint-venture restrictions on large department stores and virtually all chain stores by 2004. Scrap space restrictions on foreign-owned stores	• A regulation took effect 1 June 2004 allowing foreign retailers to do business freely in major PRC cities. The rule stipulates removing all geographic, commodity (except tobacco and salt), and shareholding limits on 11 December 2004

Sources: "Nation progressing well with WTO commitments," available: http://www.china.org.cn/english/BAT/114565.htm; "Car drivers face market overhaul," available: http://edu.sina.com.cn/en/2004-12-24/28840.html.

Outlook for 2005–2007 and medium-term trends

The economy is likely to achieve its targeted soft landing, with GDP expected to grow by 8.5% in 2005, 8.7% in 2006, and 8.9% in 2007. Manufacturing and construction, hampered by bottlenecks in energy and transportation, land constraints, and reduced levels of investment, will slow. The growth rate of industry overall is forecast at 9.3–10.1% over the 3 years. Agriculture will expand by 4.1–4.6%, reflecting government efforts to support rural production and farmers' incomes. The opening of more services to external competition should ensure continued growth of around 8% for this sector. More emphasis on developing agriculture and services will benefit job creation and poverty reduction.

Investment in fixed assets is expected to grow by about 18% in 2005, slowing from 2004's rapid 25.8% expansion, and by about 13% in 2006–2007. Overheated subsectors face the biggest cutbacks. However, curbing investment growth will be difficult in some industries, such as construction, where substantial work is in progress. Also, private sector investment is likely to grow rapidly and foreign investment looks set to remain strong. Rising labor costs and labor shortages in coastal areas may persuade some investors to move factories to inland provinces.

Consumption will maintain double-digit growth rates, but these will be significantly lower than the rates for investment. Surging investment in the past 2 years has raised the proportion of capital formation to GDP to about 45%, the highest since 1994, while the proportion of total consumption in 2004 fell to 55%, the lowest since 1978. Over the past 25 years, periods of extraordinarily high investment, without support from high levels of consumption growth, have resulted in excess production capacity and have been followed by sharp declines in economic growth. This time, the authorities are reducing investment growth and taking steps that should stimulate private consumption—raising rural incomes is an example.

The growth rate of exports is forecast to fall to 12–20% in 2005–2007 from over 30% in 2004, largely for the following reasons: growth in industrial nations will slow; major trade partners may well take more protectionist and antidumping action against PRC exporters; and rising labor costs and high oil prices will raise costs for exporters. Import growth is expected to outpace that of exports as more sectors are opened to foreign competitors and as domestic demand remains strong. Consequently, the trade surplus will decrease over the forecast period. The current account will maintain a small surplus of 0.4–1.2% of GDP in 2005–2006, but move to a 0.2% deficit in 2007.

Inflation is forecast to step down to 3.6% in 2005, 3.3% in 2006, and 3.2% in 2007. Prices of electricity and coal will rise. Production costs have been pushed up by higher prices of energy and raw materials, and some of this will flow through to prices of final products. Labor costs, too, will edge up as the economy maintains rapid growth. These upward price pressures will be eased in part by overcapacity in many industrial subsectors and by smaller price rises for grains.

Risks to the outlook include a possible return to extraordinarily high growth rates of investment. A relaxation of the macroeconomic controls could spark a rebound in investment growth and overheating in some subsectors. Capital buildups add to the risk of overheating. Commercial banks, with their deposits growing, are under pressure to expand lending, and people with substantial private wealth are seeking investment outlets.

Conversely, the soft-landing scenario could be disrupted by potential problems that cause growth to slow more sharply than planned. In rural regions, the rapid increase in farmers' incomes may be unsustainable if prices of agricultural products turn down, which would reduce consumption spending. Among SMEs, the contraction in their working capital loans during the macroeconomic tightening period seems to have curtailed their development. Finally, the financial sector may lose resources as it is opened to more competition from foreign banks to meet the country's commitments under WTO.

The expansion of SMEs is important because they create much of the employment and can assist in reducing income inequalities. However, they are one of the most vulnerable economic groups in the PRC, with limited access to financing. Strengthening the SME credit

guarantee system would help by reducing risks to lenders, as would developing private banks, which are more inclined to lend to SMEs. PBC should consider allowing banks to increase short-term lending to SMEs for working capital purposes. The Government could consider encouraging private investment companies to mobilize equity finance for SMEs, perhaps with some initial government funding. On the subject of competition for domestic banks, the critical time will be 2006, when all geographic and customer restrictions on foreign banks will be removed. If the state-owned commercial banks cannot improve their service, increase their capital, and reduce their NPLs, there is a risk that much of their deposit base could be moved to their competitors, putting further strain on them.

Energy bottlenecks are being addressed, but are unlikely to be eliminated soon, particularly as car ownership is rising rapidly. However, there is considerable potential to improve energy efficiency. The PRC uses 0.78 tons of oil equivalent to produce $1,000 of GDP, about twice the average of Organisation for Economic Co-operation and Development member countries. Steps taken so far in power reform include dismantling the State Power Corporation, separating policy and regulatory functions from production, and unbundling generation from transmission and distribution. Other measures that policy makers could consider are: encouraging the use of cleaner fuels and energy-saving technologies; imposing a consumption tax on fuel; removing constraints to private sector participation in the power industry; improving access to electricity supplies and the pricing structure for the poor; and strengthening interregional power transmission capacity to improve power system efficiency.

Hong Kong, China

The recovery strengthened and broadened in 2004, benefiting from buoyant consumption—supported by a rebounding property market—and rising exports. While export growth will ease, it will remain robust over the forecast period, and consumption and investment will be strong. The authorities are considering a goods and services tax to help stabilize revenues in the longer term, even though the fiscal position has improved with the economic upswing.

Macroeconomic assessment of 2004

The economy grew faster than expected in 2004, expanding by 8.1%, compared with 1.9% average growth in the previous 3 years. Private consumption, benefiting from the property market rebound, stronger household balance sheets, and rising employment, grew by 6.7% and contributed 3.7 percentage points to GDP growth. Total investment grew by 3.2%, contributing 0.8 percentage point to GDP growth.

Services, which account for nearly 90% of the economy, rebounded after being hit hard by the SARS outbreak in 2003. Inbound tourism was particularly strong, with a record 21.8 million foreign visitor arrivals, up by about 6 million from 2003. More than half of the visitors came from the PRC, a result of a further easing of restrictions on individual travel to Hong Kong, China. The surge in tourism helped lift retail sales by 9.1% in volume terms.

Exports of goods and services rose by 15.2%, boosted by the continued strength of the PRC economy, the weak US dollar to which the Hong Kong dollar is linked, and the robust inbound tourism. Strong domestic demand led to import growth of 13.8%. Net exports, which had been the driving force in GDP growth in 2003, contributed 3.5 percentage points in 2004, about the same as private consumption.

The strong economic recovery created 78,100 jobs in 2004 and reduced the unemployment rate to 6.5% by end-2004 from a SARS-induced peak of 8.6% in mid-2003. Median monthly employment earnings during the fourth quarter of 2004 stood at HK$9,500, the same as a year earlier; median household income edged up to HK$15,500 in the fourth quarter, from HK$15,000. Yet poverty remains a concern. According to the Hong Kong Council of Social Service, for every 100 children below the age of 15 in Hong Kong, China, almost 25 live in families with household income below half the median.

Residential property prices, as measured by the Centaline Leading Index, bottomed out in August 2003 and had risen by over 60% by end-February 2005, in part reflecting supply management policies introduced by the authorities late in 2002. Rising prices reduced the number of apartment owners suffering from negative equity, i.e., when mortgages exceed the value of the property, though apartment prices in the first quarter of 2005 were still well below their 1997 peaks. Prices of commercial property—offices and retail—rebounded even more strongly, some by as much as 80–100% in 2004. The recoveries in the economy and property market also lifted corporate earnings and the stock market, with the Hang Seng Index finishing the year with a modest gain of 13%.

Bank earnings and the quality of bank assets also benefited from the stronger property market. The recovery in investment and consumption stimulated demand for bank loans, and robust external trade increased trade financing activity. The launch of yuan business further helped the environment for banks.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong, China and the PRC, which was fully implemented in January 2004 and was expanded to cover more goods and services in January 2005, has helped strengthen investor confidence. Under the agreement, Hong Kong, China products covered by 1,108 PRC tariff codes have tariff-free access to the PRC market, and suppliers in 26 service areas receive preferential treatment from the PRC.

Inward FDI rose sharply to US$34.0 billion in 2004, more than double the 2003 figure. The increase apparently was related in part to PRC enterprises taking advantage of CEPA and setting up businesses in Hong Kong, China.

Government revenues, too, received a lift from the economic rebound and buoyant property market. General revenues, including operational and capital income, rose by 14.0% in FY2004 (ended 31 March 2005), while operating expenditures declined by 1%. The Government reported a small consolidated surplus equivalent to 0.9% of GDP, but after excluding receipts from bond issues the result was a deficit of 1.0% of GDP. This compared with a FY2003 deficit of 3.3% of GDP (Figure 2.2). Fiscal reserves at March 2005 rose to HK$287 billion, equivalent to 14 months of government expenditures.

Deflation concerns faded in the first half of 2004. In July, the consumer price index rose by 0.9% from July 2003, the first year-on-year increase since November 1998. For the full year, though, the composite CPI recorded a small decline of 0.4%. Meanwhile, the money supply (M2) growth rate picked up to 9.3% in 2004 from 8.4% in 2003, and domestic credit rose through the year.

Hong Kong, China has for many years maintained a current account surplus on its balance of payments, with a surplus on trade in services exceeding the merchandise trade deficit, while net investment income usually offsets unilateral transfers. This pattern recurred in 2004, with the merchandise trade deficit widening to US$9.3 billion and the current account surplus representing 9.7% of GDP.

Table 2.2 Major economic indicators, Hong Kong, China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	8.1	5.7	4.1	5.6
GDI/GDP	23.0	23.5	23.3	22.6
Inflation (CPI)	-0.4	1.5	1.6	2.1
Money supply (M2) growth	9.3	-	-	-
Fiscal balance/GDP	-1.0	-1.2	-0.8	0.1
Merchandise export growth	15.9	12.2	12.3	14.2
Merchandise import growth	17.0	12.6	12.1	13.5
Current account/GDP	9.7	7.7	7.3	5.4

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

Sources: Census and Statistics Department; Hong Kong Monetary Authority; staff estimates.

Macroeconomic policy developments

With a target to balance the budget by FY2008, the authorities in 2004 maintained a policy of expenditure cuts, including reducing the number of civil servants and cutting the pay of the remaining personnel by 3% from January 2005. While the economic recovery pushed up revenues in 2004, the debate on a goods and services tax (GST) continued. About 40% of Hong Kong, China's income in its general revenue account is derived from salary and profit taxes; 30% comes from direct land-based revenues and investment receipts; the balance is indirect taxes and fees. A GST would be a way to broaden the narrow tax base, ensure a more stable revenue flow, and reduce the number of people who do not pay any taxes. The 5% GST under discussion could raise US$3 billion–4 billion a year. The financial secretary noted in the March budget that it usually takes about 3 years in any jurisdiction between making a decision to introduce a GST and actual implementation. He said that the authorities would consult the public before making a decision.

The authorities expect to balance the operating account by FY2008 and the

consolidated account by FY2007. Over the next 5 years, fiscal reserves will be maintained in a range of HK$270 billion–340 billion, equivalent to 13–17 months of expenditure.

The March 2005 budget proposed the abolition of estate duty (a tax on the estate of a deceased person). Many bankers and the Hong Kong General Chamber of Commerce had contended that repealing this tax would spur the development of asset-management services, since wealthy people would not take assets offshore to avoid estate duty.

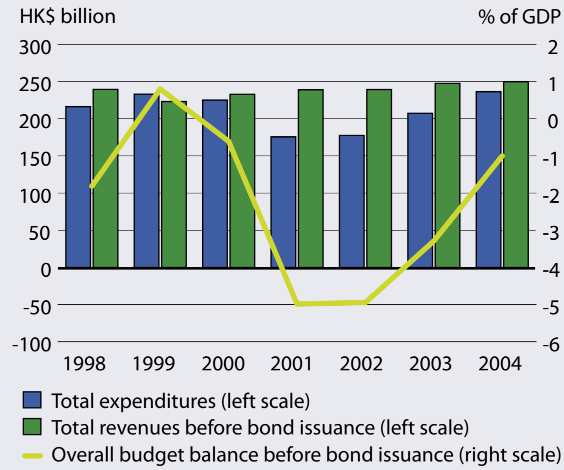
With a view to enhancing corporate governance, the authorities propose to establish a Financial Reporting Council, with two main functions. The first is to investigate irregularities of auditors of listed companies, and the second is to inquire into the financial reports of such companies to help ensure that they comply with legal and accounting requirements. The proposed law is expected to be introduced into the legislature around midyear.

Decisions in 2004 to securitize future toll income from government-owned tunnels and bridges with an offering of HK$6 billion-worth of bonds and the launching of a separate HK$20 billion government bond issue were aimed in part at stimulating the underdeveloped bond market.

Legislation for a deposit insurance plan was passed in May 2004. It will provide insurance for the first HK$100,000 of deposits per depositor per bank and is expected to come into effect in 2006. Also in 2004, banks were allowed to offer personal banking and credit cards in yuan. Together with a sharp increase in the amount of yuan that can be taken into and out of the PRC to CNY20,000 ($2,417), effective 1 January 2005, this signals closer financial ties between Hong Kong, China and the PRC, mirroring the closer CEPA trade ties.

On the monetary front, the Government and the Hong Kong Monetary Authority reaffirmed their intention to maintain the exchange rate link at HK$7.8 to the US dollar. Under this arrangement, interest rates should move in tandem with US rates. However, a combination of speculation about a revaluation of the yuan, weakened sentiment toward the US dollar, and improved economic conditions led to strong capital inflows. This resulted, in 2004, in a persistently large aggregate balance held by banks with the Monetary Authority. Consequently, Hong Kong, China's interest rates could remain below US rates, giving impetus to the property market and domestic credit expansion.

Figure 2.2 Consolidated fiscal position, Hong Kong, China, FY1998–FY2004



Sources: Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, 2004 edition; Government of the Hong Kong Special Administrative Region, available: www.budget.gov.hk/2005/eng/sum_p_e.pdf, downloaded 16 March 2005.

To address unemployment, the authorities adopted a combination of approaches—direct job creation, offering training to young workers and displaced workers, and more education opportunities. These approaches have been effective in reducing the jobless rate. On the poverty front, the authorities have recently established a commission on poverty to identify the needs of the poor, as well as make policy recommendations to reduce poverty and promote self-reliance.

Despite 6 years of generally weak growth up to 2004, Hong Kong, China's trend growth rate appears to be around 5%. Over the longer term, an aging of the population and low fertility rates could cause labor shortages, leading to wage inflation and lower economic growth. An aging population will also require much higher spending on welfare, care facilities, and health. The authorities have acknowledged the need for a sound population policy, which will require new approaches to immigration issues.

Outlook for 2005–2007 and medium-term trends

Growth is expected to slow to more sustainable rates of 5.7% in 2005, 4.1% in 2006, and 5.6% in 2007. Factors underpinning growth will be continued expansion of the PRC economy; low, though rising, interest rates; a soft US dollar; and FDI inflows. Private consumption and investment, rather than exports, are forecast to be the locomotives for growth. Buttressed by a surging tide of PRC visitors, declining unemployment, and rising wealth, private consumption is expected to grow by around 6–7% each year through 2007.

Investment growth is forecast in the 7–9% range. Construction activity is likely to revive now that the property market recovery is well under way. A revival of building activity—residential, commercial, and public works—will further reduce unemployment. Some of the major projects in the pipeline are extensions of railway lines; a 29 kilometer bridge to link the city with Macau and Zhuhai; and a new ocean liner terminal.

CEPA will continue to benefit the economy as implementation moves ahead, and is expected to help attract greater inflows of FDI. Other positive influences in the near term include: the PRC's liberalization of travel restrictions so that individuals from more PRC cities can travel to Hong Kong, China, which benefits hotels, restaurants, and retail businesses; improved investor sentiment toward the local stock market, which will boost new share offerings; and higher levels of confidence among SMEs, which will fuel investment.

Growth of goods and services exports will ease from 2004's strong rate to the 10–12% range, supported by a weak US dollar and a growing PRC economy. Services exports are expected to strengthen somewhat because of the buoyant inbound tourism—receiving a further fillip when a major theme park opens later in 2005—and the export of financial services. Imports of goods and services will grow faster than exports, by 11–13% through 2007, as a consequence of the continuing expansion of private consumption and investment. As a result, net exports will not add to growth.

Further improvement in the labor market is expected to reduce unemployment to 6.0% in 2005 and to below 5.0% in 2007. An increasing number of employees will reach retirement age in the medium term, so that the unemployment rate will continue to fall even though the pace of job growth may be only moderate. This trend may also put more upward pressure on wages over the next few years. Inflation, though, is expected to be mild at 1.5% in 2005, edging higher through 2007.

With the banking sector awash with liquidity, Hong Kong, China banks opted several times to not follow US interest rates up when the Federal Reserve raised its target for the Federal Funds rate. This widened the interest rate gap and funds started to move out of Hong Kong dollars in early 2005. In March, major banks raised rates closer to US levels. Domestic interest rates will probably continue to move up gradually, though the impact on the property market may be softened by changes to the housing finance market, under which banks are now able to grant mortgages on older buildings and are offering to lend up to 95% of the appraisal value of properties under a mortgage-insurance program. These changes will continue to support the property market recovery and—by raising land premiums collected and taxes on the profits of developers, banks, and brokerage houses, as well as stamp duties on both property and stock market transactions—bolster government revenues.

Risks to this medium-term outlook include a steeper than expected rise in US interest rates or sharper decline in world trade, and an outbreak of protectionist measures against the PRC from the US and European Union. Higher world energy costs have raised electricity charges in Hong Kong, China, but as a mainly services economy the damage is limited. Higher oil prices do hurt the economy's export destinations, though. Concerns that Shanghai could seriously erode Hong Kong, China's role as a financial center and gateway to the PRC in the medium term seem overstated. In terms of regulation, rule of law, transparency, and corporate governance, other cities in the PRC are unlikely to be competitive for many years.

Republic of Korea

The economy is on a gradual rebound from the 2003 slump induced by a household debt hangover, although the modest pace of recovery in private consumption will likely limit the speed and magnitude of near-term growth. To underpin the nascent recovery in domestic demand, the Government needs to address underlying structural weaknesses. Successful completion of comprehensive structural reforms remains key to achieving sustainable high growth.

Macroeconomic assessment of 2004

A robust recovery in early 2004—boosted mainly by strong exports—stands on shaky ground, as the usual knock-on effects of exports on investment and consumption spending failed to materialize. The economy grew by 4.6% in 2004, up from 3.1% in 2003, but its momentum weakened with year-on-year growth easing to 4.7% and 3.3% in the third and fourth quarters, respectively, from 5.4% in the first half. A 31% surge in merchandise exports proved insufficient to resuscitate private consumption, which fell by 0.5%, following a contraction of 1.2% in the previous year. Lingering effects of a household debt hangover, combined with underlying structural problems in the labor market and financial system, largely explain the weakness in consumption spending.

Despite considerable progress in debt restructuring since the credit card crisis in 2003, households remain reluctant to spend, with limited income growth and a continuing debt burden (Figure 2.3). Household debt stood at 73.8% of GDP at end-2004, with debt outstanding increasing by 5.7% from the prior year's level. More important, household disposable income (the amount of net income after tax and social security contribution that is available for household consumption or saving) has grown by an annual average of about 5.0% since the 1997 crisis, which is not enough to allow for both debt repayments and an increase in consumption spending.

Gross fixed capital formation rose by 1.9% in 2004 from a year earlier, on account of a pickup in export-led machinery and equipment investment, which grew by 3.8% in 2004 after a contraction of 1.2% in 2003. However, a continuing erosion of labor market competitiveness has deterred firms in the Republic of Korea (henceforth Korea) from investing domestically, limiting the investment gains. The absence of attractive domestic opportunities, compounded by sluggish demand, has induced corporations to use increased export earnings to lower their debts or divert their investment abroad.

The sharp contrast between external and domestic demand was further evident on the supply side. Manufacturing output rose by 11.4% in 2004, driven mainly by major export items such as information and communications technology products and motor vehicles, while services sector gains were limited to 1.3% over the year. Wholesale and retail trade continued to contract, by 0.5%, reflecting sluggish consumption. Real estate services also stagnated, as the property market cooled. Despite a mildly improving trend through the year, financial services contracted by 1.2% in 2004 in the aftermath of the credit card crisis.

Industrial production expanded by 9% on the back of robust exports. Shipments of manu-

factured goods rose by 9.1%, with those going overseas dominating with a 20.0% increase. The average operating ratio in manufacturing reached 80.3% in 2004.

The divergence between large and small firms widened. Behind this disparity lies unfinished business in reform efforts since the Asian financial crisis of 1997–98. Whereas large firms, or *chaebol*, have been subject to restructuring and refocused their businesses on globally competitive manufacturing or the high-tech sector, SMEs remain largely sheltered from the reform process. As a result of their substantial restructuring efforts, the large export-oriented companies enhanced their operational efficiency and financial stability. However, a prolonged slump in private consumption has eroded profitability of SMEs, most of which cater to domestic services markets. This has a damping effect on the overall economy since SMEs account for such a high proportion of total employment (Box 2.2).

The unemployment rate averaged 3.5% in 2004, rising marginally from an average of 3.4% in 2003. Although about 382,700 new jobs were created in 2004, a steady increase in the share of temporary workers due to structural rigidities in the labor market lessened job security, delaying a consumption recovery despite a gradual upturn in wage income. A considerable gap between permanent and temporary workers in terms of job security and overall compensation remains a problem for sustainable improvement in the labor market. Following years of militant labor action, permanent employees have gained strong legal protection for job security, improved working conditions, and significant wage increases. However, such protection has made firms reluctant to hire for permanent positions, limiting both job market improvement and increases in household income during the expansion period.

The consolidated budget balance, excluding social security contributions and repayments of the public fund for financial sector restructuring, resulted in a deficit of W3.6 trillion in 2004, from a surplus of W1.0 trillion in 2003, providing a mild fiscal stimulus. However, in the second half of the year when the economy sharply slowed, the fiscal balance even turned into a slight surplus. Total expenditures and net lending amounted to W173.2 trillion in 2004, increasing by 5.5% year on year. On the revenue side, tax collection increased by 2.7% to W117.8 trillion. Property, inheritance, and gift taxes continued to account for a substantial share of tax revenues, while collection of personal income tax strengthened, which compensated for a continuing shortfall in VAT and excise tax. Total revenue collection reached W178.8 trillion over the same period.

Table 2.3 Major economic indicators, Republic of Korea, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	4.6	4.1	5.1	4.9
GDI/GDP	29.1	30.3	30.4	30.2
Inflation (CPI)	3.6	3.0	3.3	3.6
Money supply (M2) growth	5.2	9.2	8.9	9.7
Fiscal balance/GDP	-2.0	-2.8	-	-
Merchandise export growth	30.6	11.8	9.6	9.0
Merchandise import growth	25.2	13.5	10.6	10.8
Current account/GDP	4.0	3.9	3.5	2.8

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

Sources: Bank of Korea, available: www.bok.or.kr/index.jsp, downloaded 9 March 2005; Korea National Statistical Office, available: www.nso.go.kr/eng, downloaded 9 March 2005; staff estimates.

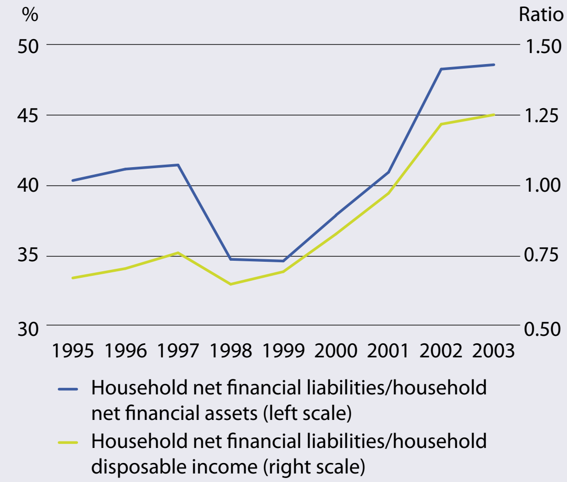
Both the consumer and producer price indexes rose in 2004, by 3.6% and 6.1%, respectively. Nevertheless, inflationary pressure abated somewhat in the fourth quarter of 2004, thanks to stabilizing global oil prices and a strengthening Korean won. Prices of agricultural products subsided following a favorable harvest, significantly contributing to the price stabilization. The subdued inflationary pressure allowed the Bank of Korea to lower its policy rate from 3.50% to 3.25% in October, following a quarter-point cut in August. Long-term interest rates fell to low levels, flattening the yield curve after the rate cuts in the latter half of 2004. Money supply crept up, reflecting the mild improvement in investment demand. Picking up from 5.4% in the first half, growth in M3 averaged about 6.3% in the second half of 2004, although lower than the 2003 average of 8.8%.

The KOSPI index of share prices rose by 10.5% in 2004. A resilient export performance in the last quarter of the year, despite concerns

about slowing global demand and the rising won, underpinned the market's rebound from a retreat in the May–July period when US interest rates began climbing. Overall, corporations raised more than W58.7 trillion in 2004 through equities and bonds, a decrease of 19.4% from 2003's level. On the back of a revamped financial situation since the credit card crisis, financial institutions resumed lending, though low investment demand restrained credit expansion. A trend of financial deleveraging accelerated due to increased export profits. Reflecting the voluntary repayment of debt by medium-sized export companies, bank credits to corporations fell significantly from W30.5 trillion to W3.8 trillion in 2004.

The won substantially strengthened against the US dollar, to W1,035/$1 at end-2004 from W1,193/$1 at the previous year-end. A robust position on the balance of payments, as well as the global trend of dollar depreciation, were the main factors. The balance of payments was again in surplus; $38.7 billion was added to foreign exchange reserves in 2004. Bolstered by a record rise in merchandise exports, the current account surplus reached $27.6 billion. The capital account turned to a surplus of $8.3 billion, as foreign investors returned to the Korean stock market in the second half of the year. FDI was buoyant, with a net inflow of $3.4 billion in 2004. Portfolio investment remained a popular choice among foreign investors, with equity and bond purchases generating net capital inflows of $9.3 billion. On the other hand, Koreans also increased FDI abroad, amounting to $12.3 billion, with the majority directed to the PRC.

Figure 2.3 Household income growth and debt burden, Republic of Korea, 1995–2003



Sources: Bank of Korea; Datastream, downloaded 2 February 2005.

Macroeconomic policy developments

The lackluster growth performance in the second half of 2004 provided a political backdrop for bringing economic and development policies to the fore. In line with a firmer political consensus, the priority of economic policy is to create quality jobs and revive robust growth. To enhance growth fundamentals, the Government is emphasizing strengthening SMEs and the overall services sector, which remain labor intensive, thus having good potential to create jobs. The policy is also to create an investment-friendly environment and to reinforce the social safety net. Efforts will center on improving the competitiveness and productivity of SMEs by encouraging new entrants, nurturing technological innovation, and facilitating effective restructuring. Opening the services sector to international competition and related deregulation will bring about restructuring in services firms, thus heightening productivity. Meanwhile, a stronger social safety net will be put in place as increased competition causes some firms to reduce staff.

Macroeconomic policies will remain supportive of an emerging recovery at least in the first half of 2005. The consolidated central government budget has been expanded to W167.3 trillion for the full year, a 3.8% increase from W161.3 trillion in 2004. About 59% of the budget will be allocated during the first half to provide an immediate stimulus, while a planned public investment strategy—the Comprehensive Investment Initiative—will reinforce an investment revival in the second half. The initiative is expected to encourage private efforts and market incentives in public sector investment such as education, roads, energy, and other social overhead capital. However, the scope of the initiative remains vague, casting doubt on its effectiveness in boosting domestic demand in the near term, when the stimulus is required. There also is some concern that the initiative may mask

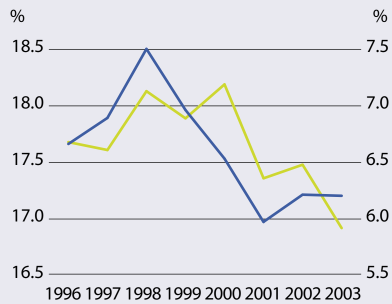
Box 2.2 Weakening small and medium enterprises pose a threat

Small and medium enterprises (SMEs)—the majority of which are small firms, including micro businesses with fewer than five employees—accounted for 99.8% of Korea's enterprises and 86.7% of total employees in 2002. Any weakening among SMEs poses considerable impediment to a domestic demand recovery by directly affecting household income through poor job creation as well as by curbing a rebound in business spending.

Profitability and financial stability among SMEs are deteriorating, following a long delay in consumption recovery (see box figure). The ratio of gross profit to sales fell from 18.5% in 1998 to 17.2% in 2003, at the same time that operating income to operating assets declined from 7.1% to 5.9%. Capacity utilization in December 2004 remained below 70% for the 23rd consecutive month, constraining business spending. Such overcapacity is mainly attributable to a surge in SME credit during 2001–2003 following a venture capital boom and subsequent household credit contraction.

Although the current ratio (an indication of a company's ability to meet its short-term obligations) has been improving since the 1997 financial crisis, this appears to reflect a trend of financial deleveraging and low investment demand, which impairs SMEs' long-term competitiveness. Corroborating this view, declining profitability has left many SMEs in financial distress. Delinquency rates on bank loans to SMEs increased from 2.0% at end-2002 to 2.6% in September 2004. Such financial problems are particularly severe in the services sector.

Box figure Deterioration in SME profitability, 1996–2003



Source: www.nso.go.kr/eng.

For example, in wholesale and retail sales, the rate rose sharply from 2.3% to 4.6% over the same period. An SME survey by the Korean Federation of Small and Medium Business suggests that both operational and financial difficulties continue, with the index of small-business health falling to 68.5 in December 2004 from 71.0 in January that year (a reading below 100 suggests a deterioration in the SME business environment).

In response to the financial deterioration in SMEs, the Government has taken several steps to avoid a large number of defaults. SME financing is generally short term. With a large share of SME loans falling due within 12 months (72.8% of outstanding loans were due within 12 months as of July 2004), the Government has urged banks to roll over outstanding loans since the second half of 2004. It has also encouraged longer maturities on loans to SMEs, by providing guarantees through Korea Credit Guarantee Fund and Korea Technology Credit Guarantee. A substantial capital injection to these agencies has been made to expand SME credit guarantees from W39 trillion in 2004 to W42 trillion in 2005. However, the effects of this financing facility will only be for the short run; long-term reforms to strengthen the overall credit system are now required to provide stable SME funding. Along these lines, recent initiatives to establish a credit bureau for SMEs and diversify SME funding sources are welcome.

Korea's long-term economic growth fundamentals will be restrained without significant improvement among SMEs. Behind the lagging performance of SMEs has been the reluctance of both SMEs and the Government to push forward with forceful operational and financial restructuring. Not only were SMEs largely sheltered during the postcrisis reforms, but government support, including guarantees for SME credit, has also prevented the emergence of an effective market mechanism to force the exit of failing firms. A broad and in-depth restructuring is necessary among SMEs to sustain robust growth, by removing policy barriers to competition that hamper investment and by opening the services sector to foreign competition.

Source: Asian Development Bank staff.

fiscal liabilities that could stem from government guarantees to induce private investment in desired areas.

While a near-term fiscal stimulus is warranted to bolster weak investment demand, equally important is the establishment of an effective fiscal management system that is tightly anchored to long-term fiscal sustainability. The lack of comprehensive budget controls, together with inadequate fiscal management, often results in unintended fiscal tightening and repeated use of supplementary budgets, as seen in 2003 and 2004, which makes tax cuts a better choice than expansionary fiscal spending for short-term stimulus.

Against this background, more comprehensive fiscal reforms should follow the near-term fiscal stimulus to maximize the role of automatic stabilizers by increasing efficiency and transparency of expenditures and by minimizing distortionary effects of the tax system within a longer-term budget framework. To this end, the revenue structure should be streamlined through rationalization of different tax treatments of various income sources and the removal of earmarked and quasi-taxes with specific purposes (such as education, transportation, and a special tax for rural development), alongside a broadening of the tax base through limiting the use of allowances and personal income tax credits.

On the monetary front, an accommodative stance will prevail at least through 2005 given the below-potential economic performance. Although negative real interest rates limit the effectiveness of monetary policy, extended weakness in the financial position of households and SMEs will further weigh on policy decisions. While the mitigation of inflationary pressure late in 2004 provides a benign context, the Bank of Korea needs to monitor money and credit conditions to avoid any asset price booms arising from monetary easing and structural weaknesses in the financial system. Over the medium term, maintaining price stability should be the primary objective of the Bank of Korea. With the recovery likely to gain momentum later this year, monetary policy needs to gradually return to a neutral stance by adhering to the inflation target.

Alongside its strengthening of the financial system, the Government is continuing to facilitate restructuring of household debt, through rehabilitation of individual credit delinquents by court orders to reschedule debt payments, private debt workouts by financial institutions for defaulters, and the establishment in 2004 of a so-called "bad bank" that acquired distressed assets from banks and credit card companies. The credit card delinquency ratio of households fell to 9.6% in October 2004 from 10.5% in December 2003. The rate of overdue (1 month or longer) payments on credit cards also edged down to 7.3% from 7.8% over the same period.

In order to buttress a stable consumption recovery without a credit crisis recurring, further reforms need to ensure more efficient but prudent banking practices, including encouraging banks to diversify their lending services and to enhance their risk management through credit derivatives and hedging products.

Outlook for 2005–2007 and medium-term trends

The near-term outlook remains weak, with GDP growth projected to slow to 4.1% in 2005. Various adverse external factors, such as sustained high oil prices, softening global demand for high-tech products, and a likely moderation in the global recovery will weigh on export growth, not least because of the exceptional export performance in 2004. Meanwhile, consumption is picking up, but at a sluggish rate because of the weakness of household balance sheets and structural weakness in the labor market.

Still, evidence points to the end of the prolonged consumption slump that has dogged the economy since the credit card crisis. Household debts and the delinquency ratio on credit card loans have stabilized, although at a higher level than before that crisis, as a result of debt-restructuring efforts. A trend of financial deepening in the household balance structure based on increasing access to household credits and more assertive credit behavior by households also suggests that households should be able to manage debts more efficiently and soon resume spending. Meanwhile, expansionary macroeconomic policies and significant improvements in corporate balance sheets provide a favorable backdrop for investment. On the basis of a stronger recovery in domestic demand with lagged effects of policy stimuli, economic growth is projected to move up to 5.1% in 2006 and 4.9% in 2007.

While growth in merchandise exports will slow to an estimated 12% in 2005 from 31% in 2004, external demand will continue to provide a gentle push to growth. Trade and industrial production data in the last quarter of 2004 were surprisingly upbeat, which reflects the global competitiveness of many of Korea's exporting companies. Such resilience will help sustain industrial production and business spending, providing a firm foothold for an economic recovery.

The investment outlook is brighter than the immediate outlook for consumption, as many

firms that retained substantial export earnings and improved their financial status throughout 2004 appear to be in a promising position. Following years of conservative spending, exporters are also in need of aggressive business investment to maintain their global competitiveness. Operational and financial difficulties faced by the SME sector should gradually ease, as business spending driven by large firms will have an effect on overall domestic demand later in 2005.

A slowdown in the real estate market poses a significant near-term risk to a recovery in domestic demand. Policy measures to curb speculative activity in the housing market have started to have an impact. Amid uncertainty surrounding the implementation of new tax laws, real estate transactions have crumbled and housing prices have fallen, in turn helping weaken consumer sentiment and driving the near-term consumer expectation index down to a historical low at end-2004. Adding to the concern, construction investment growth fell sharply to 1.1% in 2004 from 7.9% in 2003. With its significant share (about 58%) in gross fixed capital formation and effects on overall economic activity, a further slowdown in such investment could impede a nascent recovery in domestic demand.

More important, unbalanced growth between the external and the domestic sector, manufacturing and services, and large and small firms—which highlights the disparities in competitiveness and productivity between these areas—remains a medium- and longer-term risk to sustainable high growth. To tackle this, the Government needs to focus urgently on linking the supply-side performance to domestic demand by creating a favorable investment climate to unlock domestic opportunities.

Over the long run, structural reforms to promote economic efficiency and competition across all sectors are key to sustaining stronger growth. The pace of comprehensive postcrisis reforms, which enhanced overall economic efficiency by promoting competition, has slowed in the past few years as the reform agenda moved into politically sensitive areas, such as labor markets, tax policy, and restructuring of social services. However, the economy's ability to sustain high growth will depend on the successful completion of comprehensive structural reforms that entail enhancing competition in SMEs and services, closing the gap between permanent and temporary workers, minimizing tax distortions, reducing inefficient regulatory interventions, and further strengthening governance in the corporate sector and risk management in the financial sector.

Mongolia

The economy surged in 2004 on the back of a stronger performance in agriculture, expanding mining output, and buoyant world copper prices. Rising corporate tax payments helped narrow the budget deficit to historical lows. Economic growth is expected to average 7% over the next 3 years, but sound monetary and fiscal policies as well as further private sector development are necessary to sustain growth and generate employment in order to fight persistent poverty.

Macroeconomic assessment of 2004

Surging world commodity prices and the positive effect of a milder winter on livestock nearly doubled GDP growth to 10.6% in 2004, in excess of projections and propelling it to the highest rate since Mongolia's economic transition began in 1991 (Figure 2.4). Agriculture grew by 18.9%, driven by rapid development of animal husbandry, though crop production declined. While the contribution of manufacturing was minimal, industry overall progressed by 15.4% as mining expanded with the start of operations of a new gold mine, which lifted gold production by half. Services—mainly wholesale and retail trade, telecommunications, and financial services—rose at a slower pace than in previous years, by 4.0%. Visitor arrivals rebounded by 67%, after being hit by the regional SARS outbreak in 2003.

Although continuing economic growth is helping raise living standards, poverty remains persistent in both rural and urban areas: 36% of the population live below the national poverty line equivalent of $0.75 a day. In addition, income inequalities have widened—the Gini coefficient, a measure of income inequality, increased to 0.44 in 2002 (the latest data available) from 0.31 in 1995. Poverty in rural areas is the most severe, with western Mongolia the worst region. This is broadly consistent with changes in the composition of GDP in recent years, as industry and services have boosted their share of the economy while that of agriculture has shrunk, to 25% of GDP in 2004 from 34% in 2000. One result is a significant flow of people moving from the countryside to urban centers.

High unemployment—14.2% of the workforce in 2003 according to the National Statistical Office—and underemployment are the major causes of poverty. The services sector is the main source of employment in Mongolia, followed by agriculture and industry. But only 5% of the rural workforce is employed in services, compared with 75% in urban areas. The Government's strategy to reduce poverty consists in maintaining macroeconomic stability, further liberalizing the economy, and improving public services.

The fiscal deficit remained below the International Monetary Fund's Poverty Reduction and Growth Facility target (6.0% of GDP) for a fourth year in a row. Despite a fiscal loosening in the approach to June 2004's elections, the deficit narrowed to 1.2% of GDP from 4.2% in 2003, bolstered by higher corporate tax collection, particularly from the mining sector. This enabled the Government to repay $50 million borrowed in late 2003 from a Canadian mining company as part of a debt settlement with the Russian Federation.

Higher prices for locally produced food and oil more than doubled inflation to 10.6% in 2004. A tightening of monetary policy in the fourth

quarter of 2004 sharply decelerated growth in the money supply (M2) to 16.5% for the year, from 49.7% a year earlier. Lending rates were broadly stable and credit to the corporate sector continued to expand. The togrog depreciated by 3.9% in nominal terms against the dollar. FDI inflows, concentrated in mining, totaled $132 million, similar to 2003 levels.

Total trade leaped by 28.3% to $1.9 billion in 2004, on account of a 36.0% surge in exports—led by increases in shipments of copper concentrate, textiles, and precious metals—and a 22.4% upswing in imports—driven by purchases of oil, equipment, and machinery. The trade deficit narrowed to 10.4% of GDP from 15.7% the year before, and the current account deficit, including official transfers, narrowed to 0.3% of GDP from 7.8%. The overall balance of payments recorded a $42.5 million surplus, reflecting the inflow of external assistance and growing remittances from overseas workers.

At end-2004, foreign debt amounted to $1.3 billion, equal to 89.5% of GDP. Most foreign loans are on concessional terms, so the country's debt remains manageable. Gross international reserves stood at $205 million (10.3 weeks of imports), indicating a recovery after part of the reserves had been used to repay debt to the Russian Federation in December 2003.

Macroeconomic policy developments

The new Government of Mongolia, formed as a result of the parliamentary elections in June 2004, defined an Action Plan for the next 4 years, the main objectives of which are to upgrade the quality of public services, deepen legal reforms, sustain higher rates of private sector-led growth, improve living standards, and raise education standards.

On economic issues, the Action Plan sets various targets, including a minimum of 6% annual economic growth to be pursued through economic and financial stabilization, private sector-based structural reforms, and increased foreign investment and exports. The Government will pursue macroeconomic stability by maintaining inflation within single-digit levels, the budget deficit at 3% of GDP, and sufficient international reserves to cover 17 weeks of imports.

Table 2.4 Major economic indicators, Mongolia, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.6	7.0	6.3	7.5
GDI/GDP	27.0	27.0	28.0	28.0
Inflation (CPI)	10.6	5.0	5.0	5.0
Money supply (M2) growth	16.5	19.3	-	-
Fiscal balance/GDP	-1.2	-2.5	-	-
Merchandise export growth	36.0	-0.8	-	-
Merchandise import growth	22.4	2.5	-	-
Current account/GDP	-14.0	-13.5	-	-

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

Sources: National Statistical Office of Mongolia; International Monetary Fund; staff estimates.

The financial and banking subsector is to be strengthened through the development of financial markets and financial intermediation, introduction of long-term loans and mortgages, and progressive reduction in interest rates to facilitate wider access to credit and foster domestic investment.

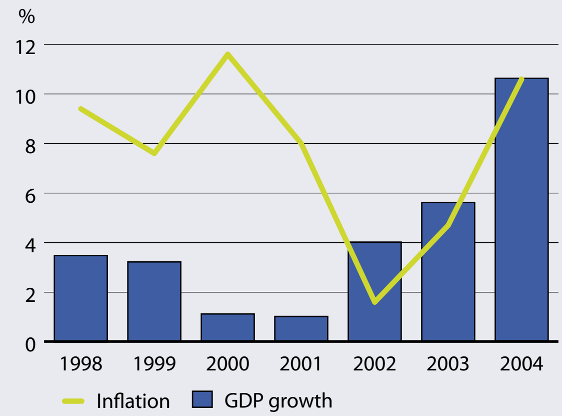
Privatization will be continued and private investment in infrastructure will be encouraged. To stimulate private sector-led growth and exports, the Government will expand the policy of establishing free economic and trade zones and industrial technology parks. The Action Plan also calls for support to SMEs through better access to credit generally and microcredits in rural areas especially, and through promotion of intensive agricultural techniques and modern farming methods. To create a stable and attractive legal environment for investors, international standards and procedures will be extended and the stock exchange will be resuscitated.

The 2005 budget, passed by Parliament in November 2004, aims for a budget deficit equivalent to 3.5% of GDP. It incorporates a new system of cash payments to children in families below the poverty line, fulfilling a promise made during the election campaign. This program will cost about $14 million a year. The budget allocates 20.8% of total expenditures to education and 10.8% for health. The president vetoed the excise tax provisions of the 2005 budget, which will reduce revenues by about $10 million, so a revision to the budget is required.

Late in 2004, the Bank of Mongolia raised the interest rate on its bills by 6 percentage points to 15.5% to damp inflationary pressures. This helped contain M2 growth to within relatively moderate levels for the first time since 2001. The slowing growth of the money aggregate indicates that demand for money and the monetization of the economy is decelerating after 3 years of fast growth in bank deposits and credit, a period when public confidence in the banking system improved. The central bank's guidelines for 2005 aim to contain the growth of money aggregates and bring down inflation to 5%.

The Bank of Mongolia expects the exchange rate of the togrog to remain fairly stable, its policy having avoided sharp swings in the currency in the past 5 years. In other areas, it plans to strengthen regulation and surveillance of the financial subsector and to draw up laws to fight international money laundering and terrorism-financing practices. In order to project the expected effect of monetary policies on the overall economy, this year the central bank also plans to develop a general equilibrium model for the economy.

Figure 2.4 Inflation and GDP growth, Mongolia, 1998–2004



Source: National Statistical Office of Mongolia.

Outlook for 2005–2007 and medium-term trends

The economy depends heavily on the weather, which can seriously damage farm production; and on the performance of just three exports (minerals, cashmere, and textiles), which account for more than 80% of total exports. Hence, projections for the economy rest largely on assumptions in these two areas. The following outlook relies on assumptions that external demand will grow; prices of gold, copper, and cashmere will remain strong; weather conditions will be favorable; the PRC and the Russian Federation will continue to grow; and Mongolia itself will remain politically stable.

On this basis, economic growth is expected to average 7% in the forecast period. Milder winters and improved breeding techniques should continue to foster animal husbandry, although increases in crop production are less certain because the sector needs restructuring and investment. The boom in investment in mining and minerals is expected to continue, given good prospects for exploration in the Gobi desert and the PRC's voracious demand for minerals—particularly copper—and energy. Mongolia is affected by the phasing out of the Multifibre Arrangement and could lose garment-making jobs if it cannot upgrade to higher value-added products and compete in international markets, though prospects may brighten following a new bilateral trade agreement with the US. Construction and services, the latter accounting for about half of GDP, are projected to grow in line with rapid development of the capital city and increasing demand for financial and telecommunications services. Tourism is likely to expand further because the country has attracted a growing number of visitors year after year, and the infrastructure for tourism is improving.

The budget deficit is likely to remain below 3.5% of GDP in the forecast period, with strong tax revenues from minerals and moves to discourage tax avoidance helping offset the increased costs of the new system of cash payments. Inflationary pressures caused by high oil prices may ease after the replacement of the agreement with a key oil supplier—the Russian company Yukos—with a new agreement to buy oil at lower prices from Kazakhstan. The lower oil prices and tighter monetary policy may be able to keep inflation at around 5% in the next 3 years.

Mongolia's dependence on a few commodities that are vulnerable to internationally volatile prices makes reliable projections on

trade particularly difficult. There is potential for increased exports to the PRC (especially oil and copper) and to the Russian Federation (animal products), though against this, the sharp increase in global copper prices seen in the past year or so is unlikely to be sustained.

Other constraints include the dependence of some of the country's major growth industries on energy consumption, which poses a risk to sustainable development. The resulting air pollution and land and water degradation could hamper future growth. Furthermore, the country's competitiveness suffers from high transport costs, insufficient infrastructure, and limited access to credit.

The private sector's share in the economy has increased to 85%, but substantial challenges remain. A large body of legislation to improve the environment for private sector development has been enacted, but a lag remains between enactment and application. Interest rates remain high and terms for lending are short, which restricts investment to big borrowers and limits broad access to credit, hindering the development of SMEs.

Although investment remains strong, mobilization of savings is not progressing—indeed, the savings ratio is declining. The gap between saving and investment needs to be covered by foreign funds.

Growth has picked up in recent years, but remains vulnerable to the economy's narrow base. Sound monetary and fiscal policy actions, a healthy financial sector, and further private sector development are crucial for sustaining growth and generating employment.

Taipei,China

The economy showed robust growth in 2004, marking a recovery from SARS in 2003 and supported by the cyclical rebound in the global high-tech sector, which boosted business investment. Growth will moderate this year before picking up in 2006–2007. Policy makers are grappling with ways to raise revenues in order to strengthen the fiscal position and upgrade technology, so that the economy can stay competitive.

Macroeconomic assessment of 2004

Growth picked up to 5.7%, its fastest rate since 2000. After reaching a peak of 7.9% in the second quarter, momentum slowed in the second half, largely reflecting the higher second-half base in 2003, when the economy rebounded from the impact of SARS. The slowdown also stemmed from decelerating export growth in the second half of 2004, which was caused by higher global oil prices, an easing in global demand for high-tech products, and the PRC's macroeconomic tightening policy.

In contrast to previous years when the external sector lifted economic growth, domestic demand—particularly private consumption and investment—was the driver in 2004. Private consumption rose by 3.1% and contributed 1.9 percentage points to growth. The recovery of the information and communications technology (ICT) industry, which is a significant part of the economy, boosted business investment. Consequently, private fixed investment grew sharply by 28.2% and gross fixed capital formation contributed 2.6 percentage points to GDP growth. The external sector did not contribute, as strong export growth was offset by booming demand for imports (Figure 2.5).

From the production perspective, industry and services contributed fairly equally to GDP growth, with around 3 percentage points each. Growth in services of 4.8% was helped by the rebound from the 2003 SARS outbreak, which boosted tourism, travel, and retail trading. Industrial growth was led by manufacturing, which grew by 9.4%, supported by the ICT subsector. Construction, though, grew by a marginal 1.1%. Overall industry sector growth accelerated to 8.3%.

Agricultural production, in contrast, dropped by 7.1% as a typhoon and floods damaged output, though this hardly affected GDP because the sector's share of the economy is only 1.7%.

The recovery, combined with the Public Services Program to hire the unemployed, increased the number of people employed by 213,000, or 2.2%, in 2004. The average unemployment rate fell to 4.4% from 5.0% in 2003. Average earnings rose by just 0.1%.

The general government fiscal deficit, including the deficit of the central and local governments, has exceeded 3.0% of GDP since 2000, although the gap narrowed to an estimated 2.9% in 2004 from 3.6% in 2003. A major cause of the deficit is weak revenue mobilization. Various tax reductions and incentives over the years, as well as low economic growth rates in 2001–2003, eroded fiscal revenues to about 13.5% of GDP in 2004 from 20.6% in 1990. Government borrowing has increased instead, pushing up public debt to the equivalent of an estimated 38% of GDP in 2004, from 23% in 1998.

Inflation returned, after more than 2 years of deflation, to average 1.6% in 2004. Food prices rose in the third quarter because of the damage to food production by the typhoon and floods. The impact of higher global oil prices was limited because fuel makes up only 2.3% of the CPI and because the regulated transport and power industries did not pass on the higher costs to consumers. However, the wholesale price index rose by 7.1% on average, pushed by rising international oil and commodity prices.

Money supply (M2) growth picked up to 7.4%, reflecting the economic recovery. The New Taiwan dollar appreciated by nearly 3% against the US dollar to NT$33.4 on average for the year as the latter weakened. However, the domestic currency depreciated against the yen, to NT$0.309/¥1 from NT$0.297/¥1 in 2003.

On the external side, merchandise exports climbed steeply by 20.7% in 2004, with exports to Asian nations up by about 25% and accounting for more than half of total exports. A large portion of this export volume to Asian economies is reexported to the US and Europe.

Imports shot up by 32.2%. Sharp increases in imports of capital and consumption goods, reflecting strong domestic demand, were largely responsible. The burst of imports caused the trade surplus to shrink to US$16.5 billion in 2004 from US$24.9 billion in 2003, and the current account surplus narrowed to 6.2% of GDP from 10.2%. Foreign reserves rose by a further US$35.1 billion to US$241.7 billion at end-2004, for two main reasons: increased portfolio investment, driven by the opening of the capital market in October 2003 that allowed foreign investors to trade on the stock market; and an appreciation against the US dollar of the reserves denominated in euros and yen.

Table 2.5 Major economic indicators, Taipei,China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	5.7	4.2	4.5	4.6
GDI/GDP	20.7	20.8	20.9	21.5
Inflation (CPI)	1.6	1.7	1.5	1.5
Money supply (M2) growth	7.4	6.1	5.5	5.5
Fiscal balance/GDP	-3.4	-4.9	-4.5	-4.6
Merchandise export growth	20.7	12.1	8.2	9.5
Merchandise import growth	32.2	18.2	12.6	8.9
Current account/GDP	6.2	6.8	6.7	6.3

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

Sources: Central Bank of China, available: www.cbc.gov.tw/EngHome, downloaded 4 March 2005; Directorate-General of Budget, Accounting and Statistics, available: www.stat.gov.tw, downloaded 4 March 2005; staff estimates.

Macroeconomic policy developments

The fiscal deficit and rising government debt are among areas receiving attention from policy makers. The tax system has become distorted by concessions and incentives that have seriously eroded the tax base. The authorities have stated that it could take 5–10 years to balance the budget, and they plan to do this by reducing government employment, enlarging the tax base, raising tax rates, and selling some SOEs. In February 2005, they proposed a new minimum business income tax on local and foreign enterprises. However, no time frame for implementation was presented.

Privatization of SOEs has fallen behind schedule because of resistance within Parliament, from labor unions, and sometimes from the companies themselves. The authorities own large stakes in many companies, including those in the airline, banking, petroleum, and telecommunications industries. In an effort to facilitate privatization, it is planned to group 43 of the companies under one (or more) holding company. However, for unprofitable enterprises such as the power monopoly Taipower, the authorities also need to allow market pricing of power before the company is likely to be attractive to investors.

In 2005, the authorities intend to issue up to NT$500 billion of bonds, among other things to cover a budget deficit of nearly NT$300 billion. Some of the bonds will be exchangeable into shares of SOEs. Although international rating agencies have expressed concern over the fiscal position and rising public debt, running into serious debt problems in the medium term is unlikely.

In the area of monetary policy, the Central Bank of China raised the official discount rate by 25 basis points to 1.625% in September 2004, the first increase since mid-2000, and lifted the

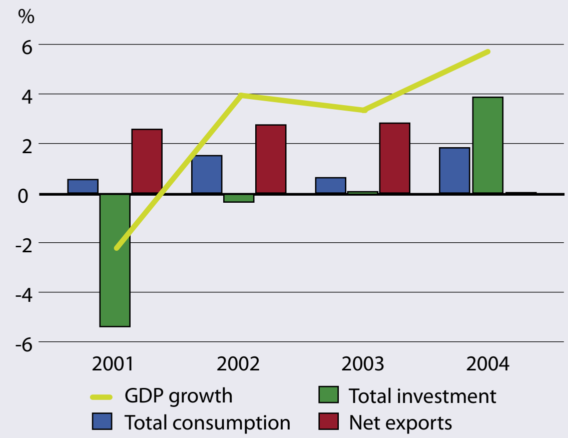
rate further to 1.75% in December. The rises were prompted by concerns about inflation, a widening spread between domestic and US rates, and the desire to maintain positive real domestic rates.

Consolidation in the banking industry is progressing slowly; the economy still has about 50 banks and a large number of small lenders. Fourteen financial holding companies were formed in 2001 to amalgamate banking, insurance, and securities operations. A number of financial-sector mergers and acquisitions were finalized in 2004, though the authorities hope to reduce further the number of financial institutions and increase the size and market share of several key domestic players. In addition, the resolution of problems that emerged during the Asian financial crisis continued in 2004. Some weak financial institutions were liquidated or acquired, and NPLs at domestic banks fell to 2.8% at end-2004 from 7.5% in 2001. The improvement in the soundness of the institutions helped spur lending to businesses.

The Financial Supervisory Commission was established in July 2004 to consolidate multiple layers of financial supervision for insurance, securities, and banking. This move is expected to lead to more transparency and accountability in the financial sector.

Of broader concern to policy makers is the decline in Taipei,China's economic growth rate to an average of 2.7% in the past 4 years, from 6.3% in the 1990s and 8.1% in the 1980s. Slow population growth and an outflow of FDI, partly caused by manufacturers relocating to lower-cost economies, are two of the main causes. The authorities consider that upgrading technology and a general increase in productivity is the way to achieve longer-term sustainable growth. To spur the development of a knowledge-based economy, they initiated the Challenge 2008: National Development Plan, which involves mobilizing around US$15 billion of government investment and encouraging the private sector to invest US$6 billion by 2008. Other goals for 2008 include achieving economic growth of more than 5% a year, raising spending on research and development, making the economy the world leader in 15 products or technologies, and connecting more than 6 million households to broadband telecommunications.

Figure 2.5 Contribution to GDP growth by expenditure account, Taipei,China, 2001–2004



Source: Directorate-General of Budget, Accounting and Statistics, available: www.stat.gov.tw, downloaded 1 March 2005.

Outlook for 2005–2007 and medium-term trends

The GDP growth rate is expected to moderate to 4.2% in 2005 as external demand eases. Supporting this forecast, the composite index of leading economic indicators—a gauge of economic activity 3–6 months ahead—fell for several months in a row in late 2004 and its rate of decline accelerated in January. Private consumption will continue to grow, by around 3% annually in the forecast period. Private fixed investment growth will remain relatively strong and government investment in infrastructure is likely to increase.

Growth in exports of goods and services will slow to 10.2% in 2005 because of softening global demand, and will decelerate to below 8% in 2006–2007. Imports of goods and services are expected to grow by 8.4% in 2005.

Per capita gross national product (GNP) is set to rise to US$15,600 this year from US$14,717 in 2004, reflecting the appreciation of the local currency against the US dollar, moderate growth in GDP, and net factor foreign income flows. This milestone could be significant because the experience of other economies suggests that technology upgrades are facilitated when per capita GNP exceeds US$15,000. It has taken

Taipei,China 8 years to increase its per capita GNP from US$13,500 to above US$15,000 because of slow economic growth and a weakening of the currency during the period.

GDP growth is forecast to edge higher to 4.5% in 2006 and to 4.6% in 2007, based on expectations of an upturn in the global technology cycle, a greater focus on economic issues by the new cabinet, and reasonably smooth relations with the PRC. If plans to increase tax revenues gain legislative approval and further progress is made in strengthening the domestic financial system, investment and growth could be greater than forecast.

CPI inflation is expected to rise to 1.7% in 2005. Regulated transport services and public utilities could well receive approval to raise prices following increases in their costs, though this should be largely offset because the appreciating currency will limit imported inflation. The CPI rose by 1.2% in the first 2 months of 2005 from the year-earlier period and the wholesale price index rose by 3.3%. Inflation is expected to be below 2% in 2006–2007, depending in large part on movements in international commodities and the exchange rate. This is expected to appreciate to average about NT$31.7 to the US dollar in 2005 and strengthen further in the following 2 years. Interest rates will be on a gradual upward trend from the low levels of recent years.

In March 2005, the central bank again raised the official discount rate, to 1.875%, the third increase in 6 months. It pointed to rising inflationary expectations, high capacity utilization in manufacturing (80.3% in January), a stronger labor market (unemployment averaged 4.2% in the first 2 months of the year), and low real interest rates.

In this context and with economic growth on track, the central bank said that monetary policy would gradually return to a neutral stance to help maintain price stability and prevent negative real interest rates from hampering fund allocation and long-term financial stability. It added that the rate rise would cause only a small increase in nominal costs for firms, given that the banking sector has ample liquidity to accommodate funding needs

Downside risks to this outlook include a larger than expected rise in oil prices; a sharp appreciation in the New Taiwan dollar, reducing the economy's export competitiveness; and any serious heightening of tensions with the PRC. Also, there is a risk that Taipei,China could be left out of closer regional economic integration, which would reduce its economic opportunities.

Southeast Asia

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

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. 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.

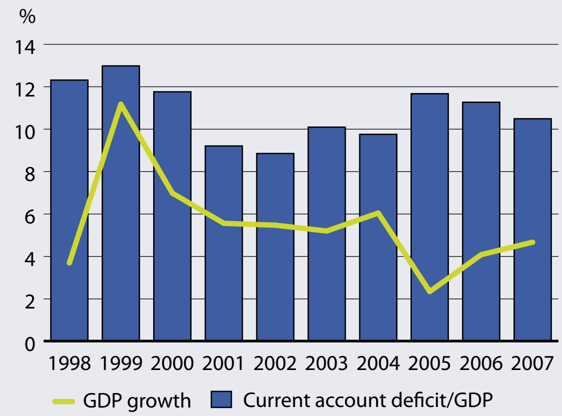
The need to broaden the growth base, and for the private sector to raise its competitiveness in light of the country's 2003 accession to WTO, has led to renewed attempts to promote private sector development. The new Government, formed in July 2004, a year after elections, launched a private sector development 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. It 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 commitment 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, 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 for 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 in expanding their plants in 2004 than in 2003. However, the value of new foreign-invested project approvals rose slightly to $5.4 billion.

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.

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

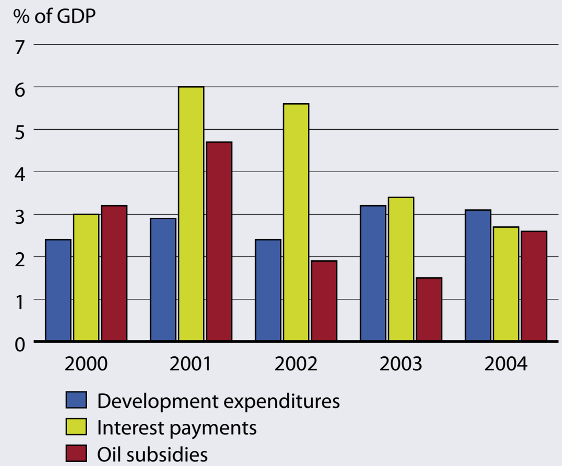
reorganized, a new treasury division was formed, and a unified budgeting system was adopted.

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 Persyarikatan Muhammadiyah under surveillance. Further progress is required in 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.

Figure 2.7 Selected budget components, Indonesia, 2000–2004



Sources: Badan Pusat Statistik; Ministry of Finance.

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 also a risk that the public is unrealistically optimistic on what the Government can achieve in the near term. For a start, the new administration'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 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.

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.

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.

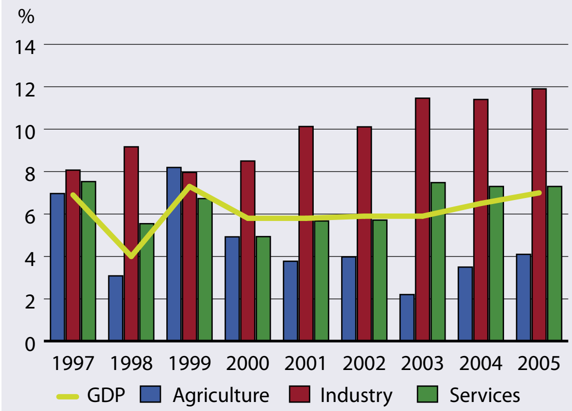
Outlook for 2005–2007 and medium-term trends

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

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



Sources: Committee for Planning and Investment; staff estimates.

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.

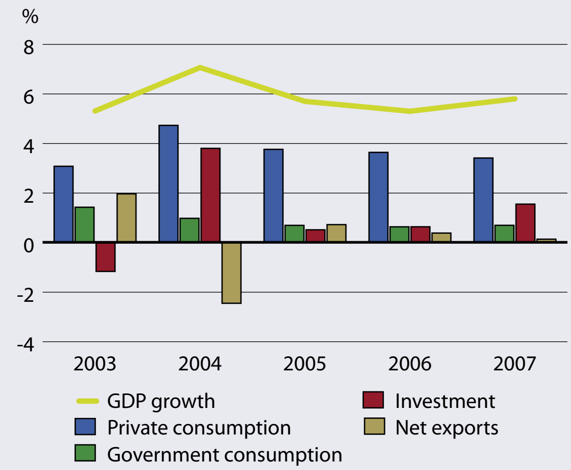
With the banking system having recovered from the Asian financial crisis, Danamodal, the agency established during the crisis to recapitalize financial institutions, was closed in early 2004. The Corporate Debt Restructuring Committee, established to help corporate debt resolution, had already been closed 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 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.

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



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

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

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.

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

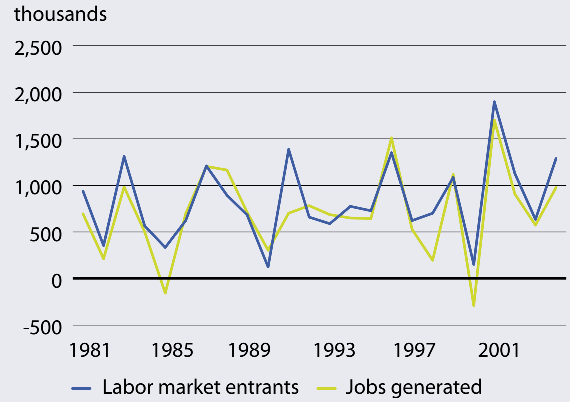
The major priorities of President Arroyo's new administration were outlined in the Medium-Term Philippine Development Plan (MTPDP) 2004–2010, unveiled in October 2004. They include an acceleration of growth, job creation, and reform of the energy sector. Fiscal consolidation and achievement of a balanced 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.

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.

These should go well beyond labor market reforms. The dilemma that 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, it 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 the 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 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.

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.

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

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.

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 slowdown 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.

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 manufacturing 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 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%.

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.

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.

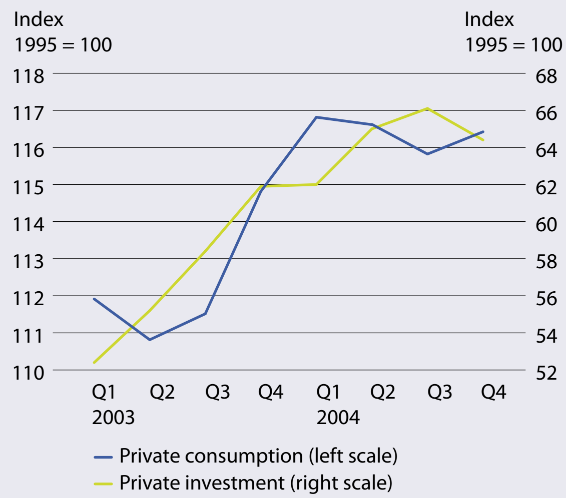
Investment plans that call for spending of up to B2.7 trillion ($69 billion) between FY2005 and FY2008, mainly on infrastructure projects in transport and energy, have been drawn up by the Government and SOEs. Large-scale projects, each costing more than B3 billion, account for 56% of the total. Planned 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 imports 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

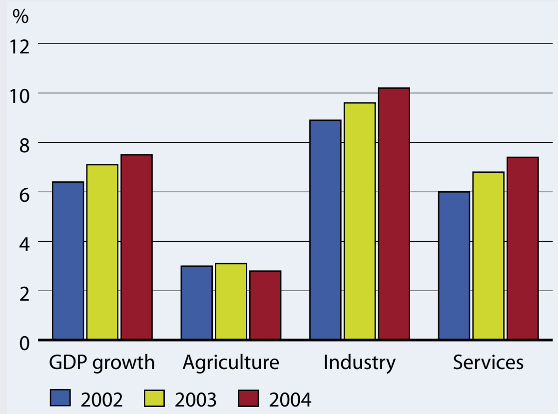
The Government continued to pursue an expansionary fiscal stance. In 2005, the last year of the current 5-year socioeconomic development plan, it is aiming for 8.5% growth to achieve the 7.5% annual average growth envisaged in the plan. At the same time, the authorities recognize the increasingly important 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 multilateral 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, both from the point of view of oil and commodities, and Viet Nam's closer integration with 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.

South Asia

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Afghanistan

After 2 years of double-digit growth, expansion slowed in 2004 as agriculture was hit by another drought. In contrast, the opium economy has grown to record levels. The Government has implemented many structural reforms, but formidable challenges remain. Long-term sustainable development will require new drivers of growth, continued commitment to the ambitious reform agenda, sustained international support, and tackling the opium economy.

Macroeconomic assessment of 2004

In 2004, another drought worked to bring down cereal production by an estimated 25%, substantially lowering GDP growth for FY2004 (ended 20 March 2005) to an estimated 7.5%, from 15.7% and 28.6%, respectively, in the 2 previous years. GDP for FY2004 is estimated at $5.4 billion, exclusive of illicit opium (poppy) production, which is estimated at $2.8 billion. (Calculations in this chapter generally refer to non-drug GDP.) Apart from agriculture, which accounts for about half of GDP, other sectors, especially services and construction, continued to show strong performance as they are mainly linked to the reconstruction effort financed by external assistance and the private spending of international personnel. Per capita GDP is estimated to have risen from $199 in FY2003 to $228 in FY2004.

According to the United Nations Office on Drugs and Crime (UNODC), opium cultivation in 2004 increased by 64% to record levels, despite falling farm gate prices (down 67%) and lower yields due to bad weather conditions and disease. Value added in the opium economy has amounted to about 50–60% of the country's (non-drug) GDP over the past 3 years. Expenditures stemming from drug-export income have generated substantial demand, production, and income in the non-drug economy, and alternative livelihood opportunities will need to be developed alongside stronger eradication efforts.

Social indicators, while improving, are still very low. Delivery of essential services still depends heavily on continued donor support and faces extreme difficulty. Particularly in remote areas and areas affected by continued unrest, even basic services are largely absent. Reliable figures for unemployment are nonexistent, but qualitative information suggests that it is significant, especially among the young, and is exacerbated by extremely low human resource capacity, a continuing influx of returning refugees, and high population growth rates. A National Risk and Vulnerability Survey conducted in 2003 estimated that per capita expenditure in rural areas amounted to $165 per year. The data also suggest that 3.5 million of the 17.5 million Afghans living in rural areas suffer from extreme poverty and another 10.5 million are vulnerable to it. In 2004 widespread crop failure, caused by localized drought and plant and animal diseases—particularly in the west, southwest, and south—led to severe food shortages.

The Government's operating budget for FY2004 was set at $609 million, with $300 million to be generated through domestic revenues and $309 million to be covered by foreign assistance. The target for domestic revenues under the IMF staff-monitored program (SMP) was set more conservatively at $256 million. It is expected that

the Government will meet or exceed the SMP targets but fall short of the budget targets. The development budget increased from $1.8 billion in FY2003 to $4.2 billion in FY2004. Following patterns similar to the previous year, operating expenditures, as well as "core" budget development spending, which includes those donor-funded projects that are administered through government accounts, were slow through the first 9 months of FY2004. The rate of spending is estimated to have picked up during the last quarter. Budget development spending has been very slow and remains hampered by the volatile security situation and capacity constraints, particularly in line ministries.

Inflation in FY2004, as measured by the CPI in Kabul, rose sharply in the first quarter, primarily due to higher housing rents and petroleum prices, but it decreased again in the second. Year-on-year inflation at end-December was 11.9% (6.6% excluding housing rents and petroleum), slightly above the 10.5% rate for FY2003.

The afghani remained relatively stable, trading in the range of AF45–49/$1 over most of 2004, reflecting widespread acceptance of the new currency, prudent macroeconomic policies, and a government commitment to keep broadly within the SMP targets for monetary growth. Currency in circulation is expected to have shown 38.0% growth by end-FY2004.

Balance-of-payments data are weak. Exports in FY2004 are estimated to have reached $2.0 billion (including reexports of $1.5 billion). Total imports are put at $3.4 billion (including items for reexport). The principal exports are carpets and dried fruits; imports consist mainly of machinery and equipment, fuel, food, clothes, and medicine. Most reexports—primarily electronic goods, cosmetics, toiletries, and auto parts—are destined for the Pakistan market. The current account deficit (excluding grants) is estimated at $1.7 billion (about one third of GDP) in FY2004. The deficit is largely covered by grants; FDI is estimated at about $100 million and net disbursements of public loans at about $141 million for the year.

Foreign reserves are expected to have increased to $1.1 billion at end-FY2004 from $814 million a year earlier. A debt management unit in the Ministry of Finance is currently identifying and reconciling outstanding obligations to bilateral creditors. Several countries have provided generous debt relief on old claims. Much of the outstanding claims are from the Russian Federation and date back to the Soviet era.

Macroeconomic policy developments

The encouraging growth performance of the last few years has been supported by the Government's commitment to an ambitious reform agenda and the achievement of several political milestones. The country's first-ever democratic presidential elections in October 2004 were met by high voter turnout without major security incidents, and confirmed the incumbent interim president as Afghanistan's first democratically elected president. These developments laid strong foundations for further political stabilization.

The Government has been implementing the SMP since March 2004. The program aims to maintain macroeconomic and financial stability, pursue essential structural reforms, and build statistical capacity. SMP performance during the first 3 quarters of FY2004 was strong and most of the targets and structural benchmarks were met. However, bottlenecks in the legal system, mainly due to a lack of capacity within the Ministry of Justice, are postponing the introduction of key laws such as those on financial management, investment, and statistics.

Budget preparation and execution have improved significantly, particularly with the introduction of a "core" budget in June 2004 that consolidated the operating budget with the development budget. Also, various government accounts have been consolidated into the Treasury Single Account.

Domestic revenue generation strengthened, from $208 million in FY2003 to an estimated $256 million in FY2004. Yet despite these improvements, donor support will remain crucial to sustaining the reform momentum and to ensuring the delivery of basic services over the medium term. Tax reform measures were enacted in early 2004, including a final wage withholding tax on higher-income employees, an improved income tax regime, and a limited range of consumption taxes on services such as telecommunications, air travel, hotels, and restaurants. However, tax administration and enforcement

remain a great challenge and require substantial improvement. Furthermore, the use of market exchange rates in customs valuation and a new streamlined tariff structure (from 25 tariff rates of 0–150% to six rates of 2.5–16%) came into effect in March 2004. Provinces have begun to regularly transfer government revenues collected in their areas to the Treasury Single Account.

Reform of the civil service is only slowly moving forward. A main pillar is the Priority Reform and Restructuring (PRR) program, which enables government departments to transfer or appoint key staff to a higher pay scale for a fixed term. This has become necessary, particularly since the heavy presence of international and nongovernment organizations distorts the local labor market, which already suffers acutely from a scarcity of qualified personnel. By end-2004, 10 ministries and two independent entities had been granted PRR status and 8,017 positions had been transferred to the PRR scales. The initial target for FY2004 was for 30,000 civil servants to have moved to these scales, including 6,000 at the provincial level. The Government's target is for domestic revenues to cover the wage bill by FY2008—a very challenging objective.

Monetary policy continues to focus on keeping inflation under control and on ensuring a relatively stable exchange rate. There is an increasingly regular regime of foreign exchange auctions. The Da Afghanistan Bank, the central bank, introduced a short-term capital note in September 2004 and a system of bank reserve requirements has been adopted. Afghanistan's financial infrastructure, including savings and investment instruments, is still largely undeveloped. Eleven national and foreign banks have been granted operating licenses by the central bank, which is gradually disengaging from its commercial banking functions. In late-2004, the Government introduced antimoney laundering legislation.

The volatile security environment, unclear and insecure property rights, inadequate and unreliable power supply, and poor communications and transport infrastructure are key deterrents for private investors. Most investments to date have focused on the hotel and restaurant businesses that cater to the large international presence, and on the rapidly growing telecommunications sector. An Afghan Investment Guarantee Facility was set up in September 2004 to provide political risk guarantees to attract further foreign investment. An industrial park has been established outside Kabul and more are to be set up in other cities. Rationalization of SOEs has started, with an audit of their financial positions. A preliminary assessment proposes that, out of a total of 71 enterprises, 41 could be privatized, 20 liquidated, and 10 kept in government hands.

The Government and its development partners consider the opium economy—with its linkages to insecurity, warlords, poverty, and poor governance—a key issue for a successful development effort. The challenge, however, is daunting, especially given the still limited capacity to deal with governance and security problems facing the Government and the opium economy's strong economic incentives.

According to UNODC estimates, the number of families involved in poppy cultivation rose by 35% to 356,000 in 2004, representing approximately 2.3 million people or 10% of the population. This is largely because opium production remains far more profitable for farmers than legitimate crops. Despite the fact that the yearly gross income of opium-growing families declined sharply by 63% from $4,600 to $1,700 in 2004 according to UNODC, mainly due to weaker prices, this income was still many times higher than the gross income from wheat cultivation ($390). Also, many poor farmers are deeply involved in opium-related debt or sharecropping arrangements, which forces them to continue cultivating poppies. There are, though, early indications that farm gate prices have been falling and that eradication measures are showing signs of progress, most likely leading to a reduction in the 2005 harvest.

Outlook for 2005–2007 and medium-term trends

At the Berlin Donor Conference in March 2004, the Government outlined its program of action in the document, Securing Afghanistan's Future: Accomplishments and the Strategic Path Forward, based on the country's National Development Framework. The document stresses the importance of the private sector as an economic driver and emphasizes investments in human

capital, physical infrastructure, security, and good governance. It argues that an average of 9% growth a year of the non-drug economy (10–15% in the short term and 7–9% in the long term) is needed to assure a visible improvement in economic and social conditions while the drug economy is gradually eliminated. Total financing of $31.8 billion is needed until 2010 to raise Afghanistan to an annual per capita GDP of about $500, including an external financing requirement of $27.6 billion over 7 years. Donors pledged $8.2 billion for March 2004–2007 at the Berlin conference, the equivalent of 69% of the $11.9 billion government target for this period.

The high growth rates seen since the end of the conflict have been fueled primarily by donor-supported assistance and construction activities as well as by some relief from the drought. Reconstruction-related activities and growth in the services sector are also likely to sustain overall growth levels of about 10% annually in FY2005–FY2007. However, to achieve the Government's own growth targets over the medium term and to gradually replace opium production, there is a need to shift to broader-based and sustainable development and to identify new drivers of growth. This is particularly important in light of the Government's counter-narcotic efforts. Abrupt efforts to eradicate opium production could well have severe social and political consequences and adversely affect the overall economy and poverty reduction. Considering the size of the opium economy, a comprehensive strategy that creates alternative livelihoods in the rural economy—combined with eradication measures and legal reform—is required, supported by broad-based economic growth and sustained donor commitment.

Substantial continued donor assistance will be required for the recurrent budget over the medium term. There are serious concerns about the fiscal sustainability of the PRR program, the government payroll, and security expenditures. Revenue measures and tax enforcement will have to improve significantly to meet ambitious targets for covering recurrent expenditures. In early 2005, the Government started to develop an interim poverty reduction strategy paper, which will update and integrate various ongoing strategies and programs for reducing poverty, sustaining rapid economic growth, and promoting social inclusion. The 15-month formulation process is to include widespread consultation with civil society and the development of a 3-year macroeconomic framework.

Any future growth scenario will depend on the continuation of political reforms, sound economic policies, and the security situation. This remains volatile and could deteriorate in the run-up to the parliamentary elections originally scheduled for April 2005 but recently postponed until September. The scenario is also highly dependent on developments in the agriculture sector. With very high growth rates in cereal production of 84% in 2002 and 50% in 2003, even accounting for the 2004 shortfall, cereal production is nearing its natural ceiling on irrigated land. The frequency and duration of drought over the past 7 years are a serious concern and are partially attributable to deforestation and soil degradation. Through the expansion of irrigation and improvements in irrigation efficiency, productivity levels and the proportion of land under cultivation can still be significantly increased.

For the private sector to be the primary engine of growth and to create employment opportunities, support mechanisms will have to be strengthened, and the legal foundations for property rights, contract enforcement, and bankruptcy legislation strengthened; in addition, a legal framework for the extractive industries needs to be introduced. Currently, the exploitation of Afghanistan's mineral resources, including coal, copper, gems, and gold, is very limited. Another potential growth area is the carpet industry—traditionally one of the main exporting industries—particularly in rural areas and for women.

Significant growth potential also lies in the exploitation of Afghanistan's geographic position between Central and South Asia. Currently there is very limited trade between Afghanistan and the Central Asian republics (CARs) as tariff and nontariff barriers remain significant. If these barriers could be substantially eliminated with trade and transit linkages established, this would create new markets for Afghan exports, while transit trade from the CARs to South Asia through Afghanistan would benefit all parties substantially.

Bangladesh

Despite widespread and destructive flooding, GDP growth in FY2005 is expected to slow only moderately, aided by flood-damage reconstruction efforts and continued expansion in export-oriented industry and services. In the policy field, initiatives are needed to mitigate the adverse impact of the termination of the MFA, including upgrading infrastructure and removing structural impediments.

Macroeconomic assessment of 2004

In FY2004 (ended June 2004), GDP expanded by 5.5%, up slightly from 5.3% a year earlier. The performance was underpinned by improvements in industrial production and services, reflecting a rebound in exports and greater private consumption. Growth in the agriculture sector slowed to 2.7% from 3.1% in FY2003, mainly due to weakness in the crops and horticulture subsector, though the fishing subsector performed well in response to greater external demand for marine fish and frozen shrimps.

Industrial output increased by 7.7% as against 7.3% in FY2003, due to somewhat greater strength in export manufacturing and construction activity. Production of garments, knitwear, pharmaceuticals, ceramics, cement, and food products registered steady upticks. Following a steep rise in international prices of construction materials, the Government provided tax concessions on their import and sale to sustain momentum in construction, where growth accelerated to 8.3%. As in the preceding year, expansion in the power, gas, and water supply subsector remained robust at over 8%. The services sector recorded a broad-based expansion of 5.7%, up from 5.4%.

On an expenditure basis, GDP expansion in FY2004 was driven by a 6.3% gain in consumption. At 23.6% of GDP, investment was marginally higher than the 23.4% of the previous year. Private investment edged up by 0.3 percentage point to 17.5% of GDP, while public investment declined by 0.1 percentage point to 6.1% of GDP, reflecting underperformance in development spending. The national savings rate, at 24.5% of GDP, was unchanged from a year earlier.

According to the preliminary report of the Poverty Monitoring Survey (PMS) of the Bangladesh Bureau of Statistics in December 2004, poverty incidence has further declined. The PMS uses the direct calorie intake and food energy intake methods to measure poverty. Based on the former method, head count poverty retreated from 46.2% in 1999 to 40.9% in 2004; the corresponding estimates under the latter method are 44.7% and 42.1%. Although not directly comparable, the PMS results are broadly in line with the latest household income and expenditure survey of the Bureau, which reported that 50% of the population was below the poverty line in 2000.

In spite of a shortfall in revenues, the budget deficit in FY2004 narrowed to 3.2% of GDP from 3.4%. Revenues remained at a low of 10.2% of GDP, and reflected continued problems in boosting tax collection, despite the various measures that have been taken. Total expenditures declined a little to 13.4% of GDP from 13.7%, reflecting restraint placed on current expenditures and underperformance in development spending. Domestic sources accounted for two thirds

(2.1% of GDP) of deficit financing; foreign assistance covered the balance.

Price pressures mounted in FY2004 with CPI inflation climbing to 5.8% from 4.4% in the previous year, due mainly to higher food prices. The food component of the CPI nearly doubled, to 6.9% from 3.5%, while the nonfood component moderated (Figure 2.14). Inflationary pressures were, in good part, due to increased international prices of major commodities. An upward revision in administered prices of some energy products also fed into inflation, although most of the rise in international oil prices was not passed on. The exchange rate was broadly stable against the US dollar in FY2004.

Broad money (M2) growth declined from 15.6% in FY2003 to 13.8% in FY2004, though still somewhat higher than the target of 12.2%. Credit growth to the private sector moved up to 14.2% from 12.7% in FY2003 on account of a pickup in manufacturing and services. Bangladesh Bank made use of newly introduced repo and reverse repo instruments to influence the level of liquidity in the banking system. Interest rates continued to decline in FY2004, aided by lower rates offered on government national savings certificates, a reduction in the statutory liquidity requirement, and improved supervision and corporate governance at commercial banks. The weighted average interest rate on bank credit slipped to 11.0% at end-June 2004 from 12.8% 12 months earlier, while that on bank deposits eased from 6.3% to 5.7%.

Exports increased by 15.9% to $7.5 billion in FY2004, up from 9.5% a year earlier. This better performance was underpinned by greater strength in woven garments, knitwear, frozen shrimps and marine fish, and leather in response to a rise in external demand. Imports rose by 13.0% to $9.8 billion, a rate similar to the previous year. Imports of textiles, industrial raw materials, capital goods, and food products increased sharply. While the trade deficit widened slightly to $2.3 billion, the current account surplus (excluding official transfers) of $115.0 million (0.2% of GDP) was essentially unchanged due to stronger current transfers of workers' remittances from a year earlier. The overall balance of payments recorded a surplus of $171.0 million, and foreign exchange reserves at end-FY2004 stood at $2.7 billion, equivalent to about 3 months of imports.

Table 2.14 Major economic indicators, Bangladesh, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	5.5	5.3	6.0	6.0
GDI/GDP	23.6	24.0	26.0	26.0
Inflation (CPI)	5.8	7.0	6.0	5.0
Money supply (M2) growth	13.8	14.0	15.0	14.0
Fiscal balance/GDP	-3.2	-4.7	-4.6	-4.5
Merchandise export growth	15.9	15.0	10.0	8.0
Merchandise import growth	13.0	20.0	16.0	13.0
Current account/GDP	0.2	-1.0	-1.0	-1.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1995/96 market prices.

Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 28 February 2005; Bangladesh Bureau of Statistics; Export Promotion Bureau, Ministry of Finance; staff estimates.

Macroeconomic policy developments

Bangladesh's Interim Poverty Reduction Strategy Paper (I-PRSP) was completed in March 2003. Since then, substantial progress has been achieved in moving from the I-PRSP to a full PRSP, which incorporates prioritized strategies and a medium-term macroeconomic framework for combating poverty. The draft PRSP released in January 2005 centers on eight policy priorities that pursue the goal of accelerated poverty reduction. These include maintaining macroeconomic stability, maximizing pro-poor benefits from the growth process, strengthening the social safety net, advancing human development, assuring participation of poor and disadvantaged groups in the development process and their empowerment, promoting good governance, improving service delivery in the areas of basic needs, and protecting the environment.

The FY2005 budget sets an ambitious revenue target of a 16.7% rise in revenues. The revenue-enhancing measures adopted in the budget include expanding income tax and VAT coverage and rationalizing rates of customs duty, supplementary duty, and income tax. Attaining the revenue target will require an effective revenue mobilization drive and enforcement of greater discipline in tax management, including closer monitoring and supervision of staff. The budget seeks to enhance

total spending by 15.6% year on year. The budget prioritizes projects with growth and poverty reduction potential in the infrastructure and social sectors. Fully achieving these development priorities will require improved public expenditure management and stronger institutional capacity for implementing development projects.

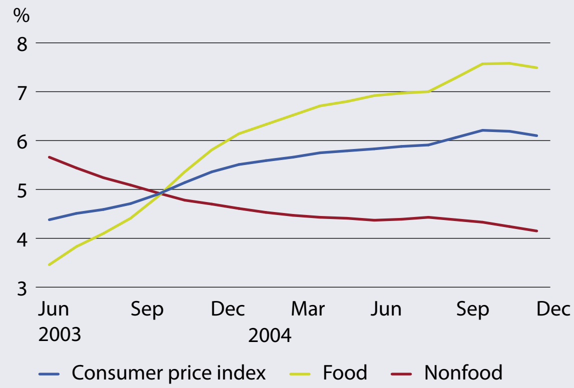
The financial sector is overwhelmingly bank based, with 49 banks accounting for about 95% of the sector's resources. There has been progress in financial sector reforms, including bringing more discipline to the banking sector, increasing the operational autonomy and regulatory power of the central bank, and improving the governance of public financial institutions.

The Government has secured commitments from the nationalized commercial banks (NCBs) to restrict new lending, reduce NPLs, and rationalize their branch networks. Special audits of the NCBs have been undertaken in accordance with international auditing and accounting standards. The ratio of NPLs to total loans in the banking system was 20.9% in September 2004, having declined from 41.1% in 1999. However, the NCBs were still burdened with a 29.7% NPL ratio in September 2004, due mainly to loans made on noncommercial grounds that date back to the 1970s and 1980s. While local private banks as a group have a healthier financial position than the NCBs, even some of these face difficulties due to large NPL portfolios.

Under IMF's ongoing Poverty Reduction and Growth Facility, the Government has undertaken major reforms of the NCBs, including defining bank-by-bank resolution strategies. In the interim, it has also taken steps to strengthen bank management and to restrain lending so as to stanch additions to NPLs. The World Bank's Development Support Credit also supported key banking sector reforms. The implementation of the ongoing reform agenda for the NCBs and their eventual privatization will require strong political support.

Despite recent improvement, the capital market remains underdeveloped, and at end-2004 had a market capitalization of a mere \$3.8 billion (6.7% of GDP). The capital market consists primarily of equity issues, while government securities and savings instruments account for almost the entire limited amount of debt securities issued in the country. Moreover, high interest rates offered on long-term government savings instruments have discouraged the development of the equities market and distorted the market for issuing private debt securities. To pave the way for the development of a secondary market in debt securities, the recently introduced government 5- and 10-year bonds were listed for trading on the Dhaka Stock Exchange. Moreover, high interest rates offered on the Government's 3- and 5-year savings certificates have been trimmed to better align them with market-determined rates.

Figure 2.14 Inflation, 12-month moving average, Bangladesh, June 2003–December 2004



Source: Bangladesh Bureau of Statistics.

Partly in response to restructuring of government interest rates, the Dhaka Stock Exchange general index moved up to 1,971.31 by 30 December 2004, for a 104% gain over the year. However, investor confidence in corporate governance of the listed companies and in execution of the rule of law remains low. In addition, the unavailability of issues with strong fundamentals and the absence of sufficient initial public offerings are major problems for sustaining the stock market's growth.

Although the MFA was phased out with effect from 1 January 2005, exporters are optimistic about continued steady growth of the garment sector in a quota-free world. The garment industry is stressing the need for the creation of a central bonded warehouse, funding facilities for development of an integrated domestic supply chain, and relaxation of the rules of origin to enable it to face the post-MFA challenge of global competition. Many garment entrepreneurs have prepared

themselves by consolidating and restructuring their operations to improve competitiveness.

The garment industry is hampered by costly infrastructure bottlenecks. The challenge is now to lower costs and improve infrastructure to meet increasingly stiff competition. Because of poor infrastructure and high import dependence, the purchase order to delivery cycle (or lead time) of the garment industry is 1 month longer than in major competing countries. This problem has become even more critical in the post-MFA era since the industry now needs to compete with much smaller margins. Over the years, the role of FDI in the garment industry has significantly declined as the Government opted to preserve the valuable quotas for the locally owned factories. This has deprived the country of benefits from the inflow of superior technology and management as well as direct market access and links to EU and US buyers.

Outlook for 2005–2007 and medium-term trends

GDP growth in FY2005 is estimated at 5.3%, down slightly from the preceding year, mainly due to the devastating floods of July–September 2004. Affecting about 38% of the country, the floods caused extensive damage to standing crops, infrastructure, and livelihoods of 36 million people across 39 districts. According to a preliminary assessment conducted in September 2004, damage is estimated at about $2.2 billion, comprising $1.3 billion in asset loss and $0.9 billion in output loss. The impact of the flood damage, together with a steeper oil bill, is expected to be largely offset by flood rehabilitation expenditures mainly financed by aid and increased workers' remittances.

It is estimated that the flooding will bring down agricultural growth in FY2005 to 0.4%, primarily due to its adverse effects on the *aman* (wet-season rice crop). Industrial growth, however, is likely to be pushed higher, to 7.8%, by export-oriented manufacturing. During the first 4 months of FY2005, manufacturing output, boosted by garment production, rose by 8% over the same period in the previous year. The services sector in FY2005 is likely to show improved growth of 6.0%. Expansion in transport and trade services, an upturn in recruitment in public administration, and higher profitability of private sector banks are expected to lift services.

During FY2005, the fiscal deficit is projected to worsen to 4.7% of GDP, reflecting increasing expenditures in the face of weak revenue performance. In the first half of FY2005, revenues under the National Board of Revenue were only 9% higher than in the same period of the previous year, and well below the 16.7% targeted in the budget. Meanwhile, the Government in December 2004 raised prices of kerosene and diesel by 15% to Tk23 per liter, to reduce the losses of the state-owned Bangladesh Petroleum Corporation and to alleviate pressure on the government budget caused by high international oil prices. Further adjustments will be required, though the current government policy is for partial adjustments spread over time.

Inflation is expected to accelerate to 7.0% in FY2005. Overall inflation, on a 12-month moving average basis, has been on a rising trend and reached 6.1% in December 2004, with the food component at 7.5%. With the setback in rice production, food prices are unlikely to decrease significantly during the rest of the year, raising the overall index. Moreover, the December upward adjustment in petroleum prices has not been fully passed through.

Exports are estimated to grow by 15.0% in FY2005, reflecting a steady uptrend in garment exports. During the first half of the year, exports recorded a 15.2% gain over the same period of FY2004 with an especially strong performance in knitwear (up by about 38%). Imports are also projected to pick up in FY2005, by 20.0%, due to increases in industrial raw materials, capital goods, and oil.

During the first 5 months of the year, imports jumped by 22.8%. According to estimates of the central bank, the balance-of-payments impact of higher oil prices is in the order of $300 million–400 million, on an assumed oil price of $40–45 per barrel. A mitigating factor in the energy outlook is that locally produced natural gas is being substituted for petroleum products, particularly in the transport sector. Despite an increase in workers' remittances, a widening trade deficit is expected to push the current account (excluding official transfers)

into a deficit of about $600 million (1.0% of GDP) during FY2005. Additional foreign assistance has been available in FY2005 and foreign exchange reserves rose (by about $300 million) to $3.0 billion at end-January 2005.

GDP growth is expected to strengthen to 6.0% in FY2006–FY2007, with budget and external deficits remaining within manageable levels. The improvement will reflect a recovery in agricultural output to 3.0%, as well as steady performance in industry and services. Investment is projected to rise to 26.0% of GDP in FY2007, propelled by an acceleration in private investment induced by ongoing reforms.

Inflation will likely moderate to 5.0% by FY2007 as crop production returns to normal levels and as the Government continues its policy of gradually reducing petroleum subsidies. The budget deficit is forecast to decline to 4.5% of GDP by FY2007 with revenues and expenditures both growing each year, by 0.5% and by 0.4% of GDP, respectively.

Growth in exports is expected to fall to 8.0% by FY2007 as more intense global competition limits expansion in garment exports. However, the current account deficit (excluding official transfers) is forecast to remain modest at 1.0–1.5% of GDP, aided by the steady growth in remittances from workers abroad.

These forecasts face several downside risks over the medium term, including an even greater adverse impact from the phaseout of MFA quotas, an unforeseen and abrupt increase in oil prices, and the possible intensification of the country's confrontational politics, which could trigger an upsurge in general strikes and lawlessness. The Government needs to address crucial policy and institutional issues to temper some of these risks.

In line with its medium-term macroeconomic framework, macroeconomic stability needs to be maintained and the necessary structural reforms implemented. In particular, the Government will have to focus on augmenting domestic resources while rationalizing expenditures. Raising private investment levels will require major efforts to improve the investment climate, including improving governance and stepping up reforms to improve the efficiency of the banking system and capital market.

In addition, the authorities should undertake policy initiatives to mitigate the impact on the balance of payments of the elimination of MFA quotas. These include efforts to promote diversification of the export base and enhancement of competitiveness so as to encourage FDI (especially in the garment industry) and to remove structural impediments. To realize the potential for anticipated higher export-led growth, the ports, roads, railways, and waterways, as well as energy provision and ICT, all require significant infrastructure improvements.

Bhutan

Strong economic growth, due principally to hydropower, is likely to continue in the medium term. While the country remains on track to achieve the Millennium Development Goals, the challenges of economic diversification, employment generation, private sector development, and domestic resource mobilization require continued attention.

Macroeconomic assessment of 2004

In 2004, GDP is estimated to have grown by 7.0%, moderately higher than the 6.5% achieved in 2003. The power and construction subsectors continued to be the main drivers, with the industry sector accounting for essentially all of the pickup in GDP growth. In September, 32 megawatts of additional generating capacity came on line at the Basochu hydroelectric plant. Tourist arrivals grew by about 48% to reach 9,249, a record, with the industry earning $12.5 million, or about 1.6% of GDP. Tourism was boosted during the year by the opening of a luxury hotel while other high-end projects also financed by FDI are under way. Major investments under construction include the 1-gigawatt Tala hydropower project, housing projects, and road network expansion.

Domestic revenues in FY2004 (ended 30 June 2004) were up by 10.7% from the previous year. An increase of 27.4% in nontax receipts offset an 8.1% decline in tax revenues, with the tax-to-GDP ratio declining further to 8.4% in the year. While domestic revenues remained sufficient to cover recurrent expenditures, the financing of most capital spending relies on external assistance. Total expenditures fell by 11.8% from the previous year's level, due mainly to lower capital expenditures on the Tala hydropower project, which is nearing completion. The combination of much larger inflows of grant assistance—stemming from completion of aid discussions with India—and a reduction in capital expenditures resulted in an overall budget surplus of 4.5% of GDP, a marked contrast to the previous year's deficit of 10.4%.

During FY2004, broad money (M2) expanded by 4.1%, while net foreign assets of the banking system declined by 6.1%. These developments reflected a marked drawdown in and use of private sector foreign currency deposits held at commercial banks, and were consistent with a surge in imports during the year. Credit to the private sector was buoyant, increasing by 30.0%, while the government budget surplus held total banking system credit expansion to 12.5%. Subsectors most favored for private sector lending are, in order: building and construction, manufacturing, trade and commerce, and services (including tourism). Interest rates declined over FY2004: the 1-year deposit rate subsided from 7% to 6%, while the lending rate decreased from 16–12% to 16–10%. Average inflation in FY2004 was 1.3%; however, this measurement reflects an outdated basket, and a new CPI is being introduced.

Balance-of-payments preliminary estimates for FY2004 show unusually rapid growth in exports (up by 39.7% to $157.6 million) and imports (up by 29.6% to $245.6 million) (Figure 2.15). Robust exports reflected increased sales of power as well as agricultural and manufactured products. The import expansion was due to large imports for the Tala project but also the import of two Airbus A319 aircraft. The current account remained in surplus at $48.9 million (7.1% of GDP) due to a

continued large inflow of official transfers. Apart from official aid, the capital account included $3.5 million in FDI for hotel development and the first loan from the International Finance Corporation to the private sector.

At end-FY2004, outstanding external debt was $529.2 million with convertible currency debt at $216 million and the balance in Indian rupees. The debt service ratio was only 4.1%, as most debt is on concessional terms. Gross international reserves increased to $383 million at end-FY2004, providing nearly 19 months of import cover.

Figure 2.15 Trade profile, Bhutan, FY2000–FY2004

Source: Royal Monetary Authority of Bhutan, *Annual Report 2003–2004*, available: www.rma.org.bt, downloaded 7 February 2005.

Macroeconomic policy developments

Significant policy actions were undertaken in 2004. The Government published a "cover note" to the Ninth Five-Year Plan (July 2002 to June 2007) and together these two documents constitute the Government's Poverty Reduction Strategy Paper (PRSP). An extensive document, the cover note was prepared by the Government in broad consultation with IMF and the World Bank. In an effort to strengthen the budget process and the management of public expenditures, the Government has introduced a 2-year rolling budget from FY2005. A medium-term expenditure framework has been developed covering the 2 preceding and next 3 financial years.

A lower (food) poverty line and an upper (income) poverty line, using the data of the 2000 Household Income and Expenditure Survey, supplemented by the 2003 Bhutan Living Standards Survey, were established and the findings were used in the PRSP. These estimates show a national poverty incidence of 25.3%—2.9% urban and 29.0% rural—using the lower poverty line, while the upper poverty line shows national poverty at 36.3%—6.4% urban and 41.3% rural. A poverty monitoring and assessment system is being developed.

Outlook for 2005–2007 and medium-term trends

Reflecting the Government's preliminary medium-term expenditure framework, GDP growth is expected to average about 8.0% annually over FY2005–FY2007. Total budget expenditures as a share of GDP are projected to decline, while a projection of revenues as a share of GDP sees an improvement of 2 percentage points in domestic resource mobilization by FY2007. A 5 percentage point expected decline in external resources (grants and loans), however, points to a moderate projected fiscal financing gap averaging about 2.5% of GDP over the forecast period.

The outlook for economic growth over the medium term appears favorable, despite the continued heavy reliance on only two subsectors—power and construction. The hydropower project at Tala is expected to be commissioned by end-2005. Its export of power to India will eventually decrease the trade deficit and increase government revenues, facilitating the progressive reduction of the existing reliance on external resources. However, given the low employment elasticity of power, the task of fully absorbing the 70,000 people estimated to enter the labor market during the period of the Ninth Plan is challenging, and adds urgency to promoting private activity.

Implementation of planned financial reforms would result in increased competition and enhanced corporate governance. Tourism, which is the major source of hard currency income, has expanded rapidly and, with FDI in luxury hotels and resorts, will materially contribute to private sector development and absorb part of the incoming labor force. Expansion of subregional economic cooperation activities will aid export diversification and expansion of the economic base.

India

The economy remained buoyant, but major challenges included the devastation caused by the tsunami in December, fluctuating agricultural growth, high inflation, and reemergence of a large current account deficit. The medium-term challenges for the economy include meeting the fiscal consolidation targets, stepping up infrastructure investments, managing burgeoning foreign exchange reserves, and reinforcing the economy's competitive advantage in textiles and garments in the post-MFA world.

Macroeconomic assessment of 2004

In FY2004 (ended 31 March 2005), the economy remained buoyant. GDP grew by 7.0% during the first 2 quarters of the year (Figure 2.16), following 8.5% growth in FY2003. For the year as a whole, the best estimate for growth is 6.5%. (The Government has made a somewhat higher advance estimate of 6.9%.) This strong expansion is on account of marked improvements in investment as reflected in the leading macro indicators, such as production and imports of capital goods, production of commercial vehicles, and nonfood credit offtake. Moreover, strong growth in consumer durables in FY2004 also indicates a pickup in consumption demand.

The major challenges faced during the year include the devastation caused by the 26 December tsunami, a slowdown in agricultural expansion, a high price of oil that is fueling inflation, and the reemergence of a current account deficit. The tsunami, which affected the coastline of some mainland southern states of India besides the entire Andaman and Nicobar Islands, led to large-scale loss of life and displacement, widespread damage to property, destruction of coastal fisheries and agriculture, and temporary disruption to tourism in coastal areas. The adverse impact of the tsunami is, however, localized, and the level of national economic activity has not been significantly affected.

Agricultural expansion slowed sharply to 1.5% during April–September 2004, significantly down from the unprecedented growth of 9.6% in FY2003. This stemmed from below-normal rainfall both during and after the monsoon, which also had a highly skewed geographic distribution pattern. As a result, 2004 *kharif* (summer) foodgrain production is expected to be 102.9 million tons compared with 112.1 million tons in 2003. The area sown for most *rabi* (winter) crops has also declined, and consequently the winter crop harvest is also expected to decline. The adverse impact of the tsunami on agriculture due to devastation of standing crops, destruction of irrigation facilities, and depositing of nonfertile sediments may further lower agricultural growth. For the year as a whole, total agricultural production could, at best, rise marginally by 0.6%.

Industrial growth accelerated to a robust 7.5% in April–September 2004 from 6.2% in the same period in FY2003. Manufacturing expansion was broad based, and high growth in different segments of textiles and garments is noteworthy, as the sector needs to maintain its productive efficiency in order to remain competitive in the post-MFA world. Such broad-based manufacturing expansion was supported by strong growth in key infrastructure industries such as

energy and cement. Buoyant industrial growth reflects primarily a pickup in investment and consumption demand. The strengthening of business confidence and other leading indicators such as growth in nonfood credit, especially housing credit, as well as other commercial sectors, suggests that the high industrial growth will be sustained during the rest of the year. For the year as a whole, industrial growth is estimated at 8.0%.

The services sector continued to pick up strongly and maintained an average growth rate of 8.8% during the first 2 quarters of FY2004. This was led by accelerating growth in trade, hotels, and restaurants, as well as by transport and communications, which was in turn due to a turnaround in trading and transport services, and strong performance of telecommunications. The two subsectors of financial and business services, and real estate, and of community, social, and personal services also registered high growth during this period. The strong performance in the former is attributable to a buoyant capital market, continuing expansion in exports of IT-enabled services, and a boom in the real estate market. Services sector growth is also expected to remain at above 8.0% in FY2004.

On the fiscal front, the consolidated fiscal deficit of the federal and the state governments is estimated to improve marginally from 9.4% in FY2003 to 9.1% in FY2004. The federal fiscal outcome for FY2004 is somewhat mixed. The major effort at fiscal consolidation notwithstanding, the federal fiscal deficit situation did not show any improvement in FY2004 from the previous year, while the revenue deficit declined from 3.6% of GDP in FY2003 to 2.7% in FY2004. This is in spite of significant expenditure containment and impressive gains in tax revenue collection during the year. However, capital receipts of the federal Government generated by recoveries of loans to state governments and other receipts from disinvestment proceeds have declined. Finances of the states also remained worrisome.

Money supply (M3) growth has started declining in recent months, reaching 13.3% on 4 February 2005, which is lower than the monetary policy target of 14% for the year as a whole. Growth of reserve money remained at above 14.0% as of that date, mainly on account of large inflows of foreign capital and continued buying of dollars by the Reserve Bank of India (RBI) to prevent appreciation of the rupee. Despite high growth in the foreign exchange assets of RBI and a consequent expansion of the monetary base, the excess liquidity scenario reversed as a consequence of the increase in demand for nonfood credit, along with a rise in the cash-reserve ratio and sterilization through the Market Stabilization Scheme. As a result, interest rates started moving up, with yields on 91-day treasury bills increasing from 4.4% to 5.4% in April–December 2004. However, early indications suggest that the liquidity position has been easing since January 2005.

Wholesale price index inflation rose sharply in FY2004. The average inflation rate was 6.9% during April–December 2004. With a decline in recent months, inflation for the year as a whole is expected to be 6.0%. Given the unutilized capacity in some sectors, demand-driven inflation is not a concern at present. Instead, the sharp increase in inflation has been cost-push, mainly due to high world oil prices and rising prices of iron and steel. Inflation based on the Consumer Price Index for Industrial Workers was lower, at 3.7% in April–December 2004.

Table 2.15 Major economic indicators, India, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	6.5	6.9	6.1	7.0
GDI/GDP	26.5	26.5	27.0	27.5
Inflation (WPI)	6.0	4.2	3.0	3.5
Money supply (M3) growth[b]	14.6	14.5	12.5	13.9
Fiscal balance[c]/GDP	-9.1	-8.8	-8.5	-8.0
Merchandise export growth[d]	23.2	14.1	13.8	13.2
Merchandise import growth[d]	39.0	19.7	15.4	14.4
Current account/GDP[d]	-1.0	-1.0	-1.4	-1.9

GDI = gross domestic investment, GDP = gross domestic product, WPI = wholesale price index. [a] Based on constant 1993/94 factor cost. [b] Data for 2004 are for April 2004–January 2005. [c] Includes combined fiscal deficit of the federal Government and all state governments. [d] Data for 2004 are for April–September.

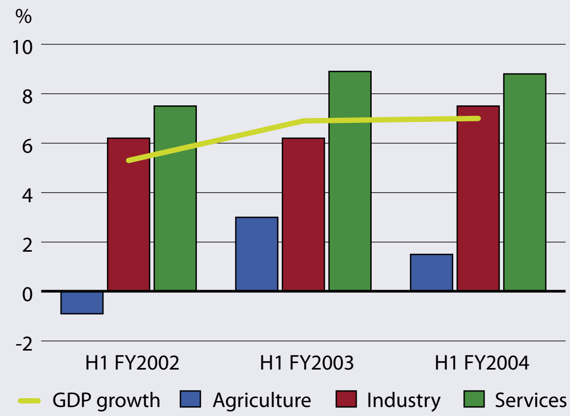
Sources: Central Statistical Organization, available: http://mospi.nic.in/cso.htm, downloaded 9 February 2005; Ministry of Finance, available: http://indiabudget.nic.in, downloaded 28 February 2005; Reserve Bank of India, available: www.rbi.org.in, downloaded 1 March 2005; staff estimates.

Bullish expectations, driven by buoyant growth and rising corporate profits, are reflected in the recent boom in stock prices. After declining quite sharply during April–May 2004 in the run-up to elections (and the formation of a new coalition Government), the market has rebounded to reach record levels of market capitalization. Despite fluctuations during the year, the Sensex market index closed at 6,752 on 15 March 2005 to record a 19.3% increase for 50 weeks of FY2004. The volatility of the index during December 2004 and January 2005 reflects the movements in portfolio investments by foreign institutional investors, primarily on account of expectations of an increase in the US Federal Funds rate.

External sector performance was also robust in FY2004. Merchandise exports grew by 23.2% and imports by 39.0% during the first half of FY2004 from the same period a year earlier. With imports outpacing exports during the period, the trade deficit increased. Despite 22.8% growth in net invisibles trade, the current account has recently switched to a deficit of $3.3 billion, having previously been in surplus from the third quarter of FY2000. Greater import growth is the result of higher oil prices and strong domestic absorption. The acceleration in merchandise exports mainly reflects strong growth of world demand, especially in ASEAN+3 countries.

On the capital account, the country received a net capital inflow of $10.1 billion in the first half of FY2004, though net FDI was only around $2.0 billion. The surplus on the capital account was the result of external commercial borrowing and short-term loans, and other capital inflows. Data show an upsurge in foreign institutional investment inflows in later months, which pushed up foreign exchange reserves to $134.6 billion (as of 11 March 2005). The accumulation of large reserves along with the weakening of the US dollar against major international currencies caused the rupee-dollar exchange rate to appreciate on average by about 2.1% during the first 50 weeks of FY2004. This accumulation also led to the expansion of the monetary base and a consequent sharp increase in money supply growth. This latter problem becomes more acute with the limits on sterilization. Thus, for prudent foreign exchange reserves management, the central bank has to make a critical balance between arresting rupee appreciation, on the one hand, and keeping money supply growth within the stipulated target to control inflationary pressures, on the other.

Figure 2.16 Sectoral composition of growth, India, FY2002–FY2004



Source: Central Statistical Organization, available: http://mospi.nic.in/cso.htm, downloaded 9 February 2005.

Macroeconomic policy developments

At the policy level, the federal Government intends to carry forward the reform process "with a human face." Significant policy initiatives bear on the fiscal reform proposals in the FY2005 federal budget and on social and rural development programs, including the rural employment guarantee scheme. Reforms in foreign trade and investment policies, credit policy, and the existing Patents Act were also initiated.

The finance minister presented the FY2005 federal budget to Parliament in February 2005. As expected, this budget marks a major milestone in the revival of growth-promoting fiscal reforms. At the same time, it is an inclusive budget, aimed at promoting equitable growth focusing on the rural sector and social services, in line with the goals of the United Progressive Alliance Government in its Common Minimum Program. The FY2005 budget also marks a major change in federal fiscal relations vis-à-vis the states, based on the recommendations of the Twelfth Finance Commission (Box 2.3). Much of the growth-oriented fiscal reform relates to revenues. Indirect tax rates and direct tax liabilities have been significantly reduced; the tax base has been expanded,

especially in terms of the coverage of services taxation; and a slew of exemptions has been abolished. These exemptions had been earlier identified by several committees as one of the major factors accounting for India's porous tax system and a relatively low tax-to-GDP ratio of only 16%.

Equity concerns have been addressed mainly through the expenditure proposals. The budget has substantially increased the allocation of resources for agriculture and rural development, including water resources management. There is also a significant increase in social expenditures on education, health, and antipoverty programs. The expenditure budget has also addressed key growth constraints through a large increase in allocation for road transport and power infrastructure. Despite this, the total increase in federal expenditure has been contained at 1.7%. This has been possible mainly because of a sharp reduction in federal loan assistance to the states, following the recommendations of the Twelfth Finance Commission. Henceforth, states will have to access the capital market for their borrowing requirements.

This major effort at fiscal consolidation notwithstanding, the fiscal deficit of the federal Government for FY2005 remains high at 4.3% of GDP, with a revenue deficit of 2.7%. This would imply a large overall fiscal deficit of about 8.8% of GDP after the deficits of the state governments are included. The federal fiscal and revenue deficit estimates also fall short of the corresponding targets of 4.0% and 1.8% under the Fiscal Responsibility and Budget Management (FRBM) Act as envisaged in the previous year's budget. The shortfall in meeting the fiscal deficit target is largely derived from a large reduction in the federal Government's receipts from recoveries of loans to state governments, primarily due to the expiry of the Debt Swap Scheme in FY2004 in preparation for a complete rescheduling of repayment of state government debts to the federal Government, following the recommendations of the Twelfth Finance Commission. However, the finance minister has indicated that the federal Government will still meet the FRBM targets by FY2008.

Less encouragingly, the budget makes no attempt to cut down subsidies, nor has it

Box 2.3 Recommendations of the Twelfth Finance Commission

The Twelfth Finance Commission (TFC) was appointed by the president of India on 1 November 2002. The terms of reference included the following: recommend the distribution of net proceeds of taxes between the federal Government and the states and the principles that should govern the grants-in-aid of the states; recommend measures to supplement the resources of the local governments; and review the state of finances of the federal Government and the states and suggest a comprehensive fiscal consolidation plan, including specific suggestions for better tax efforts and a feasible debt-reduction plan for the states.

Specific TFC recommendations for fiscal consolidation in the states will have far-reaching implications for the federal-state fiscal relationship. TFC has correctly identified that large revenue deficits have led to large fiscal deficits and spiraling debt, resulting in the emergence of a vicious cycle of deficit, debt, and debt service payments.

Thus, every state is now required to enact fiscal responsibility legislation to eliminate its revenue deficit by FY2008. This precondition for debt relief triggers a consolidation of the federal loans to states outstanding as of 31 March 2005 for a fresh term of 20 years at an interest rate of 7.5%. TFC has also put forward a debt write-off scheme linked to the reduction of revenue deficit of the states.

TFC has suggested that the plan size of each state needs to take into account the sustainable level of debt and the capacity to borrow in the market. Thus, it has proposed a thorough overhaul of the system of providing federal assistance for state plans. The system of imposing a 70:30 ratio between loans and grants for extending plan assistance to nonspecial category states (10:90 for special category states) should be abolished. The federal Government should only extend pure grants to the states, and leave it to the states to decide how much they wish to borrow. Moreover, all external assistance will also be transferred to the states on the same terms and conditions, and the federal Government will act merely as a financial intermediary without making any gain or loss.

Source: Government of India. 2004. *Report of the Twelfth Finance Commission*. New Delhi. November.

announced any major policy initiatives with regard to disinvestment in public enterprises or liberalization of labor laws. However, the federal Government has moved forward with further dereservation and deregulation among SMEs. In addition, there was some move during the year by the Ministry of Finance and RBI with respect to liberalization of foreign equity participation in private sector banks, as well as in the construction, mining, trade, and pensions subsectors.

On the monetary policy front, RBI in its midterm review of the Annual Credit Policy 2004/05 has aimed at provision of adequate liquidity to meet credit demand and support investments, while emphasizing price stability. In this review, RBI increased the repo rate by 25 basis points to 4.75%, while leaving the bank rate unchanged at 6.0%. RBI addressed the issue of the liquidity overhang by raising the Market Stabilization Scheme limit to Rs800 billion, which is expected to mop up the increase in money supply through selling government securities and impounding these resources in a special account of the central bank. Given the prescribed limit of the scheme, RBI has raised the cash reserve ratio by half a percentage point to 5.0% to absorb surplus liquidity and control inflationary pressures.

With regard to rural employment generation, the federal Government introduced a National Rural Employment Guarantee (NREG) Bill 2004, in Parliament. This bill seeks to implement an employment guarantee scheme in 150 of the most backward districts of the country in the first phase, and then extend the coverage in stages to the entire country within 5 years. This provides a legal guarantee of 100 days of employment a year to at least one member of each rural household, and thus provides the rural poor with an effective safety net.

The NREG Bill, which has been criticized on the grounds of its limited scope, leaves room for discretionary interventions by state governments. In addition, it may also be criticized in terms of large leakages and poor delivery systems. However, the beneficial effects of such programs in terms of employment generation and poverty reduction are evident in Maharashtra and were seen in Rajasthan and Gujarat during the droughts of 1987/88. The other important benefits of such programs include expected reduction of rural-urban migration, empowerment of women, creation of useful assets in rural areas, and change of power equations in rural society to foster a more equitable social order.

The 2004 amendment to the Patent Act 1970, which is designed to comply with India's commitments under the TRIPS Agreement in WTO, marks a departure from the past regime of granting only process patents. The new amendment allows for the introduction of product patents and exclusive marketing rights under certain conditions in the area of chemicals—including agrochemicals and pharmaceuticals—and food. Certain features of the recent amendment have generated controversy: some commentators claim that the new amendment restricts affordable access to various essential drugs.

Outlook for 2005–2007 and medium-term trends

GDP is expected to expand by 6.9%, up from 6.5% in FY2004. Agriculture is projected to grow at a high rate of 4.4%, which is not unusual in a year that follows one with relatively low agricultural growth. In FY2005, industry is predicted to grow at a lower rate of 6.7%, and services sector growth is estimated at 7.7%. A slowdown in industrial growth in FY2005 can be attributed to cost-smoothing behavior of firms to tide themselves over an anticipated cost escalation as reflected in the latest business confidence survey carried out by the National Council for Applied Economic Research, New Delhi. This is corroborated by the fact that firms are very upbeat about capacity utilization but not very optimistic about demand conditions, suggesting the desire to hold larger inventories. The survey indeed shows that the proportion of firms willing to accumulate such inventory levels, especially in consumer goods, has gone up significantly. This explains the beginning of a downturn in the industrial business cycle in FY2005.

In FY2006, GDP growth is predicted to decline to 6.1%, mainly on account of a further decline in the growth of industry and services to 5.2% and 7.3%, respectively. The revival of industry and services growth in FY2007 will drive up overall expansion to 7.0%.

The medium-term challenges for the economy include meeting the fiscal consolidation targets as laid down in the FRBM Act of 2003, stepping up infrastructure investments, managing burgeoning foreign exchange reserves, and reinforcing India's competitive advantage in textiles and garments since the termination of the MFA.

Inflation is forecast to decline to 4.2% in FY2005, down from 6.0% in FY2004, and then to 3.0% and 3.5% in the following 2 years. The moderation of inflation will be largely attributed to expected stability in prices of fuels as well as prices of manufactured goods through FY2007. The downside risks that could undermine the inflation projections include a weak monsoon and a sharp rise in global oil prices.

Expansion in investment—especially in infrastructure—holds the key to sustaining high growth over the long run. The investment rate increased to 26.3% of GDP in FY2003 and is estimated to have increased to 26.5% in FY2004. However, the current rate of infrastructure investment at 3.5% of GDP is way below the 8.0% of GDP target for FY2005 made by the Expert Group on the Commercialization of Infrastructure Projects.

The current rates of both private and public infrastructure investments have been well below target. The key problem in attracting adequate private capital in infrastructure is the lack of appropriate risk allocation between creditors and investors. One such crucial risk originates in the fact that lenders are paid only from the cash flow generated by an infrastructure project, and they have limited options if investments fail to provide the expected returns because of a shift in policy parameters. Moreover, infrastructure projects usually have long gestation periods and there is usually a maturity mismatch between loans and returns. Developing a domestic market for long-term securities is therefore critical for infrastructure financing. ADB's recent issue of domestic currency long-term bonds is an important step in this direction.

Thus, in a bid to boost infrastructure investments, the federal Government has proposed financing infrastructure investment in specific areas such as roads, ports, airports, and tourism through a special-purpose vehicle in terms of additional borrowings with longer-term maturities. Therefore, with an anticipated increase in public infrastructure investment using such a vehicle over the medium term, it is expected that there will be a gradual step-up in the overall investment rate to 27.5% in FY2007.

The key factor constraining higher public investment in infrastructure is the large consolidated deficit position of the federal and state governments. Despite expected improvements in the consolidated fiscal deficit over FY2005–FY2007, reflecting tax reforms, improvements in tax administration, and containment of expenditure, the fiscal deficit is expected to remain high at above 8.0% of GDP. The consolidated revenue deficit will also stay high. Therefore, it will remain a challenge for the federal Government to increase public investment in infrastructure through additional borrowings while ensuring compliance with the FRBM targets. This will be possible only if adequate fiscal space is created by initiating effective fiscal consolidation measures.

The external sector is expected to remain buoyant. Growth of merchandise exports is forecast to be 14.1% in FY2005, 13.8% in FY2006, and 13.2% in FY2007. This is despite the strengthening of the rupee-dollar exchange rate over FY2005–FY2006. Anticipated appreciation in the real exchange rate notwithstanding, the projected large increases in merchandise exports are largely due to high growth in world trade. Strong expansion in ASEAN+3 countries in FY2005 (particularly in the PRC), which now accounts for about 23% of India's total trade, will provide a stimulus to merchandise exports.

Merchandise exports are better diversified than imports, which largely comprise bulk items. The growth in merchandise exports stems from expansion in exports of textiles and garments, automobile parts and ancillaries, and chemicals (including pharmaceuticals). Textile export composition is well diversified, and it has a competitive edge in products ranging from cotton textile items, yarns, and fabrics to knitwear.

The ending of the MFA will have a large impact on India's textile and garment exports, which account for about 20% of total exports. Even though the high growth of textile and garment exports shows the competitive strength of these products in the international market, it is still too early to assess gains, and the sector's

performance needs to be monitored closely. The benefits from the MFA phaseout will accrue only if India makes substantial improvements in efficiency, reduces unit costs, diversifies to higher value-added products, and consolidates scale economies. Also, to remain competitive, Indian textile and apparel firms need to be a part of the global value chain, and reposition themselves accordingly.

Merchandise import growth is likely to be 19.7% in FY2005 and around 15% in the following 2 years. The anticipated lowering of international oil prices in FY2006 and FY2007 largely explains the declining growth of merchandise imports during these 2 years. With import growth exceeding that of exports during the 3 years, the trade deficit is expected to remain high. Services trade, especially in software and IT-enabled business processes, will continue to rise at a robust rate over this period and expand the positive invisibles balance.

The current account will continue to post a deficit, forecast in the range of 1.0–1.9% of GDP over FY2005–FY2007. This will partly offset the surplus on the capital account. Moreover, with the expected hardening of US interest rates over the next 2 years, there may be a reduction in net portfolio investments, which will lower the capital account surplus. Hence, the rapid accretion to foreign exchange reserves observed since 2001 is likely to moderate over the medium term. Nevertheless, managing foreign exchange reserves and striking an appropriate balance between a competitive exchange rate and internally consistent money supply growth will remain a significant challenge for RBI.

Maldives

The tsunami of 26 December 2004 was the country's greatest natural disaster. While loss of life, fortunately, was low, damage on many islands was great. A curtailment of peak-season tourism means that growth will plummet in 2005, but should rebound in 2006 as the tourist facilities themselves are largely intact. However, substantial aid will be required for the reconstruction of infrastructure needed to sustain the past high-growth path that had reduced poverty in previous years.

Macroeconomic assessment of 2004

In 2004 GDP grew by 8.8%, slightly faster than in 2003 (8.4%). As in the past, expansion of tourism, up by 11.4% in GDP terms, fueled growth in related sectors, including construction, transport and communications, and utilities. Tourist arrivals increased by 9.4% during the year and the average hotel occupancy rate rose to 84%, while foreign exchange earnings grew by about 19%. Tourism accounts for about one third of GDP, 70% of foreign exchange receipts, about 50% of domestic budget revenues, and almost 20% of employment. Fishing, the traditional mainstay of the economy (now about 6% of GDP), also enjoyed a good year with total exports up by about 22%.

Government expenditures grew by 7.6% during 2004, amounting to 38.3% of GDP. Although domestic revenues increased by 8.8%, a lower amount of grants caused the overall budget deficit to increase slightly to 4.4% of GDP. Nevertheless, there was no borrowing from the banking system, indeed a net repayment as in 2003, consistent with current policy intentions.

Broad money expanded rapidly in 2004, up by 32.6%, with a large buildup in net foreign assets in the banking system. Following a slow expansion in 2003, credit to the private sector surged by 57.8%, with over one half of new lending going into development of tourism facilities. CPI inflation picked up from midyear to average 6.4% for the year, compared with a 2.9% fall in 2003; however, this reflects changes in fish prices, which have a heavy weight in the CPI.

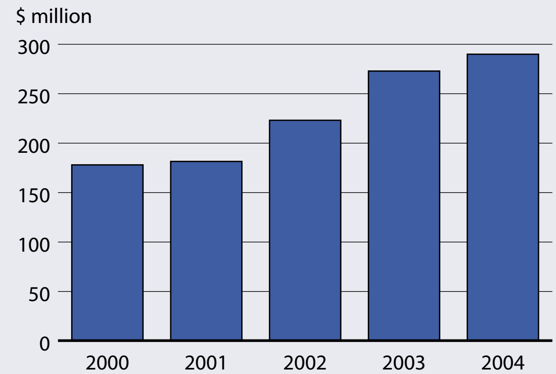
Exports and imports increased rapidly by 13.0% and 30.7% respectively, raising the traditional large trade deficit to $370 million (49.1% of GDP) in 2004. Petroleum products and intermediate and capital goods were notable in boosting imports. Despite higher tourism receipts, the current account deficit increased to $90.3 million or 12.0% of GDP from 4.6% in 2003. Sizable private capital inflows as well as larger official borrowing led to a capital account surplus of $114.8 million, bringing the overall balance to a surplus of $24.5 million. Gross international reserves rose to $205.1 million at end-2004, providing 3.8 months of import cover. The rufiyaa is pegged to the US dollar at Rf12.8/$1. External public debt increased to $289.9 million at end-2004 (Figure 2.17), equivalent to 38.5% of GDP, though the debt service ratio remains low, at 3.8%, as most debt is contracted on concessional terms.

Macroeconomic policy developments

The focus of macroeconomic policy must now be on measures to mitigate the adverse economic impact of the tsunami on the population and on the economy. Key policy measures will include: providing income support to those affected by the tsunami with special attention to the outer atolls

where destruction was especially severe; helping restore livelihoods in the atolls by financing assets lost and employing local labor in rebuilding infrastructure; fostering a rebound in tourism by ensuring that the world knows that facilities such as the airport are functioning normally and resorts are open for tourists, as usual; and ensuring that the reconstruction effort is carried out consistent with macroeconomic stability, i.e., through containing the fiscal deficit and keeping monetary policy on a course to preserve relative price stability and to maintain the fixed exchange rate.

Figure 2.17 External public debt, Maldives, 2000–2004



Source: Maldives Monetary Authority, *Economic Statistics*, February 2005.

Outlook for 2005–2007 and medium-term trends

The tsunami disaster was by far the greatest natural calamity experienced by the Maldives. While the loss of life was fortunately low, nonetheless it resulted in widespread damage to infrastructure facilities. About one third of the country's population of 280,000 was directly affected. According to a joint needs assessment conducted by World Bank, ADB, and United Nations, total damage is estimated at $470 million or about 60% of GDP. Of this loss, the direct loss is $298 million or about 8% of the replacement cost of the national capital stock. Severe damage was caused to houses; some resorts; harbors; boats and other fishing equipment; schools; health facilities; transport and communications equipment; and water, sanitation, and electricity infrastructure.

Overall macroeconomic developments will be affected by the pace of restoration of tourism and fishing, as well as the amount and timeliness of external assistance that becomes available. The Government has projected a 25% decline in tourism in 2005 relative to 2004 as the peak holiday season was badly hit, though the fish catch is expected to remain largely unchanged due to more intensive use of the fleet. Despite a sharp expansion in other sectors, such as construction and government services, which will offset much of the decline in tourism, overall GDP growth is expected to decelerate sharply to about 1% in 2005, well below the pre-tsunami expectation of a 7.6% GDP expansion. Most resorts were not damaged and nearly all were operating normally by March. Since the country is a unique destination with well-established source markets for tourism, it is expected that arrivals will quickly rebound to near normal levels to push GDP growth to 9% in 2006.

The impact of the disaster on the budget is expected to be substantial, as needed spending has been boosted while domestic revenue sources are expected to be under downward pressure. The 2005 budget had projected expenditures to rise by about 25%, reflecting a public service pay increase and greater capital spending. Despite efforts to contain such spending, the amounts required for relief, cleaning up, and reconstruction will cause an even more rapid growth in outlays. Reflecting these developments, the overall budget deficit, including grants, is now projected to widen to over 10% of GDP in 2005. Moreover, preliminary projections indicate that a budget financing gap of about this size is likely in 2006 as well.

The current account deficit is now expected to widen substantially to about 23% of GDP in 2005. Apart from the major loss of tourism revenues, this unusually large deficit is due to an enlarged import bill as a lower import requirement of supplies for the tourist industry is offset by large imports of material needed for reconstruction. The current account deficit should fall in 2006 but remain high. It is important to recognize that unless adequate foreign assistance is received to cover most of the 2005 financing gap—estimated at about $70 million—official foreign exchange reserves will come under severe pressure or the reconstruction effort will need to be scaled back sharply.

Nepal

The economy continued to recover from the downturn in FY2002 on the basis of improved performance in agriculture and services, though the recovery is fragile. Increased political uncertainties following the royal proclamation imposing emergency rule in February, the complex security scenario, and agriculture's continued dependence on the weather pose significant risks for higher economic growth over the short to medium term.

Macroeconomic assessment of 2004

The economy has been adversely affected by exacerbation of the insurgency and political instability since the second half of 2001. Economic growth slowed to an average of 1.2% during FY2002–FY2003, which was well below the annual average of 4.7% in the decade before FY2002. In FY2004 (ended 15 July 2004), GDP growth recovered moderately to 3.3% from 2.9% in FY2003, supported by improved performance in agriculture and services, which offset the conflict-induced weak performance in industry.

Agriculture grew by 3.9% in FY2004 from 2.5% in the previous year, contributing 1.5 percentage points to GDP growth (Figure 2.18). The improvement in output was due mainly to favorable weather, which helped increase paddy production by 7.8% year on year. The impact of lower growth in cash crop output, which suffered from declines in sugarcane, tobacco, and jute production, was thereby largely mitigated. However, the prospect of marked expansion in agriculture is limited by inadequate irrigation, an insufficient transport network, and lack of access to modern technology and credit.

Growth in industry declined to 1.0% in FY2004 from 3.0% a year earlier, reflecting sharply lower gains in the manufacturing and construction subsectors. Manufacturing grew by only 1.7%—much lower than the average rate of 7.5% in the decade before FY2001—due to conflict-related disruptions such as frequent *bandhs* (general strikes), forced closure of businesses, and restrictions on the movement of people and goods. Construction activity (about 50% of industrial output) was a particularly heavy drag on the industry sector, recording only 0.2% gain in the year. Besides suffering the effects of the conflict, the sector, especially manufacturing, remains constrained by poor infrastructure, lack of easy access to seaports, inflexible labor laws, and a weak legal and institutional framework for business.

The services sector grew by 4.3% in FY2004 from 3.3% in the previous year. The gain was driven by improved performance in the tourism, transport, and communications subsectors. Despite the conflict, tourist arrivals picked up by 35% due to competition-stimulated low prices and promotional efforts by the private sector and the Nepal Tourism Board. High growth in transport and communications services reflected investment in the stock of vehicles and a significant expansion of mobile telephone services.

On the demand side, both public and private investment was sluggish in FY2004, reflecting the weak investment climate in the country. At 19.2% of GDP, the gross fixed investment rate was below the average investment rate for FY1991–FY2001. The economic recovery in FY2004 was led by remittance-driven consumption expenditure,

which accounted for almost all of the growth in GDP. The sustainability of such an expansion, however, will depend on continued buoyancy in remittances and a pickup in other sources of personal income.

On the fiscal side, government spending was 12% below the budget target due to constraints imposed on capital spending by the conflict. The capital spending shortfall, together with an 11% improvement in revenue mobilization, held the budget deficit to 1.5% of GDP in FY2004, about half the forecast. Foreign loans financed two thirds of the deficit while domestic loans financed the remainder. Despite the conflict, Nepal's fiscal deficit has narrowed since FY2001, as the increase in security spending has been more than outweighed by underspending of the capital budget and improvement in revenue collection. However, a further worsening of the insurgency could change this outcome.

The financial sector was flush with liquidity due to continued growth of remittances and significantly higher flows of foreign loans. Broad money (M2) grew by 12.8% in FY2004, somewhat above the central bank's 11.2% target. However, domestic credit rose slowly, reflecting the weak investment demand, tighter credit control by the two large government-controlled commercial banks undergoing restructuring, and a sharp decline in the Government's domestic borrowings. Urban inflation was contained at 4.0% in FY2004, aided by higher food production and some appreciation of the local currency.

Interest rates fell for the second consecutive year in FY2004. The average weighted interest rate on the Government's 91-day treasury bills fell to 2.9% in FY2004 while commercial bank deposit rates dropped to 2.2–5.0% in July 2004 from 2.5–6.3% in July 2002—both items negative in real terms. The average lending rate of commercial banks for industry remained unchanged during the year at about 11%. The large spread between lending and deposit rates is indicative of both the inefficiency in financial intermediation and the credit risk in the present conflict environment.

On the external side, exports rebounded, rising by 12.4% to $733 million, and imports jumped by 18.4% to $1.8 billion. Export growth was based on a recovery in exports of woolen carpets and leather goods, which overcame a decline in exports of readymade garments. Import growth reflected strong demand for consumer durables, while the appreciation of the domestic currency was also a contributing factor. The larger trade deficit during the year was, however, more than offset by improvements in tourism receipts, workers' remittances, and foreign grants. In dollar terms, the current account surplus at $163 million was marginally higher than in FY2003 but was marginally lower in terms of GDP (2.4%). Apart from the current account surplus, foreign exchange reserves were buoyed by aid inflows, and stood at $1.4 billion or around 8 months of import cover at end-FY2004.

Table 2.16 Major economic indicators, Nepal, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	3.3	3.0	3.7	4.3
GDI/GDP	27.3	26.2	28.0	29.9
Inflation[b] (CPI)	4.0	4.5	4.0	4.0
Money supply (M2) growth	12.8	11.7	12.5	13.5
Fiscal balance/GDP	-1.5	-1.7	-3.0	-3.5
Merchandise export growth	12.4	10.0	10.0	10.0
Merchandise import growth	18.4	5.0	20.0	20.0
Current account/GDP	2.4	1.9	0.3	-1.1

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1994/95 factor cost. [b] Urban consumers only.

Sources: Ministry of Finance, available: www.mof.gov.np, downloaded 14 January 2005; Nepal Rastra Bank, available: www.nrb.org.np, downloaded 28 February 2005; staff estimates.

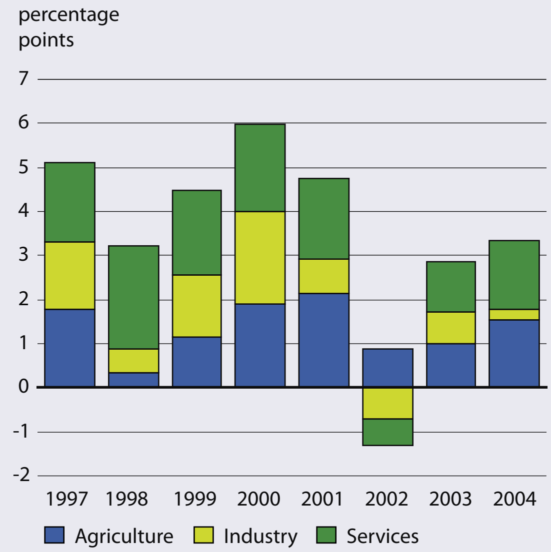
Garment exports face the threat of a sharp decline following the abolition of the MFA quota system on 1 January 2005. To cope with the threat, Nepal needs to shift its export strategy from quota utilization to one that makes use of preferential trading arrangements, such as the EU's Everything But Arms initiative and Canada's Market Access Initiative.

The economy also faces difficult challenges in reducing poverty and achieving the Millennium Development Goals. The results of the 2004 Living Standards Survey show that nominal per capita income has grown by 97% since 1996, with farm, nonfarm, and remittance incomes contributing 33%, 45%, and 19%, respectively. Remittance and nonfarm incomes have increased much faster than

farm income, revealing a structural shift in the economy. Income levels of both the poor and the rich are reported to have risen proportionately. The results show that Nepal is making some progress in reducing income poverty despite the challenges posed by the conflict and political instability.

Human development indicators remain unsatisfactory. Nepal ranked 140 out of 177 countries on the human development index in 2004—lower than all other South Asian countries except one. The country presents significant regional disparity in human development, with the conflict-affected Far-Western and Mid-Western regions faring the worst. The economy is unable to provide gainful employment to all of its rapidly growing population, though the situation has been ameliorated somewhat by migration of labor to India, Southeast Asia, and the Middle East.

Figure 2.18 Sources of growth, Nepal, FY1997–FY2004



Source: Central Bureau of Statistics.

Macroeconomic policy developments

The Government's fiscal policy objective over the medium term is to raise the revenue-to-GDP ratio and improve efficiency of public spending. The FY2005 budget aims to boost capital spending, especially in rural areas, by improving utilization of block grants to local governments along with community-led development projects in the areas of health, education, and rural infrastructure. However, this is proving increasingly difficult in the current environment.

To raise the revenue-to-GDP ratio, the Government is improving administration of VAT, simplifying the income tax law, and implementing a 3-year customs reform and modernization program. It also announced a 3 percentage point increase in the VAT rate to 13% during the midterm review of the FY2005 budget, though much of the additional revenue will finance increases in civil service allowances and security spending.

As part of the Government's public enterprise reforms, the Bhaktapur Brick Factory was privatized in FY2004. Petroleum prices were adjusted to better reflect international prices in January 2005 and to fully offset the financial losses of Nepal Oil Corporation. The Government intends to adopt the Petroleum Products Sale and Distribution Ordinance in FY2005 to allow private sector participation in oil imports and distribution.

Nepal Rastra Bank is continuing its accommodative monetary policy to stimulate the economy. It has reduced the mandatory cash-reserve ratio from 6% to 5% for FY2005, aiming to narrow the widening differential between deposit rates and lending rates. It is targeting broad money growth of 12.5% and an inflation rate of 4% to facilitate the maintenance of the current parity peg with the Indian rupee.

Under financial sector reforms initiated by the Government, the NPLs of the two government-controlled banks being restructured under external management—Nepal Bank Limited and Rastriya Banijya Bank—have declined, respectively, from 61% and 60% in FY2003 to 52% and 56% in FY2004. The effort to improve the deteriorating financial health of these two banks has, however, substantially reduced banking services in rural areas, further concentrating them in urban locations. The Government has initiated restructuring of the Agriculture Development Bank to provide improved and affordable banking services in rural areas.

A new agriculture policy was adopted in November 2004, aimed at increasing productivity and commercialization. Based on the Government's 20-year Agriculture Perspective Plan, the new policy envisages provision of

modern technology inputs and credit to farmers to purchase land (for productivity), and supports tariff incentives for establishing agroprocessing industries and the promotion of contract and leasehold farming (for commercialization).

Recognizing that weak governance is one of the underlying causes of the conflict, the Government has recently refocused reforms to make governance more inclusive by enhancing participation of excluded and disadvantaged groups (i.e., women, *dalits*, and *janjatis*). It has approved reservation of 45% of vacant civil service positions for these groups. It also continues to pursue reforms to rightsize the civil service, establish an automated personnel information system (for civil servants and teachers), and facilitate community participation in government projects.

To achieve its estimated growth potential of 5–6%, the Government needs to focus on several areas. First, peace and stability must be restored. Second, it must improve the investment climate by strengthening the legal, institutional, and regulatory framework for the private sector. This has become increasingly important in the liberal trade regime brought about by the expiration of the MFA and Nepal's entry into international trading arrangements such as WTO, the South Asia Free Trade Area agreement, and the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Co-operation. Third, efforts must be made to foster stronger links with the country's rapidly growing neighbors to tap the economic benefits of integration with their economies. Fourth, Nepal must accelerate the pace of ongoing governance reforms.

Outlook for 2005–2007 and medium-term trends

The royal proclamation on 1 February 2005 and the imposition of emergency rule have increased political uncertainty. Together with the complex security situation and agriculture's continued dependence on the weather, they pose significant risks for economic expansion over the medium term. Growth will likely ease in FY2005, mainly due to the anticipated weaker performance in agriculture, tourism, and transport activities, and deterioration of the conflict in the second half of the year. Beyond FY2005, it will hinge on credible progress toward a lasting resolution of the insurgency. The underlying assumptions of the *ADO 2005* projections are that: there will be no further deterioration of the insurgency situation and that progress will be made toward a lasting resolution in FY2006; stronger growth will be seen in both private and public sector investment in FY2006–FY2007; the global economic expansion will be maintained; the Indian economy will grow by about 6%; and weather conditions will be normal in FY2006–FY2007. Based on these assumptions, GDP is forecast to increase by 3.0% in FY2005, 3.7% in FY2006, and 4.3% in FY2007.

On the output side, agricultural growth is expected to moderate to 3.0% in FY2005 as the overall expansion will be limited by the weather-related decline in the production of paddy, which accounts for almost a quarter of agricultural output. Industry is forecast to grow by 2.4%, mainly on account of a remittance-driven recovery in depressed construction activity. Growth in services is projected to slow to 3.2%, reflecting an easing in tourism and transport. On the demand side, the gross fixed investment rate is projected to fall to about 18%, as a result of sluggish public and private investment in the conflict situation.

The fiscal deficit is projected at 1.7% of GDP in FY2005 compared with the Government's midterm budget target of 2.5%, signaling the difficulty in implementing development projects. Broad money is likely to increase by 11.7%, or lower than the Government's target of 12.5%. Growth in credit to both the government and private sectors will remain sluggish. The current account surplus is likely to shrink to 1.9% of GDP on account of the projected decline in tourism receipts, but foreign exchange reserves will continue to expand. Inflation is likely to rise to 4.5% due to the upward adjustment in petroleum prices, the increase in the VAT rate, and the decline in paddy production.

Agricultural growth will average about 3.5% over FY2006–FY2007; a rate higher than that is unlikely given the numerous structural weaknesses in the sector. Industry is projected to expand by 3.5% in FY2006 and 4.0% in FY2007, with improved growth in both construction and

manufacturing driving the industrial recovery. Growth in services is likely to pick up to 4.3% in FY2006 and 5.0% in FY2007. Expansion in tourism, transport, and communications services is expected to strengthen, on the assumption that the security situation improves. An improvement in the security situation would also fuel a rebound in investment over FY2006–FY2007.

The fiscal deficit is forecast to widen to 3.0% in FY2006 and 3.5% in FY2007. Government expenditures are projected to grow strongly in both years on the assumption that an improvement in the security situation will allow the Government to undertake major reconstruction work. The revenue-to-GDP ratio is forecast to improve further over FY2006–FY2007, with better revenue management, efforts to check excise leakages, stronger collection of income tax arrears, and the increase in the VAT rate. Monetary policy will stay geared to maintaining the peg with the Indian rupee and to being accommodative to aid economic recovery. Accordingly, broad money growth is likely to remain in the range of 12–14% over FY2006–FY2007. Growth in credit to the government and private sectors is forecast to pick up. The discount rates on government treasury bills are therefore expected to rise. Consumer inflation is projected to fall to 4.0% in both years, as the effects of upward adjustment in petroleum prices and VAT subside and food production returns to normal levels.

The current account surplus is projected to further narrow in FY2006 and a deficit is seen in FY2007, as imports pick up. Export growth will be limited by the loss of MFA quota access and increased external competition. Foreign exchange reserves are likely to fall slightly in FY2006–FY2007, but should remain in excess of 6 months of imports.

Actual performance of the economy will be subject to significant downside risks. In particular, an exacerbation of the conflict could further restrict development spending, undermine the growth in industry and services, and impede poverty reduction efforts. The targets set out in the current Tenth Plan/Poverty Reduction Strategy of the Government and the Millennium Development Goals could then remain unattained. However, if Nepal can resolve the conflict and make progress toward peace and political stability, there is significant potential for the economy to achieve higher growth.

The economy remains well inside its production possibilities frontier, which makes further acceleration of the growth rate perfectly feasible. With 71% of its labor force in agriculture and underemployed, Nepal can hasten its transformation from an economy based primarily on agriculture to one based primarily on services and industry. If labor-intensive services and industry grow and pull even a quarter of the rural labor force into more productive employment, the economy can be expected to grow much faster. Simultaneously, the accompanying reduction in the population pressure on farmland will help raise agricultural productivity and wages.

Pakistan

The economy picked up further in FY2004, with GDP growth coming in at over 6% for the first time in 7 years. With sound macroeconomic fundamentals achieved and key sectors strengthened by reforms implemented in the past 4–5 years, the economy is well positioned to sustain 7% or more growth in the medium term.

Macroeconomic assessment of 2004

Economic performance improved further in FY2004 (ended 30 June 2004), and GDP growth exceeded 6% for the first time in 7 years. Investment in key sectors, such as large-scale manufacturing (LSM), oil and gas, telecommunications, and construction, picked up. The fiscal position strengthened further, the current account of the balance of payments remained in surplus for the fourth consecutive year, and foreign exchange reserves touched new highs. However, the size of the current account surplus fell sharply, and inflation started to creep up.

GDP growth accelerated to 6.4% from 5.1% in FY2003, driven by investment and private consumption expenditures. With historically low interest rates, a conducive regulatory and policy environment—particularly in the oil and gas and the telecoms sectors—and most industries having reached near full capacity utilization, fixed investment went up by 14.7%, accounting for more than one third of GDP growth. As a share of GDP, total investment, including changes in inventories, climbed to 18.1% in FY2004 from 16.7%. Private consumption expenditures picked up by 5.5%, contributing almost two thirds of the GDP growth.

On the supply side, GDP's improvement was led by the industry sector, which put on 13.1%. The LSM subsector, which constitutes about half of industry, registered its fastest pace in two decades. Value added in LSM rose by 17.1%, as domestic demand strengthened on the back of a rapid rise in consumer credit, higher cash incomes of farmers, continuing strong levels of remittances, and an accelerating economy. LSM's momentum was shared by all subsectors, with more pronounced rises recorded by the electronics, automobile, fertilizer, chemical, cement, cooking oil, and cotton cloth subsectors. Although the bulk of LSM's expansion came from higher capacity utilization, capacity itself also stepped up, as indicated by a 28.4% augmentation in investment in LSM in FY2004. Electricity and gas distribution, as well as construction, also exhibited marked improvements. However, agricultural growth decelerated to 2.6% from 4.1% in FY2003, due mainly to continuing water shortages, which resulted in a slide in cotton production and slower growth among other major crops.

The services sector more or less maintained the prior year's rate, though subsector performance showed considerable variation. Value added in wholesale and retail trade grew by 8.0%, up from 5.9% in FY2003, reflecting recovery in domestic economic activity, acceleration in imports, and continuing double-digit increases in exports. Telecoms services were also very buoyant, with the number of cellular phone subscribers doubling to 5.0 million. Growth in public administration and defense, conversely, was significantly slower than in the previous year.

The improved economic performance of

the past 2 years has had a positive impact on employment in the country, with the average unemployment rate declining from 8.3% in FY2002 to 7.7% in FY2004. A particularly large fall was seen in female unemployment, which dropped from 16.5% to 12.8%, although it remains about twice as high as that for males, which receded only marginally to 6.6% in this period.

Strong growth, as well as a substantial lift to poverty-related public expenditures in the past 2 years, should also have generated a positive impact on poverty. A survey of household consumption expenditures, conducted by the Government in early 2004, showed a significant reduction in poverty since 2001. However, these numbers are only indicative of the trend, because the survey covered only about 2 weeks, and was based on one third of the sample covered in the Pakistan Integrated Household Survey 2000–01.

Inflation bottomed out in September 2003, with the annual rate, based on a 12-month moving average of the CPI, accelerating from 2.6% that month to 4.6% in June 2004. On a point-to-point basis, inflation jumped from 1.9% in June 2003 to 8.5% in June 2004. The move back up was initially triggered by supply-side factors, such as a shortage of wheat and the setback suffered by the poultry business due to avian flu. This was compounded by rises in housing rents, which reflected sharply higher real estate values. Despite the upswing, the State Bank of Pakistan (SBP) did not reverse its easy monetary stance so as not to stall the nascent economic recovery. Also, as inflation was initially confined to food prices caused by supply constraints, it did not consider appropriate a tightening of monetary policy. Money supply (M2) rose by 19.6% in FY2004 compared with 18.0% in FY2003, and the increase in credit to the private sector, at PRs325.2 billion, was almost twice as large as in FY2003.

In FY2004, the Karachi Stock Exchange's KSE-100 index leaped by 55.2%. The stable exchange rate, low interest rates, higher economic growth, improved corporate profitability, and improvement in relations with India were key factors.

The Government maintained a tight fiscal stance in FY2004 and the overall budget deficit came down further to 3.2% of GDP from 3.8% in FY2003. The sharp improvement in the fiscal position was the result of strong economic growth and good expenditure management. Revenues strengthened by 11.4% and expenditures by a slower 7.9%, despite large rises in development and defense spending. Revenues exceeded their target, whereas expenditures came in below theirs. The debt profile of the country continued to improve, with the ratio of public debt to GDP declining to 72.3% from 79.3% in the previous year.

Despite a double-digit rise in exports, the trade deficit more than tripled to $1.3 billion in FY2004, as imports outpaced exports by a large margin. Imports powered forward by 21.2% to $13.7 billion, while exports rose by 13.5% to $12.5 billion. Besides a broad-based strengthening in domestic economic activity, various nonrecurring transactions, such as import of aircraft for the national airline, temporary import of dredgers on a reexport basis, and exceptionally high imports of raw cotton due to lower cotton production, also inflated the import bill. Export growth stemmed from price rises, which may partly be attributed to a shift from lower to higher value-added items. The deficit on the services account widened sharply (to $1.3 billion from only $2.0 million) due to reintegration of travel-related payments into formal channels and higher payments for shipments associated with stronger

Table 2.17 Major economic indicators, Pakistan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	6.4	7.0	7.0	7.5
GDI/GDP	18.1	20.7	22.0	22.7
Inflation (CPI)	4.6	7.5	5.0	5.0
Money supply (M2) growth	19.6	13.0	11.0	10.0
Fiscal balance[b]/GDP	-3.2	-3.1	-3.0	-3.0
Merchandise export growth	13.5	11.0	10.0	10.0
Merchandise import growth	21.2	30.0	8.0	10.0
Current account/GDP	1.9	-1.7	-1.6	-1.9

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1999/2000 factor cost. [b] Excludes one-time expenditures.

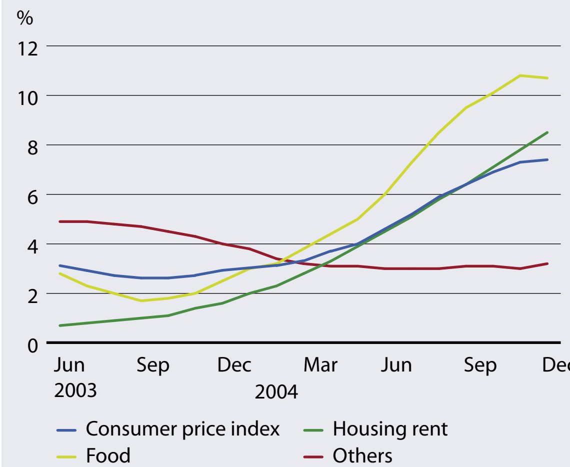
Sources: Federal Bureau of Statistics, available: www.statpak.gov.pk/depts/index.html, downloaded 1 March 2005; Ministry of Finance, available: www.finance.gov.pk, downloaded 15 February 2005; State Bank of Pakistan, available: www.sbp.org.pk, downloaded 7 March 2005; staff estimates.

imports. Among current transfers, workers' remittances weakened by 8.6% and the Saudi Oil Facility was discontinued effective January 2004. As a result, the current account surplus narrowed to $1.8 billion from $4.1 billion in FY2003.

The $0.7 billion surplus in FY2003 on the capital and financial account of the balance of payments turned into a deficit of $1.3 billion in FY2004. The deterioration in the capital account was the combined effect of a $1.0 billion debt forgiven by the US in FY2003 (which shows up in the accounts as a capital inflow) and an early repayment of $1.1 billion of debt to ADB in FY2004. A 29.6% fall in disbursement of foreign assistance in FY2004 also contributed to the wider deficit. These were partly offset by a bond issue of $500 million and larger FDI in FY2004.

Reserves held by SBP moved $1.0 billion higher to $10.6 billion in FY2004. Total external debt and liabilities further declined by $216 million to $35.3 billion, and as a share of total foreign exchange earnings, external debt and liabilities fell to 164.1% from 180.5% in the preceding year.

Figure 2.19 Inflation, 12-month moving average, Pakistan, June 2003–December 2004



Source: Federal Bureau of Statistics.

Macroeconomic policy developments

The FY2005 budget marked a break with the previous 4 years with a change in focus from fiscal stabilization to growth. The Government also continued the process of reform started in FY2002, including tax reforms, liberalization of the external trade regime, deregulation of the telecoms sector, and privatization of public sector enterprises.

The FY2005 budget took full advantage of the fiscal space created by improved revenue generation and reduced interest payments to expand development expenditures and lower business costs for the private sector. The allocation for development expenditures was increased by 25.9%, and import duties and sales tax on many raw materials and capital goods were reduced. As a result of reductions in import tariffs over the past several years, the average tariff rate has been cut to 14.9%. In addition, the FY2005 trade policy liberalized the import of used machinery to encourage the relocation of plants from abroad, mainly aimed at the textile and garment industries.

As part of the tax administration reforms, the Government plans to organize operations of the entire Central Board of Revenue on functional lines, separating the functions for collection, audit, assessment, and enforcement. It started the process in FY2003 by establishing a Large Taxpayers' Unit in Karachi, and subsequently a Medium Taxpayers' Unit in Lahore, both organized along functional lines. In these units, large and medium taxpayers can pay all their taxes in one place. Seeing the success of these experimental offices, the FY2005 budget announced the establishment of one more Large Taxpayers' Unit and five more Medium Taxpayers' Units in different cities across the country.

The FY2005 budget announced measures to shorten delays in payment of tax refunds, streamline general sales tax (GST) registration, rationalize the GST rate structure, and facilitate imports and exports. In the area of tax refunds, all GST refund claims are to be categorized as reliable, average, and risky based on past history, and prompt and full payment will be made in the case of claims categorized as reliable.

A new system of GST registration was introduced effective 1 July 2004, which does away with the requirement to submit a large number of documents with the registration application. The GST rate structure has been simplified, and now has one standard rate of 15% (from multiple rates ranging from 15% to 23%). Also, to make GST

a tax that genuinely accounts for value added, offsetting adjustment has now been allowed for tax on almost all intermediate payment items, including diesel used in generators for producing electric power by registered taxpayers. To facilitate exports and imports, a pilot project for an automated clearance of export and import consignments is being launched in Karachi. It will entail only selective examination of goods, based on the concept of risk management.

The telecoms deregulation policy was announced in July 2003 followed by the cellular phone policy in January 2004, to promote the availability of high-quality and cost-effective telephone services in a competitive market. Since then, the Pakistan Telecommunication Authority has issued 12 licenses to various national and international companies for long-distance international services and 73 fixed-line local loop licenses for services in 14 regions of the country. To provide telecoms services to rural areas, 106 wireless local loop licenses have been awarded to 28 companies through open bidding. Two licenses have also been issued for cellular services (in addition to those held by the four existing operators).

As a result of deregulation, telecoms is probably the fastest-expanding sector in the economy, having a significant impact on investment and employment. Cellular phone and Internet services have expanded at a phenomenal speed in recent years, with the number of cellular phone subscribers doubling almost every year since FY2000. The total number of such subscribers, at 5.0 million in June 2004, has exceeded that of fixed-line subscribers. The number of Internet users more than tripled from 0.5 million in June 2000 to 1.6 million in June 2004 and the number of cities linked to the Internet soared from 29 to 1,900. Growth in the telecoms sector is likely to accelerate further in FY2005, reflecting the impact of the recently issued new licenses.

The Government has made substantial progress in privatization in recent years, with the financial sector largely privatized and all telecoms services opened to the private sector. The focus has now shifted to the energy sector; 73% of the shares of the Karachi Electric Supply Company were sold to a Saudi group in February 2005. In addition, 20% of the shares of the Kot Addu Power Company have been divested through the stock market. The Privatization Commission has also initiated the process of privatizing the Pakistan Telecommunication Company Limited (PTCL) and has invited expressions of interest for the sale of 26% of its shares, along with management control. Expected to be the largest privatization transaction so far, the bidding for PTCL shares is planned for the third quarter of 2005.

Outlook for 2005–2007 and medium-term trends

A robust performance in the real sectors of the economy in the first half of the fiscal year, the steep rise in imports of machinery and industrial raw materials, and continuing high domestic demand all indicate that GDP growth is likely to improve to 7.0% in FY2005. An important factor is agriculture's envisaged strong performance. Output of cotton, the most important cash crop, is likely to be as much as 50% higher than in FY2004. Also, wheat, the largest crop in terms of value added, is expected to be boosted by prevailing high market prices, relatively early sowing, and timely rains. Moreover, an over 65% surge in imports of agricultural machinery and a 50% rise in gross disbursement of agricultural credit in the first half of FY2005 point to better prospects for agriculture. Accordingly, sector growth is forecast at 5.0% in FY2005.

The growth of the industry sector in FY2005 is estimated at 10.0%, given the strong recovery in investment in manufacturing seen in FY2004 and continuing high domestic demand. Reduction in import duties on machinery and liberalization of import of second-hand machinery, announced in the FY2005 budget, will further stimulate investment in manufacturing. Continuing modernization of the textile industry, as reflected in a 69.9% surge in imports of textile machinery in the first half of FY2005, and cheaper and abundant cotton, also augur well for manufacturing production. In the first 6 months of the year, the quantum index of manufacturing climbed by 16.1% compared with the corresponding period of FY2004. Of the two other important subsectors in industry, expansion will be sustained in construction, though electricity generation and distribution is likely to suffer a setback due to water shortages.

Services sector growth is also forecast to improve in FY2005. The expansion of the telecoms sector will accelerate further, as companies given licenses for various types of telephone services earlier in the year start their operations. Strengthened through reforms and privatization, the financial sector is also expected to expand robustly. Finally, wholesale and retail trade will be bolstered by a stronger performance in commodity-producing sectors and by burgeoning imports.

However, rising inflation is a major concern for FY2005. The 12-month moving average of CPI inflation pushed up further to 7.4% in December 2004 from 4.6% in June (Figure 2.19). Core inflation, which is more amenable to monetary policy, also picked up, from 3.7% to 6.5% during this period. To reduce inflationary pressure, SBP changed its stance from accommodative to a "measured tightening" of monetary policy in the first half of FY2005. Interest rates on 6-month treasury bills have risen from 2.5% in July 2004 to 5.2% in March 2005. The average interest rate on new loans disbursed by banks also increased, but at a slower pace, from 5.1% in June 2004 to 5.9% in December. However, monetary expansion in the first half of the year, at 9.8%, was somewhat larger than in the equivalent period a year earlier. Moreover, because real interest rates have remained negative, private sector credit is booming, while heavy government borrowing from SBP pushed up reserve money by 19% in the first half of FY2005. Reflecting these developments, inflation in FY2005 is put at 7.5%.

Despite an adverse effect of the increase in international oil prices, the fiscal deficit target of 3.1% of GDP should be achieved in FY2005. Tax collection by the Central Board of Revenue, which exceeded the target in the first half of FY2005, should remain above target for the year. Nontax revenues, such as dividends from the PTCL and Oil and Gas Development Corporation, as well as license fees for telephone services, are also expected to exceed the target. However, a shortfall in receipts from a surcharge on petroleum products will be seen, as the Government did not pass on the increase in oil prices to domestic consumers until very late in 2004. Still, total revenues are likely to be higher than budget estimates. As regards spending, only that on subsidies will be larger than budgeted. This is explained by additional losses from state-owned power utilities (due to higher fuel prices) and substitution of high-cost thermal power for low-cost hydropower (due to water shortages). Also, the Trading Corporation of Pakistan will require higher subsidies to cover losses in its trading operations pertaining to imports of wheat and urea, and procurement of cotton. On balance, though, the rise in expenditures due to higher subsidies is expected to be offset by the increase in revenue receipts.

In the first 6 months of FY2005, the trade deficit grew much more sharply than expected because of an unprecedented surge in imports of 47.7% compared with the same period in the previous year. Thus, despite an above-target rise in exports (14.6%), the trade deficit leaped from $159 million to $2.3 billion. This, along with an almost ninefold increase in the deficit on the services account to $1.5 billion, turned the current account into a deficit of $0.9 billion from a comfortable surplus of $1.8 billion in the first 6 months of FY2004. With high economic growth and the planned import of 1.5 million tons of wheat, imports are still expected to rise, though at a somewhat slower pace in the remaining 6 months of the year. The phaseout of textile and clothing quotas in January 2005, together with substantial investment in modernizing the textile industry in recent years, as well as the present cheaper, abundant supply of cotton, should boost the industry's exports. Nevertheless, imports will significantly outstrip exports, and the trade deficit will continue to widen. Consequently, it is estimated that the deficit on the balance-of-payments current account in FY2005 could be as high as 1.7% of GDP.

On the basis of the *ADO 2005* global outlook and continued sound macroeconomic policies, supported particularly by the low fiscal deficit and a much-improved public debt profile, the medium-term economic prospects look good. It is projected that GDP growth in FY2006 and FY2007 will remain at 7% or more, inflation will be brought down to 5% after the sharp increase in FY2005, and the fiscal deficit will be sustained at around 3% of GDP. Moreover, the current account deficit is expected to stabilize at less than 2% of GDP and, at this level, should not be difficult to finance.

The Government's active debt management policy and tax reforms are expected, respectively, to further reduce the debt service burden and to boost revenues. The resulting fiscal space will allow it to increase investment in physical infrastructure and to allocate more resources for operation and maintenance, as well as to raise allocations for basic social services, such as education, health, and safe drinking water.

The financial system, greatly strengthened by aggressively implemented reforms over the past several years, is also well positioned to support higher economic growth over the medium term. Such reforms, together with privatization, have resulted in a more resilient and efficient system that is better placed both to absorb macroeconomic shocks and to mobilize and allocate financial resources more efficiently. With four fifths of the assets of the banking system in the control of the private sector, political interference in the working of the system has been brought down to a minimum and, by and large, banks' lending decisions are based on economic considerations. As a result, the volume of NPLs has fallen significantly. Banks are extending their lending operations to new areas, such as consumer finance, which is propelling production of consumer durables such as automobiles and electronics. They are also helping growth in agriculture by sharply increasing both production and investment loans to farmers.

A significant improvement in Pakistan's relations with India in the last year has also enhanced the economic outlook, by reducing security concerns and by improving prospects of intraregional trade in South Asia.

Sri Lanka

High oil prices, growing fuel subsidies, and a drought in 2004 all impacted inflation, the budget deficit, and the balance of payments. The year ended in tragedy: more than 35,000 Sri Lankans perished in the tsunami on 26 December. Reconstruction and recovery is the first priority, but urgent economic reforms needed for long-term growth should not be forgotten.

Macroeconomic assessment of 2004

Growth in 2004 moderated slightly to 5.5% and remained driven by domestic consumption and fast-growing exports, with performance underpinned by the continuing cease-fire. Investment growth was not as high as anticipated, as two elections—both the parliamentary election in April, which resulted in a change in government, and a provincial council election in July 2004—produced economic and political uncertainty. A stalled peace process and uncertainty about how the new Government would approach negotiations with the Liberation Tigers of Tamil Eelam (LTTE) added to the prevailing atmosphere of hesitation. Privatization of parts of the retail arm of the Ceylon Petroleum Corporation with a foreign buyer was not carried through, and this brought down FDI inflows to 22.2% below the level of the previous year. Exports grew strongly, but significantly higher imports, mainly due to much larger oil payments, widened the current account deficit.

The mainstay of economic growth, the services industry, continued to thrive, growing rapidly at 8.1%. Banking sector performance, however, was not as strong as in 2003, as profit margins dipped following a reduction in interest rate differentials. Port services and shipping grew strongly, despite growing fears of increasing competition from the Indian market: 67% of cargo traffic is transshipment to or from India.

Agricultural output contracted by 1.8%, due to a drought. While not affecting plantation crops, the drought caused paddy production—most of which is on small-scale farms—to fall by 24%. The industry sector's performance was mixed: generation of hydropower, always prone to wide fluctuations, fell by 2%; but both the textile and garment and the construction subsectors recorded robust growth. Construction, which now accounts for about 7% of GDP, has benefited from a cease-fire building boom, mainly in privately financed projects.

Poverty levels, as measured by the head count poverty ratio, have overall declined only slowly, from 26.1% in 1990 to 22.7% in 2002, according to a survey carried out in each of those years. Given variations in the surveys' approach, which make direct comparisons difficult, income inequality seems to have increased, with the share of the lowest quintile declining from 5.2% to 4.8% over this period. Across a wide range of social indicators, Uva (the central province covering most tea plantation lands) and the east remain among the most disadvantaged in terms of access to economic opportunities, education, and general infrastructure. Following the availability of new preliminary data for the north and east in 2005 (except for those districts under LTTE control), the devastation as well as inequality in terms of basic services has been documented. For example, in the north, only 3% and 64% have access to water piped into the house and electricity, respec-

tively, compared with 52% and 93% in the relatively wealthy western province.

The hoped-for fiscal consolidation was not achieved and the budget deficit was virtually unchanged at 7.6% of GDP in 2004, owing to weaker than expected expenditure and revenue outturns in equal measure. High levels of fuel, wheat, and fertilizer subsidies to cushion the impact on consumers of sharp global price increases were the primary issue with respect to expenditure pressures, while weak tax administration and leakages continued on the revenue side. Moreover, lower inflows of foreign concessional loans resulted in a much larger than expected rise in domestic borrowing (SLRs65 billion planned as against SLRs119 billion actual) adding steam to an already rapid private sector credit expansion. Central government debt jumped to SLRs2,127 billion or 106.9% of GDP, from SLRs1,864 billion or 105.5%, though the impact of exchange rate changes on the external debt explains some of the increase.

Inflation accelerated sharply during the second half of 2004, reaching 16.8% on a December-to-December basis (Figure 2.20), and up by 7.9% on an annual average basis. Cost-push factors stoked inflationary pressures, especially higher global oil prices (which were slowly and not completely passed on to the consumer in the form of 38% and 23% price rises for diesel and gasoline, respectively) and drought-related food shortages (rice prices alone surged by over 40% in 2004).

Broad money (M2b) increased by 19.6% in 2004. Domestic credit accelerated to 22.4% from 7.6% in 2003, with private sector and net government credit advancing by over 20%. This put pressure on the balance of payments, which deteriorated markedly over the year. Policy lending rates are negative, even though the central bank put up its two key lending rates by 50 basis points in November 2004 to 7.5% and 9.0%, respectively. The average weighted prime lending rates of commercial banks rose to 10.23% at end-2004 from 9.26% 12 months earlier, while 91-day treasury bill rates stayed virtually unchanged (7.25% at end-2004). The stock market performed strongly in 2004: the All Share Price Index rose by 26.6% to end the year at 1,506.9, reflecting a capitalization of SLRs382.1 billion. The index continued its advance in the first quarter of 2005.

Table 2.18 Major economic indicators, Sri Lanka, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	5.5	5.2	5.8	5.9
GDI/GDP	25.9	27.0	27.0	27.0
Inflation (CPI)	7.9	12.0	9.0	7.5
Money supply (M2b)[b] growth	19.6	16.5	13.0	10.0
Fiscal balance[c]/GDP	-7.6	-8.0	-8.0	-7.0
Merchandise export growth	12.7	9.0	11.0	12.0
Merchandise import growth	19.3	17.2	8.5	6.0
Current account/GDP	-3.2	-5.8	-5.2	-3.0

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1996 factor cost. [b] Includes time and savings deposits held by commercial banks' foreign currency banking units. [c] Excludes privatization proceeds.

Sources: Central Bank of Sri Lanka, available: www.centralbanklanka.org, downloaded 7 March 2005; Ministry of Finance; staff estimates.

Swollen by both oil and non-oil products, imports are estimated to have risen by 19.3% in 2004. This led to a significant worsening of the current account deficit from $101 million to $626 million, equivalent to 3.2% of GDP. Exports grew solidly at 12.7%, buoyed as in the past by textiles and garments, but also this year by an impressive performance in rubber and tea, which were underpinned by significant global price increases. Workers' remittances, traditionally a major source of foreign currency, also continued to grow strongly, to $1.3 billion.

The depreciation of the Sri Lanka rupee against major currencies helped retain market shares in highly competitive textile and garment markets. The exchange rate relative to the dollar at end-2004 (SLRs104.5/$1) was 7.7% lower than a year earlier. Foreign exchange reserves fell sharply by about $0.5 billion to $1.8 billion by the end of the year, offering about 2.4 months of import cover. The reserve position was bolstered during the year by the issue of $250 million of Sri Lanka Development Bonds and by central bank negotiation of credit lines.

Macroeconomic policy developments

The approach of the new Government differs from that of the previous one: it has ruled out

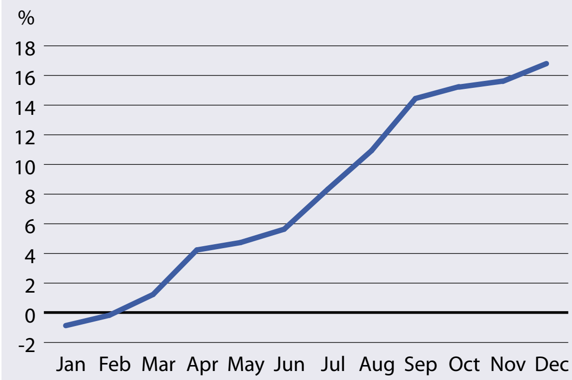
privatization of SOEs, but has announced that it is keen on restructuring them. It has also rejected the poverty reduction strategy paper developed by its predecessor, stating that it ignored the worsening regional inequality and failed to tackle poverty at its roots. The Government plans greater emphasis on direct poverty interventions and programs, and a greater role for itself in addressing increasing income inequality. However, it is not yet clear how it plans to tackle the difficult questions of reforming public utilities or of dealing with intractable land and labor issues. Discussions with IMF on a new Poverty Reduction and Growth Facility (PRGF) program are planned to take place during the first half of 2005. Finalization of a World Bank Poverty Reduction Credit was delayed because of a lack of structural reforms.

Previous governments grappled, largely unsuccessfully, with persistently weak performance of the revenue collection agencies, and the new Government also sees an improvement in revenue collection as its main priority. It has rejected the earlier administration's plans for creating a new autonomous revenue agency to improve revenue collection (a plan that faced significant labor union opposition). Instead, the Government aims to achieve change from within, and a revenue board, comprising members of all revenue collection agencies, is to be set up.

Weak revenue performance has important implications for both the size and efficiency of capital expenditures. This situation arises because new project starts are not sufficiently restricted, such that available revenues become spread too thinly over ongoing projects for them to be completed on time. Weak revenue performance slows donor-financed projects as well, since they generally require counterpart funding from the Government.

The first year's budget of the new Government presented in November 2004 envisaged further fiscal consolidation to bring down the deficit to 7.5% of GDP in 2005. At the same time, it incorporated much higher capital spending and a substantial real wage increase for civil servants. Fiscal consolidation was to be achieved almost exclusively through stronger revenue collection, primarily by a sharply higher tax on imports, but also by the elimination of most fuel and wheat subsidies in 2005. In addition to the standard 15% VAT rate and zero rate for exports, the budget announced two new rates—a 5% VAT on basic commodities and an 18% VAT on luxury goods. Capital expenditures will be ramped up by a nominal 50% to 5.8% of GDP. In addition, a 31% nominal wage rise in the civil service salary scale was made. The budget also planned a further civil service hiring drive for 30,000 trainees. The immediate impact of this latter effort on the wage bill is, though, relatively small, as the base salary is low, at SLRs3,000–5,000 a month for graduates. Since the new Government assumed office, it has created 70,000 additional government positions.

Figure 2.20 Inflation, year on year, Sri Lanka, January–December 2004



Source: Department of Census and Statistics, available: www.statistics.gov.lk/price/slcpi_monthly.htm, downloaded 28 February 2005.

The end of the MFA on 1 January 2005 has not yet had an identifiable adverse impact on the country's textile and garment industry. According to industry reports, the order books of the largest exporters are full through the first half of 2005. The Government had pinned hopes on reaching a free trade agreement with the US to reduce the impact of the loss of quotas by giving Sri Lanka's exports special tariff treatment and thus more preferable access to US markets. These hopes were not realized because national elections in both countries put negotiation of the agreement in abeyance. However, as a result of the tsunami, the EU is likely to include a larger number of textile and garment items in its preferential trade system. Consequently, 90% of textile and garment exports to the EU would then have zero-rated access.

While there is a backlog of important

economic legislation that has built up since the February 2004 election, the Government took action in July to create a Strategic Enterprise Management Agency. It is tasked with putting the 13 largest SOEs on a more commercial footing, without privatizing them. All enterprises, including the People's Bank and Ceylon Electricity Board (CEB), submitted business plans in October. The key issue for most enterprises under the agency's purview is to delink them from the political process, and allow tariff setting regulated by a fully functional public utility commission, to fully reflect enterprise costs, including an adequate return on invested capital.

In December 2004, the Government announced a phased approach to restructure the People's Bank, the largest state-owned commercial bank. The bank is burdened with heavy NPLs (over 17% of total loans) and excessive exposure (24% of total loans) in the form of advances to SOEs. The restructuring is tied to specific performance targets, reached in agreement with the People's Bank's labor union and management, on achieving levels of profitability and bringing down the NPL ratio to 9.7% by 2008.

The financial position of the CEB, the state-owned energy utility, has deteriorated substantially. Tariff increases of well over 40% would now be necessary to prevent it from incurring a loss. An attempt to raise the average tariff by 3% in November 2004 failed and the matter is now under consideration in the courts. Reform of the power sector was started in 1996 with the ultimate goal of unbundling CEB to improve efficiency, linked with a least-cost power generation expansion plan. This reform has not been seen through and no major additional power generation capacity (above 300 megawatts) is likely to come on line before 2009, a prospect that risks holding back economic growth.

Despite the mixed performance in 2004, the economy has proved remarkably resilient in the past, and continued to grow despite two decades of civil war. Its educated workforce, geographic location (next to a booming India), and its openness to international trade are important strengths. However, key policy issues—restrictive land regulations, expensive and unreliable power supplies, low agricultural productivity, rigid and nontransparent labor laws, as well as an overstaffed bureaucracy and inefficient public services—need to be tackled for the country to fulfill its substantial long-term growth potential.

Outlook for 2005–2007 and medium-term trends

The 26 December tsunami struck more than 1,000 kilometers, or two thirds, of Sri Lanka's coastline. Coastal infrastructure—as well as a large number of houses—was destroyed or significantly damaged, with an overall asset loss estimated at $1.0 billion, or 4.5% of GDP. Reconstruction costs, including upgrades, are estimated at $1.5 billion–1.6 billion. While the human loss was staggering, the impact on GDP growth might be relatively small, perhaps shaving less than 0.5 percentage point off expected growth in 2005 for an outturn of 5.2%. This is because neither the port of Colombo—through which most of the country's exports are channeled—nor the main production and exporting industries were affected. Only the fishing, tourism, and tourism-related subsectors, which together account for only about 3% of GDP, suffered extensive damage. Moreover, reconstruction activities, which are expected to be funded mainly by aid, and the easier access to EU markets should have an important offsetting impact.

Assuming reconstruction plans are implemented speedily, economic growth is likely to be 5.8% in 2006 and then rise to 5.9% in 2007. This expansion will be underpinned by strong growth in construction, the key sector in post-tsunami reconstruction activities. But tourism—which was in fact less damaged than fishing—should recover quickly, assuming that rebuilding and cleaning-up activities along the coast are not delayed.

In 2005 imports are estimated to increase by 17.2%, with much of the expansion attributable to reconstruction needs, but also by a higher oil bill. This suggests that the current account deficit for the year will nearly double to almost 6% of GDP, or about $1.3 billion. After the first year of tsunami-related imports, import growth is projected to fall to about 6.0–8.5% in 2006–2007. Export growth is projected at 9.0% in 2005 growing at 11.0–12.0% in the 2 subsequent years. The export performance assumes a solid performance of the textile and garment industry that

will benefit both from government programs to enhance productivity and preferential EU access.

The fiscal impact of the tsunami will be reflected in the budget over time. On 9 March 2005, a meeting of the Paris Club decided to grant a 1-year debt repayment moratorium for Sri Lanka. Interest rates, to be negotiated on a bilateral basis, will be capitalized. The precise details still have to be worked out, but the Government was due to pay some $500 million for debt amortization and service in 2005, including amounts due to international institutions. This will give it considerable fiscal breathing space.

With this relief and larger aid, the fiscal deficit is projected to increase only moderately from the original budgeted 7.5% of GDP to 8.0% in 2005 and 2006, and decline to 7.0% in 2007. Given the large pledging of donor funds, both from bilateral and multilateral sources, the Government should be able to finance reconstruction costs without resorting to domestic borrowing to the extent that it did in 2004. A framework to meet annual requirements and monitor assistance over the medium term is being established.

During the forecast period, numerous factors will put upward pressure on prices. These include the Government's commitment to reducing subsidies, especially for fuel; rises in utility tariffs; the substantial civil service wage increase in the 2005 budget; and the influx of donor funds that will work to raise salaries. Already, anecdotal evidence suggests that high demand for skilled labor from international agencies is leading to labor shortages; prices of construction materials are also reported to have increased. Inflation is projected at about 2 percentage points above earlier expectations at 12.0% in 2005. It will then likely moderate to 9.0% and to 7.5% over the next 2 years.

The greatest risks to growth stem, as in the past, from uncertainty in the peace process. Official peace talks between the LTTE and the Government have not taken place since April 2003, although both sides remain committed to maintaining the cease-fire, and to finding a peaceful solution. This uncertainty continues to stymie domestic and foreign investment. A wide-ranging investment climate survey conducted by ADB and the World Bank in 2004 identified the key impediments to private sector growth as weak infrastructure (e.g., lack of reliable power and reasonable roads), uncertainty over macroeconomic policies, and red tape. But following the tsunami, there is now an elevated risk that key economic reforms and investment in infrastructure will receive less attention than before, as more resources of both the Government and other stakeholders are focused on reconstruction.

Central Asia

Azerbaijan
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Azerbaijan

Set against impressive economic growth, which will continue as large oil sector investments begin production, rising inflation highlighted the underlying sensitivity of the macroeconomic environment. The Government should, though, take advantage of this prosperity to institute the necessary structural changes that will sustain strong performance and enhance welfare over the longer term.

Macroeconomic assessment of 2004

In line with the 10.7% average annual growth of the past 5 years, GDP grew by 10.2% in 2004. Progress in foreign capital investments in the oil and gas sector—namely the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, the Azeri-Chirag-Gunashli (ACG) oil fields, and the Shah-Deniz gas field and pipeline—provided the stimulus for the overall outcome. Industry, up by 12.2%, accounted for 62% of the GDP increase, with construction expanding by nearly 42%. Construction has benefited from the oil sector investments, as well as from a building boom in the capital and from foreign-funded infrastructure projects, and has more than quadrupled in size during the last 3 years. Despite agriculture's importance as an employer—accounting for nearly 40% of total employment—its 4.6% rise contributed only 5.9% to total GDP growth. Services expanded by 7.7%, reflecting mainly an upsurge in communications and trade.

Official unemployment remained low in 2004 at 1.5%, but this figure includes only individuals registered for unemployment assistance. The State Statistical Committee carried out a labor force survey in 2003 (following international standards), showing unemployment at 10.7%, with the urban rate double that of rural areas (14.0% versus 7.0%). Women suffered higher rates than men (12.2% versus 9.6%).

According to the latest figures from the 2002 household budget survey, nearly half of the population is living in poverty, based on monthly minimum consumption needs of food and nonfood items of AZM175,000 ($36) per person. Urban areas suffered somewhat higher rates than rural areas; this atypical outcome stems from the fact that the camps of internally displaced persons are located in urban areas.

In 2004, the Government continued to pursue a prudent fiscal policy. Revenues and grants were 25.0% of GDP, with VAT the main source of funds. Government spending reached 27.0% of GDP, partly stemming from increases in wages and energy subsidies. The overall deficit at 2.0% of GDP was somewhat less than in 2003. While small deficits have kept national debt levels low, the limited supply of treasury bills has created difficulties in managing the money supply.

Although high world oil prices in 2004 had a beneficial impact on growth and fiscal performance, price stability suffered. The efforts of the National Bank of Azerbaijan (NBAR) to avoid a nominal appreciation of the exchange rate, coupled with the thin treasury bill market, led to an unsterilized accumulation of foreign assets and a rapid expansion of the money supply. Although NBAR began in August to issue its own bonds to absorb liquidity, broad money still jumped by 47.5% over the year. Moreover, increases in some administered prices—notably retail prices for fuel—further aggravated inflation. By December, consumer prices were 10.5% higher than at end-2003, and average annual inflation for 2004 reached 6.7% (Figure 2.21). Although NBAR's

intervention efforts succeeded, with the average exchange rate against the dollar remaining essentially unchanged over the year, the real exchange rate appreciated somewhat because of the inflation differential.

Buoyant oil sector developments were reflected in the balance of payments as well. Exports grew by 31.5%, triggered by high world oil prices, such that the level of exports was nearly $3.5 billion, or 40.5% of GDP. Investment activities led to a rapid 25.2% expansion of imports, with the result that the level of imports was on a par with exports at 40% of GDP. While the trade account was virtually balanced, an increase in the large net services and income deficit (primarily associated with the oil sector) widened the current account deficit to 30.7% of GDP in 2004 from 28.3% a year earlier. As in recent years, net capital inflows, mainly FDI, exceeded the current account deficit and international reserves (including the oil fund) climbed by $284 million.

Table 2.19 Major economic indicators, Azerbaijan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.2	14.5	19.0	22.0
GDI/GDP	40.0	35.0	30.0	30.0
Inflation (CPI)	6.7	5.5	4.5	4.0
Money supply (M2) growth	47.5	31.0	35.0	38.0
Fiscal balance/GDP	-2.0	-1.1	-1.0	-1.0
Merchandise export growth	31.5	24.5	50.5	45.0
Merchandise import growth	25.2	7.5	-2.5	-5.0
Current account/GDP	-30.7	-20.0	-6.0	4.5

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

Sources: Ministry of Finance; National Bank of Azerbaijan; State Statistical Committee of Azerbaijan Republic; International Monetary Fund; staff estimates.

Macroeconomic policy developments

In November 2004, Parliament approved the 2005 budget, the first budget to be consistent with the Government's new long-term strategy on the management of oil revenues. This strategy appropriately provides for annual limits on the change in the non-oil deficit to guide fiscal policy. The budget targets a fiscal deficit of AZM579 billion (1.2% of GDP), using a projected world oil price of $25 per barrel in its calculations. Even accounting for the discount on the price of Azerbaijan's oil relative to Brent crude, on the assumption of higher prices it is likely that the budget deficit will be smaller than targeted, regardless of whether retail prices are adjusted to restrict the increase in the budgeted cost of domestic oil subsidies.

NBAR's stated policy target is inflation, but exchange rate management dominated actions in 2004. Remonetization of the economy has enabled the rapid money supply growth of recent years to be absorbed without it putting excessive pressure on the price level, but the reemergence of inflation in 2004 clearly shows that there are limits to this "inflation-free" monetary expansion. Since success in achieving inflation targets affects people's willingness to hold the local currency, the introduction of central bank bills gives NBAR a valuable tool to maintain price stability. Managing large foreign exchange inflows generated by the oil sector is a key policy challenge over the medium term.

The Government took several important steps in reforming the financial sector. In January 2004, it adopted the Banking System Law that is consistent with the Basle Core Principles, thereby fostering better corporate governance at commercial banks. Moreover, the law creates a level playing field by applying prudential requirements consistently across all financial institutions. In December 2004, the National Bank Law was enacted. This gives NBAR considerable independence to pursue monetary policy, but also holds it accountable for results. It also includes measures to improve the transparency of NBAR's operations.

Outlook for 2005–2007 and medium-term trends

The medium-term outlook for the economy is very positive, with the main driving force switching from investments in the oil sector to resultant production and export. The BTC pipeline should become operational by September 2005. The first phase of the ACG oil fields began production during the first quarter of 2005. Although the BTC investment is winding down, the Shah-Deniz gas field and its pipeline, plus further development of the ACG oil fields, will ensure that investment and construction remain dynamic. Additionally,

the Government has announced its intention to rehabilitate completely the east-west and north-south road corridors in the coming years. Moreover, NBAR will continue to resist undue real exchange rate appreciation to assist development of the non-oil sector, so as to avoid the deleterious effects of "Dutch disease." Accordingly, the outlook is for GDP growth to accelerate to 14.5% in 2005, rising further to 19.0% in 2006 and 22.0% in 2007.

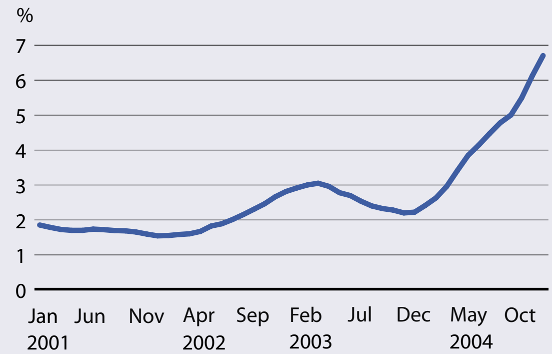
The authorities are expected to continue to pursue prudent fiscal and monetary policies over the medium term. Fiscal policy plans are consistent with the sustainable use of oil wealth, as laid out in the Government's long-term strategy on the management of oil revenues. For 2005, the Government is targeting a non-oil deficit of 16.8% of non-oil GDP that will rise to 18.7% by 2007, and the *ADO 2005* budget projections assume that these targets will be attained. With no major declines in world oil prices expected, the projected overall deficits of less than 2% of GDP should be met, even accounting for wage and pension increases planned for 2005 and the ambitious public investment program.

With greater foreign exchange inflows from the oil sector, NBAR will face challenges in balancing price and exchange rate stability. NBAR is targeting an inflation rate of 5% in 2005 and 2–3% in 2006–2007, but this will be difficult to achieve without some appreciation of the exchange rate. *ADO 2005* forecasts a somewhat higher rate of 5.5% in 2005, slowing to 4.0% by 2007.

The changing pattern of investment and hydrocarbon production will be seen in balance-of-payments developments. Export growth will accelerate sharply in 2006, as the first two phases of the ACG oil fields begin production, and moderate only slightly in 2007. Import growth, in contrast, will decline in 2005 as investment in the BTC pipeline and much of the work on the ACG oil fields is completed. Gas production from the Shah-Deniz field should begin in 2006, displacing some of the gas imports (and contributing to export growth). As incomes improve, growth in imports of consumer goods will offset part of the decline in capital goods imports, though total imports are projected to fall slightly in 2006–2007. Despite the fact that factor income outflows will rise as oil profits are repatriated, the current account will swing from a large deficit of 30.7% of GDP in 2004 to a surplus of 4.5% in 2007.

Growth in the non-oil sector hinges on progress in the structural reform agenda. Even though reform of the two state-owned commercial banks needs to be accelerated to create a truly competitive financial sector, policy changes in the sector mark a beginning—but more work is required to foster an economy with a diverse production base. Governance reforms, including enforcement of the anticorruption law passed in January 2004 and simplification of the bureaucratic requirements for businesses, are needed. Encouragingly, negotiations on the settlement of issues from the Nagorno-Karabakh conflict have shown some recent positive signs, and concrete progress would further enhance growth prospects.

Figure 2.21 Inflation, 12-month moving average, Azerbaijan, January 2001–December 2004



Source: State Statistical Committee of Azerbaijan Republic.

Kazakhstan

Rapid economic growth continued in 2004, and the medium-term outlook is positive. The Government has maintained its prudent macroeconomic and reform policies, and has also adopted programs for economic diversification. Successful implementation of current development priorities and creation of a conducive environment for the private sector will ensure sustainable, broad-based growth.

Macroeconomic assessment of 2004

The brisk economic advance of recent years continued through 2004 with GDP rising by 9.4%. The boom was fueled by a combination of high world oil prices, expanded domestic production, buoyant investment, strong domestic consumption, and prudent macroeconomic policies. On the supply side, an 11.5% rise in oil production—aided by high world oil prices and greater capacity at the Karachaganak and Tengiz oil fields in western Kazakhstan—was the main factor in the rapid 10.1% advance in industrial output. Other industrial components were also buoyant: manufacturing grew by 8.9%, spurred by the engineering and chemical subsectors (up by 32.5% and 11.5%, respectively), while construction strengthened by 11.2%, reflecting significant investment in housing and infrastructure in the new capital, Astana. Based on the broad-based expansion in activity and incomes, the services sector increased by 10.8%, in part driven by vibrant banking and financial services activities. Meanwhile, the agriculture sector grew by only 0.1%, well below its historical average, mainly due to a poor harvest caused by bad weather conditions.

On the demand side, strong private consumption, generated primarily by large increases in real incomes and bank credit, was a major source of the economy's advance, as was (to a lesser extent) a surge in government spending. Investment rose by 10.6%, mainly due to large private foreign investment in oil and gas, private domestic investment in housing, and public investment in manufacturing and transport. A 66% surge in net exports contributed 0.9 percentage point to GDP growth.

Continuing economic growth has resulted in higher living standards. According to official statistics, real per capita income grew by 13% in 2004 while unemployment declined from 8.8% in 2003 to 8.4% at end-2004 (Figure 2.22). This reflected the increased demand for qualified workers in certain areas (construction, services, and agriculture) and the impact of government measures for reducing unemployment through a public works program, providing training for the unemployed, and supporting SME development to create jobs. The Government also strengthened the Labor Code during the year to protect employee rights, and improved safety regulations. The share of the population living below the subsistence minimum (T5,427 or $40) fell from 19.8% in 2003 to 15.0% in 2004, reflecting the economic expansion and the impact of the Poverty Reduction Program for 2003–2005. Improving living standards remains a major challenge in many rural areas, however, and reducing the urban–rural gap is a current development priority.

The general government budget, inclusive of the large savings of oil revenues made by the National Fund of Kazakhstan (NFK), recorded a surplus of 2.3% of GDP in 2004. The cautious

fiscal stance helped restrain aggregate demand and mitigate inflationary pressures in the context of large current and capital foreign exchange inflows during the year.

Excluding the NFK savings of 2.6% of GDP gives a small budget deficit of 0.3% of GDP. Despite tax cuts amounting to an estimated 1.2% of GDP, general budget revenues rose to 23.5% of GDP (excluding the NFK), reflecting strengthened tax administration, high world oil prices, and one-time payments related to oil and gas. Total budget expenditures grew to 23.8% of GDP, driven largely by higher expenditures on education, health, and social welfare; the state housing program; the Industrial-Innovative Development Strategy 2003–2015 (to foster economic diversification and technological upgrading); and public sector investments in Astana and Almaty. Total public debt in 2004 rose by 7.5% to $5.1 billion (12.1% of GDP), entirely reflecting increased domestic borrowing as the outstanding external debt component declined by 11.0% to $2.7 billion.

Monetary aggregates climbed rapidly in 2004. Nevertheless, inflation at 6.9% for the year was held just within the revised inflation target of the National Bank of Kazakhstan (NBK) of 5.6–7.0%. Higher prices for gasoline, transport services, and utilities contributed cost-push inflationary pressures, which also felt the demand-pull of rapid monetary expansion (M2 accelerated to 36.4% from 27.0% in 2003). Credit to the economy spiraled up by 51%, with banks giving priority to consumer, housing, and SME financing. Interest rates remained broadly stable. Remonetization of the economy has helped keep inflation within the NBK target; the ratio of M2 to GDP increased to 25.8% in 2004.

NBK continued its interventions in the market to prevent excess of volatility and undue appreciation of the exchange rate. There were pressures on the tenge due to a surge of inflows related to exports and FDI as well as greater external borrowing by the private sector. Over 2004, the tenge appreciated in real terms by 15.3% against the dollar, 7.0% against the euro, and 1.3% against the Russian ruble. The real effective exchange rate appreciated by 5.9% year on year, eroding domestic producers' price competitiveness.

Exports soared by 53.7%, propelled by high world oil and metal prices in 2004. Although imports also shot up by 47.7% as a result of strong domestic demand, the trade surplus expanded by two thirds to $7.0 billion. While the usual deficits on the net balances in services, income, and current transfers widened (mainly due to hydrocarbons operations), preliminary data suggest that the current account switched to a surplus of 1.6% of GDP ($0.7 billion). Total international reserves (including the assets of the NFK) improved by $5.7 billion to $14.3 billion at end-2004. Of this total, NBK's net international reserves amounted to $9.3 billion (or 6 months of imports of goods and services). External borrowing by commercial banks, in response to offers of attractive rates and long maturities, increased substantially during the year to bring outstanding external debt (excluding intracompany debt) from 29.3% of GDP in 2003 to 34.2% at end-2004.

Table 2.20 Major economic indicators, Kazakhstan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	9.4	8.5	8.0	8.0
GDI/GDP	25.1	25.9	26.4	25.4
Inflation (CPI)	6.9	6.0	5.7	5.3
Money supply (M2) growth	36.4	26.7	22.4	22.6
Fiscal balance[a]/GDP	-0.3	-1.2	-1.0	-0.9
Merchandise export growth	53.7	14.2	15.0	17.3
Merchandise import growth	47.7	16.3	18.2	23.7
Current account/GDP	1.6	1.0	1.3	1.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Excluding the National Fund of Kazakhstan.

Sources: Agency on Statistics of the Republic of Kazakhstan; Ministry of Finance; National Bank of Kazakhstan; staff estimates.

Macroeconomic policy developments

Underlining its commitment to prudent macroeconomic policy management, the Government took several major fiscal policy initiatives in 2004, including the development of the first medium-term fiscal policy for the period 2005–2007 (approved in September 2004) and improvements to the budget code. The objectives of the former are to improve the efficiency of government spending, ensure stability of government revenues,

and more consistently achieve the targets of development programs. In similar vein, the Government is considering adopting target limits on the non-oil budget deficit in an attempt to reduce volatility of oil-revenue fluctuations on fiscal policy, a step advocated by IMF.

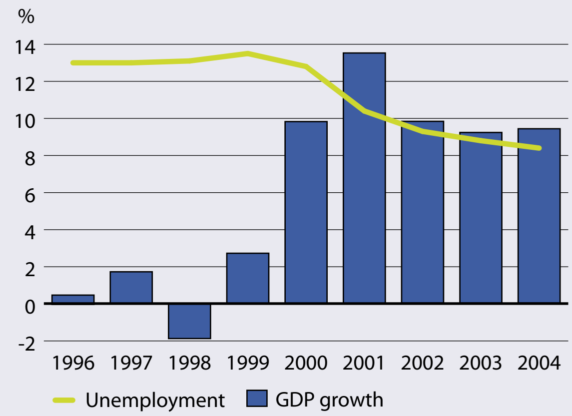
The changes to the budget code have provided a basis for greater transparency in budgeting and a clearer delineation of financial responsibilities between central and regional governments. For example, expenditures on health, social assistance to invalids, and special education programs were transferred to local budgets while spending on fire prevention and special state allowances were kept in the central budget. Furthermore, budget transfers were fixed for a 3-year period, allowing local governments to better plan their medium-term budgets.

The Government has continued to strengthen the financial sector in order to assist economic diversification and private sector development, and articulated a number of policy initiatives including promotion of a stock market, pension system reform to improve asset management, modern risk-management systems for commercial banks and pension funds to facilitate investments in foreign securities markets, and development of insurance markets. The independent Financial Supervision Agency, established in January 2004 to oversee financial institutions, is now formulating a detailed action plan to implement these policy initiatives.

Following the establishment of the agency, NBK has concentrated on its macroeconomic policy functions. As part of its objective of price stability, NBK plans to adopt an inflationary targeting framework by 2006, and has developed a set of core inflation indicators that are closely monitored. To keep inflation within the target range in 2004, NBK conducted open-market operations to contain excess liquidity and growth in broad money. It also increased bank reserve requirements and raised the refinance rate from 7.0% to 7.5%.

The Government has strengthened efforts to diversify the economy through the development of nonextractive sectors. The Industrial-Innovative Development Strategy aims to develop priority nonextractive sectors in the context of a competitive economy. Detailed studies have identified seven priority clusters: tourism, oil and gas engineering, food, textile, logistics services, metallurgy, and construction materials. These clusters are expected to facilitate development of industrial bases outside the extractive sectors. State-owned funds supporting the strategy have identified 24 projects for assistance and a further 350 are under consideration. The Government's efforts to support food industries will help prepare agriculture and agro-industries for WTO accession, while government infrastructure investments are being undertaken to provide an environment conducive to developing non-oil industries.

Figure 2.22 Unemployment and GDP growth, Kazakhstan, 1996–2004



Source: Agency on Statistics of the Republic of Kazakhstan, available: www.stat.kz/ru/index.shtml.

In addition, promoting a favorable environment for SMEs is among the Government's key development efforts, including streamlining of administrative procedures for business operations and setting up a small business development fund to help finance SME business opportunities.

While making efforts toward economic diversification, the Government is also seeking to ensure balanced, inclusive growth through support to rural areas. Priority programs are supporting the rural population. The 2004 budget allocated an additional T30 billion for rural education and health. A detailed medium-term plan for rural infrastructure has been prepared and the Government is planning to augment the 2005 budget by T100 billion with a large part directed to rural areas.

Outlook for 2005–2007 and medium-term trends

The economic outlook for the next 3 years is positive. Economic diversification remains a priority for reducing the impact of external shocks to the economy, and the Industrial-Innovative Development Strategy is expected to play an important role in promoting a larger non-oil sector. In the medium term, however, the oil and gas sector will remain the principal engine of economic expansion, with services, construction, and manufacturing continuing to play their supporting roles.

GDP growth is forecast to moderate to 8.5% in 2005, reflecting some easing in world oil prices and a softening of global growth. Oil production is expected to rise from 56 million tons in 2004 to 69 million tons in 2007. In 2006–2007, economic growth will likely continue at around 8%, on the back of accelerated activity in the non-oil sector stemming from economic diversification. These projections, of course, are sensitive to factors such as world oil prices, global demand, as well as the actual response to government policies and incentives in the non-oil sector.

The fiscal position is expected to remain strong in the medium term, since growing oil revenues and improvements in tax administration are expected to offset plans for additional tax cuts and to cover nearly all planned expenditures. Estimated revenue performance and future medium-term spending plans (particularly on infrastructure development, employment creation, and social welfare) indicate that the general budget deficit (excluding the NFK) will be in the range of around 1% of GDP in 2005–2007.

Fueled by increases in public sector wages and expansion in the money supply, inflation is expected to again be at the higher end of the current NBK target range (4.5–6.5%). Inflation of 6.0% is projected for 2005, moderating to 5.7% and 5.3% in the next 2 years. The tenge is expected to continue appreciating but a weakening in world oil prices would halt this. Despite NBK plans to adopt an inflationary targeting policy in 2006, it will most likely continue sterilized intervention operations to prevent an undue appreciation of the exchange rate, as development of the non-oil sector is a key priority.

Exports of goods will likely remain buoyant at the level of $20 billion–35 billion given expected world prices for Kazakhstan's major commodities (oil and metals), and projected production trends. Driven by anticipated strong domestic demand, imports of goods are set to rise to around $15 billion in 2005 and to about $23 billion in 2007. The trade balance is forecast to record a surplus in the medium term, scaling up from $7.7 billion in 2005 to $8.6 billion in 2007. The current account balance is projected to be positive at around 1–1.5% of GDP over 2005–2007, despite a rising trend deficit in services, income, and current transfers as payment outflows grow, especially of foreign investors' earnings.

Continued economic expansion will help improve living standards. According to official forecasts, the Government's efforts to reduce the urban–-rural gap and to strengthen the social safety net for vulnerable people are expected to bring down the number of people living below the subsistence minimum to 10% by end-2007. However, improvements in living standards will depend substantially on new job creation by the private sector. In this regard, the ongoing measures to diversify the economy are likely to play an important part. A new state program on employment, approved in January 2005, sets specific measures to promote employment in SMEs and tourism, where two thirds of the targeted nearly 1 million new jobs are to be created during the next 3 years.

Kyrgyz Republic

Economic performance was robust due to favorable external conditions and prudent macroeconomic management, though excessive dependence on gold production, a high debt burden, and low levels of saving and investment threaten sustainable economic growth. Such growth requires diversification of exports, implementation of reforms to improve the business environment, restructuring of external debt, and fiscal consolidation.

Macroeconomic assessment of 2004

Belying expectations, GDP grew very rapidly in 2004, by 7.1%, underpinned by strong external demand and prudent macroeconomic policies. Agriculture, aided by favorable weather conditions and an improved external environment, expanded by 4.1%. Despite a setback to gold production, which has a 45% weight in industrial production, the industry sector grew by 3.5% as non-gold industrial output jumped by 6.7%, reflecting strong gains in electricity generation, food processing, chemicals, transport equipment, and coal. Of greatest importance, however, was the services sector. With a 32% share in GDP, it saw a large 11.7% expansion. A combination of higher tourist arrivals, buoyant foreign trade, and the introduction of a lump-sum tax (the "patent system") on small businesses, which brought some of their activities into the registered sector, contributed to this strong performance. Gross domestic investment, having fallen from 17.6% of GDP in 2002 to 16.2% in 2003, may have recovered to 19.0% in 2004, despite an estimated decline in the externally assisted public investment program. This suggests a welcome pickup in private investment. Gross domestic saving is also expected to improve.

Broad-based growth in non-gold output (at about 5% annually since 2000), low inflation, increased real wages, and a decline in income inequalities contributed to an overall improvement in living standards. The incidence of poverty fell from 55.3% in 1999 to around 41% in 2003, and preliminary estimates indicate a further decline to about 39% in 2004 (Figure 2.23). Nevertheless, poverty is still a major problem, especially in rural areas where some three quarters of the poor live.

The Government is estimated to have met the 2004 budget deficit target of 4.3% of GDP, an improvement on the 5.1% deficit recorded in 2003. Fiscal consolidation was achieved by an increase in tax revenues and cuts in nonsalary current and capital expenditures. Better tax administration and the measures taken to widen the tax net improved revenue performance. The external debt burden is large but falling, from 102% of GDP at end-2003 to an estimated 92% of GDP 12 months later. Since 91% of the external debt is public, it is an important determinant of fiscal sustainability.

High demand for money has sustained a substantial monetary expansion in recent years without causing inflation. Broad money grew by 32.0% in 2004 on top of a 33.5% increase in 2003. The growing coverage of credit unions in rural areas and improved availability of microcredit have propelled the rapid monetization process. Weighted average interest rates fell marginally, but remained high at 24.6% for domestic currency loans and 19.2% for foreign currency loans. The entry of a number of foreign banks, which now own about half of banking assets, seems to be

rekindling public confidence in the banking sector. The level of financial intermediation remains low, however. Consumer price inflation was 4.0%, associated largely with higher prices of energy, food, and public services.

Preliminary data indicate strong growth in foreign trade in 2004. Merchandise exports expanded by 23.8%, with a significant contribution from non-gold exports. Increased demand in the rapidly growing economies of Kazakhstan and the Russian Federation accelerated exports of a wide range of goods. Merchandise imports were up by 24.6%, reflecting strong consumer demand. The trade gap widened to $171 million and, though private remittances accelerated, the current account deficit is estimated to have reached $115 million, or 5.2% of GDP. Net FDI inflows grew to about $122 million during the year. Together, FDI inflows, government portfolio sales, and official aid covered the deficit and helped raise gross international reserves to $565 million, providing about 7 months of merchandise import cover. The Government maintains a managed floating rate regime. The som appreciated against the dollar by 5.1% in nominal terms during the year but this seems not to have affected competitiveness.

Table 2.21 Major economic indicators, Kyrgyz Republic, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	7.1	5.0	5.5	5.5
GDI/GDP	19.0	22.4	22.6	22.7
Inflation (CPI)	4.0	4.6	4.0	4.0
Money supply (M2) growth	32.0	15.0	15.0	15.0
Fiscal balance/GDP	-4.3	-4.3	-4.1	-3.7
Merchandise export growth	23.8	3.9	10.0	9.7
Merchandise import growth	24.6	9.3	7.8	6.7
Current account/GDP	-5.2	-5.8	-4.6	-3.3

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

Sources: Ministry of Finance; National Bank of the Kyrgyz Republic; National Statistical Committee; International Monetary Fund; staff estimates.

Macroeconomic policy developments

Structural reforms in 2004 focused on two areas—strengthening governance in both public and private sectors to create a conducive business climate, and improving public resource management.

Corruption, poor governance, and a weak judicial system have emerged as major impediments to private sector-led, pro-poor economic growth. A new national anticorruption strategy was adopted and the UN Convention against Corruption was ratified by Parliament in 2004. All government officials are now mandated to declare their income and wealth. A three-member council was constituted in September 2004 to manage and regulate the civil service as a prelude to comprehensive civil service reform. In addition, a Law on Fundamentals of Technical Regulation was introduced to make public consultation compulsory before any new business-related law or regulation is introduced, or existing ones amended. This will minimize the risk of introducing conflicting and excessive regulatory measures. The Law on Joint-Stock Companies was further amended in 2004 to align it with international best practices and to remove contradictions with the legislation governing banking regulation. The Government took further steps to implement international accounting standards in large joint-stock companies. Parliament also enacted the Bank Insolvency Law for expeditious liquidation of problem banks. The Law on Pledge was approved in January 2004 to bring it into line with international norms. This law is expected to protect creditors' rights; it should also help bring down interest rates as debtor behavior becomes more disciplined.

The Government has continued its efforts to broaden the tax base and improve tax administration. The customs code was revised and simplified to bring it in line with WTO requirements and the revised Kyoto convention, and came into effect on 1 January 2005. The Government has also improved coordination between the customs administration and the state tax inspectorate, and prepared a comprehensive plan to modernize the former. In addition, the tax code is being revised to simplify taxation, rationalize the rate structure, and make the tax system investment friendly without sacrificing revenue. The new tax code is likely to be adopted in 2005.

The Paris Club of creditors provided debt relief

to the Government in March 2005 in the form of cancellation of 50% of credits given on commercial terms (about $124 million) and rescheduling repayment of the remaining balance of such credits over 23 years with a 7-year grace period. The repayment of bilateral official development assistance of about $306 million has been rescheduled over 40 years, with a 13-year grace period. Even after receiving debt relief on concessional terms in 2005, debt parameters are likely to remain above the World Bank's Heavily Indebted Poor Countries threshold until 2008, and the debt situation will remain vulnerable to external shocks. Continued focus on fiscal consolidation is critical for fiscal sustainability and for providing adequate resources for social services and public investment.

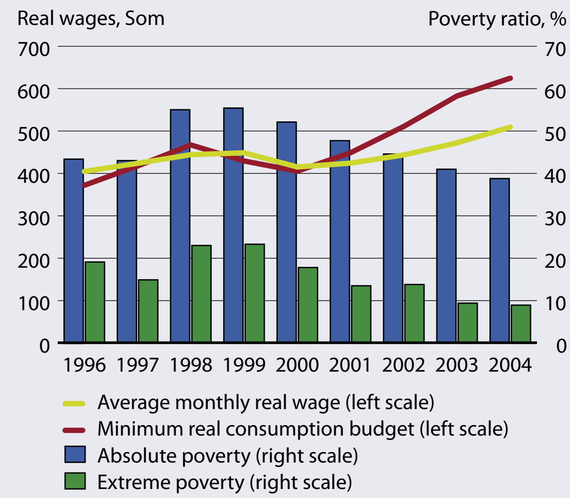
The Government made progress in privatizing key public sector enterprises. The Kairat Bank was privatized, leaving only one bank in the public sector. Efforts to privatize KyrgyzTelecom to a consortium of German companies hit a roadblock after Parliament raised questions about the process. Reforms in the electricity sector, which generates a huge quasi-fiscal deficit (11% of GDP in 2003), made little headway over the year. The Kumtor Gold Mining Company was, in effect, privatized, with the Government swapping its two-thirds stake in the company for a one-third stake in Centerra Gold Inc., a newly formed holding company listed on the Toronto Stock Exchange. Subsequently, the Government sold a part of its stake in Centerra Gold Inc. and deposited the proceeds of $86 million—earmarked for poverty reduction projects—in its account at the National Bank of the Kyrgyz Republic.

Outlook for 2005–2007 and medium-term trends

The medium-term outlook for the country, though positive, is subject to several risks, especially to higher oil prices and lower gold prices on the economic side. On the political side, the March 2005 uprising and apparent change of government appear to be related mainly to governance issues rather than to economic policy. However, it will take some time to assess the full impact of these events on the economic outlook.

For the *ADO 2005* projections, GDP growth is expected to decelerate to 5.0% in 2005,

Figure 2.23 Real wages and poverty, Kyrgyz Republic, 1996–2004



Sources: National Statistical Committee, *Social Development of the Kyrgyz Republic* (various issues); staff estimates.

reflecting depletion and continued decline in gold production at the Kumtor gold mine. This could be offset to some extent in 2006–2007 if production begins as scheduled at the Jerui and Taldy-Bulak mines. The start of operations there will increase gross domestic investment to over 22% of GDP and widen the current account deficit to close to 6.0% of GDP in 2005. Inflation is targeted at 4.6% for the year and is projected to moderate to 4.0% in 2006 and 2007. The 2005 fiscal deficit target was fixed at the same level as in 2004, at 4.3% of GDP; thereafter it is projected to fall, to 3.7% of GDP by 2007.

Diversification and expansion of non-gold industrial activity—especially export-oriented areas—fiscal consolidation, implementation of structural reforms, and pursuit of sound macroeconomic policies are crucial to achieving sustainable growth. The country needs to align its production and exports with the evolving demand in neighboring countries, particularly PRC, Kazakhstan, and Russian Federation. In this context, agriculture—including high-value crops, agroprocessing, and animal husbandry—light industry, and tourism have considerable untapped potential if better technologies are introduced. Proactive pursuit of subregional cooperation in the areas of trade, transport, and transit is needed to ease transit problems and costs.

Tajikistan

Following a period of robust growth that was grounded in recovery from the low base after the civil war and in strengthening export prices, a slowdown is expected in the medium term, though reforms under the Poverty Reduction Strategy Paper are likely to maintain the tempo of poverty reduction. Further domestic policy reform, economic diversification, and stronger regional cooperation could put the economy back on a high-growth track in the longer term.

Macroeconomic assessment of 2004

Building on annual average growth of 9.5% since 2000, the economy showed strong performance in 2004. GDP grew by 10.6%, due primarily to gains in light manufacturing and the fast-growing services sector, particularly trade and other market services. This outcome broadly follows the realignment observed in 2003 to broader-based growth beyond the traditional engines of cotton and aluminum. While cotton production is estimated to have expanded by 4%, aided by favorable weather conditions, the agriculture sector nevertheless remains hobbled by structural constraints, such as limited access to inputs and inadequate marketing and credit systems, as well as a deteriorating irrigation system and obsolete agricultural machinery.

In the industry sector, aluminum production is estimated to have grown by 9.4% in 2004 as higher global prices strengthened earnings at the large Tajik Aluminum Smelter.

On the expenditure side, growth continued to be fueled by demand from rapidly rising workers' remittances, financing higher consumption and investment expenditures.

Notwithstanding reforms to date, government officials still function in a command and control framework, hampering an enabling environment for private enterprises to operate. Accordingly, privatization of SMEs remained slow during the year. Reinforcing this trend, the Government's emphasis on large-scale industrial projects has slowed the impetus for development of small private sector enterprises that have a significant employment potential.

Strong growth, policy reforms, and a favorable economic environment led to a sustained reduction in poverty from 82% in 1999 to 64% in 2003, based on a daily $2.15 per capita purchasing power parity expenditure poverty line. Per capita nominal GDP is estimated to have grown from $236 in 2003 to $269 in 2004, but this is still way below $1 a day. Significant regional differences in poverty persist. Moreover, inequality has worsened and is higher in Tajikistan than in other low-income countries in central Asia.

One result of these developments is that poverty and a lack of proper facilities keep school attendance low, while inadequate funding has led to a severe shortfall of teachers, as many have moved to better-paying jobs. Economic opportunities are still sparse, which encourages continuing outward migration.

Those engaged in cotton farming—the largest source of employment and the core of the agriculture sector—account for three quarters of all farmers. Yet cotton farming suffers from restrictive financial practices (contract farming), low productivity, official intervention in farm decisions, and poor marketing. Reflecting this, cotton farm debt owed to banks and investors is estimated to

have increased from $180 million at end-2003 to $230 million at end-2004, as falling cotton prices over the year exacerbated structural weaknesses.

Through rationalized tax and fiscal policies, the budget in 2004, excluding the externally financed public investment program (PIP), was kept in surplus, at 0.3% of GDP. In exchange for a space-monitoring center, the Russian Federation in 2004 wrote off $250 million of its total debt of $300 million owed by Tajikistan. Debt-restructuring negotiations with bilateral creditors reduced external public debt from $1.0 billion or 66.3% of GDP at end-2003 to $822 million or 41.1% of GDP at end-2004. The improved external debt outlook allowed the limit on the PIP to be raised from 3% to 4% of GDP.

The National Bank of Tajikistan adhered to all of its monetary policy targets in 2004. Strengthened execution of monetary policy and a stable nominal exchange rate contributed to a substantial reduction in inflationary pressure. From 17.1% in 2003, inflation in 2004 fell to 6.8%, within the Government's target of 7%. With the repeal of 30% duty on remittances, more people used banking channels to send funds from abroad and flows through formal banking channels reached $300 million in 2004 (about 15% of GDP). This was also reflected in an upward trend in domestic bank deposits over the year.

With higher import prices and a drop in cotton export prices, the trade deficit is estimated to have risen to $290 million or 14.5% of GDP in 2004 from $204 million in 2003. Mainly reflecting price developments, over this period the share of cotton fiber in exports fell from 24% to 16% while the share of aluminum increased from 54% to 62%. Despite high global oil prices and a decline in prices for cotton, the current account deficit in 2004 was kept relatively low at $46 million or 2.3% of GDP (1.3% in 2003) due to the larger inflow of workers' remittances. The overall balance-of-payments position was in surplus; preliminary data indicate that foreign exchange reserves were $192.9 million at end-2004, the equivalent of 2.2 months of imports.

Macroeconomic policy developments

The Government has been pursuing an economic and financial reform program supported by IMF's Poverty Reduction and Growth Facility (PRGF) over the past 2 years. The fiscal reform measures initiated in 2003 were consolidated in 2004 through a new tax and customs code compliant with the requirements of WTO, which was passed by Parliament for implementation effective 1 January 2005. Moreover, the Tajik Aluminum Smelter and Barki Tajik (the state power company) are now required to make full tax payments. Based on a new tariff policy, also beginning on 1 January 2005, a mechanism of quarterly adjustments will be implemented to raise power prices over the next few years to cost-recovery levels and to maintain gas tariffs at their real end-2003 (cost-recovery) level. These moves represent an attempt to make the energy sector self-sufficient, addressing the issue of large arrears (mainly in power) that amounted to about 20% of GDP at end-2003. A compensation mechanism introduced in 2003 mitigates the impact of energy price increases on the poorest 20% of the population.

It is estimated that improved governance has led to better internal security and higher living standards. Good governance received enhanced emphasis from donors at a consultative group meeting in November 2004, which also drew attention to a slowdown in the reform drive and emergence of serious governance issues. Corruption, though less severe, persists,

Table 2.22 Major economic indicators, Tajikistan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.6	8.0	6.8	5.9
GDI/GDP	-	-	-	-
Inflation (CPI)	6.8	7.1	5.0	5.0
Money supply (M2) growth	26.7	17.8	-	-
Fiscal balance[a]/GDP	0.3	-0.5	-0.2	-0.1
Merchandise export growth	15.4	2.2	5.4	6.8
Merchandise import growth	20.8	7.9	6.6	7.2
Current account/GDP	-2.3	-5.2	-5.9	-6.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Excluding the public investment program.

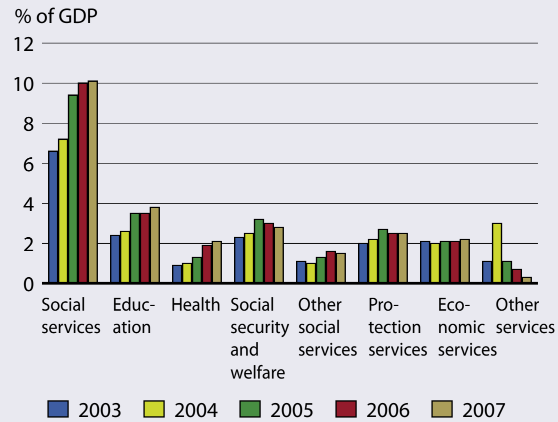
Sources: Ministry of Finance; National Bank of Tajikistan; State Committee on Statistics; International Monetary Fund; staff estimates.

preventing to some extent the Government's efforts to fulfill its obligations in many public sectors, such as education and health. Indicators in these sectors have deteriorated since independence. To address such problems, the Government is spending more on the social sector, especially education and health, through the 2005 national budget passed by Parliament in December 2004 and the medium-term budget framework (Figure 2.24). This increase is partly financed through a reallocation of spending from noncore social services and savings in interest payments resulting from debt write-offs. The Government will also continue efforts to improve local service delivery and the quality of public services by strengthening local government capacity and by fostering a favorable investment climate for developing the private sector.

The civil service reform that began in 2003 is raising public sector wages and reducing staff numbers in phases. In continuation of this initiative, a major structural reform of public administration consonant with the transition to a market economy was approved in 2004. Key ministries will be restructured and streamlined. Departments are to be grouped according to function and noncore functions eliminated. As part of the PRGF program, there will be an upfront reduction in staff positions of 3–5% to accommodate substantial public sector wage increases geared to structural changes in agency operations that enhance productivity. These higher wages are intended to boost worker performance and improve the quality of hirees. This scheme has been approved by Parliament and will be implemented in five *raions* (districts).

Monetary policy in 2004 was designed to bring down inflation by improving liquidity management. Operations in the foreign exchange market helped keep the exchange rate stable. Under the PRGF agreement, the National Bank of Tajikistan has stopped providing credit to the banking sector (except for true lending of last resort) and it is to pay no dividends. Both policies aim to ensure better control over growth in reserve money. To assist commercial banks in their operations, the central bank is to help develop mechanisms for interbank lending. An innovation for 2005 is the plan of the Ministry of Finance to issue and auction short-term treasury securities.

Figure 2.24 Public spending on social and economic services, Tajikistan, 2003–2007



Sources: Tajikistan authorities; International Monetary Fund estimates.

Reforms in the agriculture sector have been slow. The enormous cotton debt that has been accumulated requires cotton farms to repay $65 million credit annually before the start of the new season. Building on an initiative in 2004, the Government, with donors, has developed a two-track comprehensive solution to the farm debt problem: measures to address debt reduction and the introduction of more competition in marketing, and the elimination of intervention in producer decisions related to cotton production.

The Government is seeking to integrate the economy with foreign markets, particularly through regional cooperation with neighboring countries. In this regard, a recent agreement with the Russian Federation is to generate a substantial investment in the energy sector while Iran is to invest in the Sangtuda hydropower plant and the Anzob tunnel in the north. A new road between Tajikistan and the PRC, laid in 2004, will facilitate better trade with that country. The Government has also sought cooperation with Afghanistan on establishing power, transport, and trade links.

In its preparation for accession to WTO, the Government is developing a domestic and external trade regime and will need to balance its tax harmonization commitment to its subregional country customs partners against WTO requirements of reduced tariffs. Having implemented a WTO-compatible tax code, it also plans to bring relevant laws into line with WTO requirements.

Outlook for 2005–2007 and medium-term trends

The high GDP growth achieved in the last several years depended to a large extent on external factors such as export earnings that were boosted by higher international prices and ever-growing workers' remittances. However, cotton and aluminum, the two major export products, are susceptible to price volatility that can impact both export earnings and tax receipts. Due to anticipated global price trends and capacity constraints in aluminum production, a slowdown in growth is expected in the medium term.

Consequently, GDP growth is projected at 8.0% in 2005 with the downtrend continuing to about 6% by 2007. The impact of, for example, strengthened domestic policies, development of markets, accelerated investments in infrastructure and industry, as well as more effective use of development aid is likely to be felt only with a lag.

Policy changes in the agriculture sector could boost agricultural productivity and contribute to growth, since the Government now has a better appreciation of the importance of diversifying farm production to achieve higher growth. Resolution of the cotton farm debt issue and accession to WTO would allow better access to foreign markets and would expand the scope for a market-based strategy, allowing farmers to allocate crops based on profitability.

The budget for 2005 envisages the fiscal deficit to be limited to 0.5% of GDP. Total budgetary expenditure (excluding the PIP) is estimated to rise to 18.2% in 2005. Social sector spending is emphasized, and is projected to increase markedly from 6.6% of GDP in 2004 to 7.2% in 2005. Government revenues are also anticipated to rise to 17.7% of GDP due to the implementation of new measures on tax and customs codes, despite a decline in sales tax revenues stemming from the drop in cotton prices. Revenue measures include new taxes on businesses and a unified land tax.

External debt is projected to fall from 41.1% of GDP in 2004 to 37.5% in 2005, reflecting the impact of successful debt negotiations; it should stabilize at about 35% of GDP thereafter. Future debt service obligations would see a steep fall to 10.1% of exports in 2007, down from 49.2% in 2004, giving fiscal space for social expenditures. The budget deficit (excluding the PIP) in 2006–2007 is expected to be very small, at about 0.1–0.2% of GDP.

Inflation is expected to remain under control, bearing witness to improved implementation of monetary policy. It is expected to be 7.1% in 2005, reflecting pressures from wage adjustments granted in the budget, and then to moderate to 5.0% in the following 2 years.

In the face of export growth slowing to 2.2%, large hydropower projects will mean a faster expansion in imports, of 7.9%, than exports, which will substantially raise the current account deficit in 2005 to 5.2% of GDP. Larger capital inflows and external aid are projected to more than offset this and allow for some increase in gross international reserves. The current account deficit is likely to widen to 6.5% by 2007, mainly due to continued high levels of project implementation.

While poverty has declined in Tajikistan, it is still the highest among the Central Asian republics, and the country remains one of the poorest in the world. High growth and climbing per capita income mask rising inequality, and provision of adequate social services remains a challenge.

Economic developments so far indicate that it is unlikely that growth will be sustainable at high levels without structural reforms. Although the prospects for the medium term are for moderate growth, the long-term prospects could be brighter, but they depend on the strength of actions taken on domestic policy reform and on institutional change that the Government is undertaking, as well as on the success of regional cooperation.

Turkmenistan

Official statistics indicate that the economy continued to grow very rapidly in 2004. The ongoing expansion of energy production and exports will underpin economic activity and ensure reasonable growth in the medium term. However, more broad-based and equitable growth requires greater reliance on macroeconomic management and structural reforms.

Macroeconomic assessment of 2004

According to official statistics, gross output (used as a proxy for GDP) grew by 21% in the first 11 months of 2004, only slightly down from 23% in 2003. This contrasts with IMF's estimate of 7.5% growth in GDP for the whole of 2004. The difference in growth rates exemplifies the difficulties in using available statistics for assessing economic development. Government figures showing the breakdown of gross output by main economic activity are not available for 2004. Figures for 2003 indicate that gross industrial output (including gas extraction, oil extraction, and oil refining) grew by 22.0%, agriculture by 20.2%, and services by 18.5%.

On the expenditure side, growth continued to be driven by domestic investment, which for the first 11 months of 2004 reached TMM15.6 trillion (15.6% of gross output), up by 15% from the same period of the previous year. The priority areas were, as before, oil and gas extraction, petrochemicals, electricity generation and transmission, textiles, and luxury housing. The share of foreign capital in total investment in the country increased from 6.0% in 2003 to 9.2% in 2004, due to the nearly fivefold increase in the amount of foreign credits in domestic investments.

The Government has not released inflation figures for 2004, although IMF estimates 5% for 2004 as a whole, which is in line with the *ADO 2004* forecast. At end-December 2004, the official exchange rate remained pegged at TMM5,200/$1 (as it has been since 17 April 1998), but the parallel market rate rose to TMM24,500/$1 from TMM20,000/$1 in 2003, due to a scarcity of foreign exchange. This depreciation led to significant price increases for most imported goods.

The average monthly wage rose by 12% to TMM1.8 million (equivalent to $346 at the official rate of exchange) in 2004 due to improved conditions for activity outside the state sector and the development of private entrepreneurship (the private sector's share of GDP is about 25% according to the European Bank for Reconstruction and Development). In industry, transport, and construction, the average wage increased to TMM2.0 million a month. Official unemployment figures are unavailable. However, there are indications that a rise has occurred in unemployment, reflecting a public employee retrenchment program begun in February 2003 that sought to reduce public sector spending.

The state budget deficit, according to official figures, amounted to TMM12.2 billion, equivalent to less than 1% of GDP. Of total expenditures in 2004, the bulk went to social and public services, mainly education (27.8% of total expenditures) and health care (12.5%). However, the budget does not capture the true scale of government operations, since many state spending commitments are carried out through extrabudgetary funds, which are not reflected in the official figures.

The total trade surplus for the first 11 months of 2004 narrowed to $546 million from $918 million in the same period in 2003. Exports rose to $3.4 billion, a 9% same-period increase, mainly due to high world prices for energy products and cotton fiber. There was a relative increase in the share of high-value exports, such as refined oil products, textiles, and cotton fiber, whereas the share of natural gas and crude oil in total exports declined. The commodity composition of imports changed little, with capital goods and raw materials accounting for 64% of total imports. Ukraine remained the largest trading partner (72% of all gas exports and 34% of total exports). A notable reorientation of trade away from countries in the Commonwealth of Independent States toward other countries was seen during 2004.

Determination of poverty is difficult, since there is no official poverty line and the figure for the subsistence minimum is kept strictly confidential. Nevertheless, income inequality appears to be the worst among the Central Asian republics, according to a recent living standards survey conducted by the National Institute of State Statistics, which indicates that the country has a Gini coefficient of 0.39.

Macroeconomic policy developments

Central planning and management persist. Production targets, mandatory state procurement, directed bank credits, foreign exchange restrictions, and intergovernment trade arrangements continue to be used by the Government. Key sectors, including oil and gas, remain in state hands. A central element of social protection is the provision to the entire population of basic services, goods, and utilities (e.g., electricity, gas, and water) free of charge, or at heavily subsidized prices.

The Government has now completed a full year of the implementation of its Strategy for Turkmenistan's Economic, Political, and Cultural Development for the Period up to 2020. This 2020 Strategy sets ambitious production targets for all sectors of the economy, to be supported by state-led investments. Initial implementation results seem, however, mixed at best. On the production side, the Government appears to have achieved its wheat target under the strategy; however, only one third of the cotton production target was met. In an effort to revive the flagging agriculture sector, the People's Council adopted new land and water laws in October 2004, though most observers believe that these new initiatives are unlikely to greatly improve the situation.

The Government adopted an investment program covering the period mid-2004 to end-2005. Although specific details of the program are lacking (the Government considers it confidential), press reports indicate that the program included a total of 442 projects amounting to more than $6 billion for the 18-month period. In 2005, the program reportedly plans that 244 projects will be implemented, in the amount of $4.8 billion.

A balanced state budget was approved for 2005, with both revenues and expenditures set at TMM76 trillion ($15 billion at the official exchange rate). Under the budget, the Government continues heavily subsidized provision of basic services, goods, and utilities. Revenues from taxes contribute only a low share of government income—less than 25% in the 2005 budget—in part because of widespread tax exemptions for state enterprises, which in practice means the majority of the economy. Moreover, revenue collection measures are ineffective, with tax revenues in 2003 coming in at less than half of the amount targeted. The People's Council approved a new tax code at its October 2004 session. This is intended to streamline the tax system, though the majority of commentators do not believe that this will be very successful in boosting revenue collection.

More job cuts are expected in the public sector, as an offset to plans to increase salaries by 50% in January 2005. This would be the third major job-cut drive in the last 4 years. Earlier redundancy programs concentrated on health care and education, while other areas of government remained relatively unaffected. This time the cuts appear to be across the board. The increase of salaries at the expense of jobs will add to unemployment, as the fledgling private sector will be unable to absorb the released workforce.

In terms of energy policy, the existing long-term intergovernment agreement on gas shipments to Ukraine was renegotiated in January 2005. Gas prices, previously fixed at $44 per 1,000 cubic meters (m^3) and 50:50 barter/cash transactions, were increased to $58 per 1,000 m^3.

Although a similar long-term agreement is in place with the Russian Federation, negotiations to increase gas prices have been inconclusive. The current agreement stipulates a gradual increase of gas shipments from 5 billion m^3 in 2004 to 80 billion m^3 in 2028, though the throughput capacity of the old Central Asia-Centre (CAC) pipeline will be unable to accommodate the expected volumes of gas without the rehabilitation of the entire pipeline system. Even if upgraded and modernized in the future by Gazprom (the Russian company that has announced a rehabilitation of the CAC pipeline), the growing gas export potential of Uzbekistan could significantly impinge on the pipeline capacity that could be devoted to gas exports from Turkmenistan.

Thus the continued expansion of gas exports faces major constraints. Consequently, the Government has been searching for alternative ways to secure the export of its gas, including via Afghanistan, for example by participating in the Turkmenistan-Afghanistan-Pakistan (TAP) Natural Gas Pipeline Steering Committee. It is also concluding the certification of the Dauletabad gas field reserves, and the results will be an important factor in determining the final economic feasibility of the TAP pipeline.

Outlook for 2005–2007 and medium-term trends

Analysts share a general consensus that growth prospects will be quite good over the short run. *ADO 2005* forecasts slowing GDP growth of 10.0% in 2005, 7.0% in 2006, and 6.3% in 2007. This reflects expected declines in world oil and gas prices, which are likely to more than outweigh the anticipated increase in the Government's oil and gas production and exports, against a background of slowing export earnings that will limit investment and growth.

The Government has not released information on its new 2005 targets for natural gas and oil production. The Government's 2020 Strategy has indicated that natural gas production should increase to 67 billion m^3 in 2005, of which 53 billion m^3 are for export. Likewise, crude oil production according to the 2020 Strategy should increase to 18 million tons. Many commentators consider these government targets somewhat ambitious. Nevertheless, the production and export of natural gas, crude oil, and petrochemicals products are likely to increase substantially in 2005–2007, as are the production and export of electricity. In contrast, agricultural production is likely to stagnate (in the case of cotton this is already the case), unless the Government initiates much-needed sector reforms, including the dismantling of the existing mandatory state procurement system.

Inflation is expected to be kept to about 5% by a combination of tight monetary policy, subsidies, price controls, and cash restrictions. The official exchange rate is likely to remain fixed at TMM5,200/$1, and the parallel market rate broadly stable at around TMM25,000/$1.

The total trade surplus is forecast to widen further in 2005. Exports will rise, mainly due to an increase in the volume of energy exports. Imports are also projected to strengthen, in part because most of the country's natural gas is exported under the barter arrangements, and in part because of the ongoing construction of large-scale projects.

The anticipated rapid output growth, macroeconomic stability, and trade surpluses will have only a limited positive impact on the living standards of the majority of the population. The reason is that few new jobs will be created, while much of the additional national income will be invested in state-led projects of questionable economic and social value.

Furthermore, the economy will remain vulnerable to possible swings in world energy prices, bottlenecks in export routes, and possible delays in payments for deliveries of natural gas by its major trading partners. A sharp fall in world oil prices or constraints on increased exports of natural gas due to the limited throughput capacity of existing pipelines would have a major adverse impact on exports, output growth, and the Government's fiscal position. Finally, growth based on exploitation of natural resources is likely to be short lived, if the experience of many other resource-rich countries is repeated. Therefore, in order to foster broad-based sustainable and equitable growth, the Government needs to rationalize public expenditures, halt—and then reverse—the negative developments in the country's human capital base, and embark on structural reforms to diversify the economy.

Uzbekistan

Tight economic policies in 2004 resulted in further macroeconomic adjustment, but progress on structural reforms was uneven. Accelerated GDP growth, a balanced budget, a sizable current account surplus, and the maintenance of current account convertibility must be set against the continuance of trade restrictions and the imposition of further impediments in the internal market. A reinvigorated approach to structural reform is needed to speed development and poverty reduction.

Macroeconomic assessment of 2004

Recording the highest rate since independence, GDP growth in Uzbekistan accelerated to 7.7% in 2004, according to official estimates. Growth was led by the agriculture sector but the other major sectors all played their part. Favorable climatic conditions contributed to agriculture's strong performance, with the cotton crop showing a recovery after a poor harvest in 2003. Grain production in 2004 was lower though than in 2003, in part due to a reduction in the land area sown. Notably, the contribution of private farms to crop production doubled in 2004. The acceleration in industrial growth was driven by the resource sectors, particularly fuel and ferrous metals, and machine building, especially the automotive and aircraft industries.

Economic assessments based on official data need to consider the following two factors. First, in the past, official real GDP growth estimates were higher than other estimates partly because of differences in GDP deflators. For 2004, while there was a significant drop in the official GDP deflator, other official inflation estimates, such as producer prices, stayed high. Second, in past years, the official growth numbers based on the production side of the national accounts were inconsistent with GDP by expenditure category. For 2004, even taking into account the significant contribution of net exports of goods and services, the officially estimated 7.7% growth would require unrealistically sharp growth in domestic consumption and/or investment. Preliminary unofficial estimates put GDP growth for 2004 at 5.5%.

Limited employment opportunities and low returns to labor have perpetuated poverty levels at more than a quarter of the population. Poverty data based on a household budget survey updated in 2003 show a marginal decline in poverty incidence from 27.5% in 2000 to 26.2% in 2003. Surprisingly, the latest results also indicate a very sharp decline in poverty incidence in the southern region, hitherto the poorest in the country, from 47.4% to 26.4% in the period. The official reported unemployment rate is 3.1%, but alternative sources suggest that the actual rate is about 6%. While this figure appears relatively low by international standards, the significant informal sector (estimated at between a third and a half of the economy) engaged in less productive activities suggests that there are bottlenecks in labor absorption, including impediments to private sector development. Employment growth during 2004 remained stagnant.

The authorities maintained a tight fiscal stance in 2004 with the budget balance (excluding extra-budgetary funds) posting a small surplus. The revenue-to-GDP ratio decreased to 23.7% in 2004 from 24.2% in 2003, due in part to cuts in certain tax rates. Budget expenditures as a share of GDP

declined to 22.9% in 2004 from 24.6% in the previous year. The burden of the expenditure cuts has fallen on centralized investment financing and "other expenditures." The share of social sector spending has been maintained, but spending on social protection continued to decline.

Inflation in 2004 remained subdued and virtually unchanged as per the official estimates, with the year-on-year end-period change in the CPI at 3.7%. (Alternative estimates suggest an inflation rate of around 15%. These estimates are based on the consideration that the basket used to compute the official estimates does not adequately represent goods and services actually consumed by the public.) Higher nonfood prices, led by utility price increases, partially offset the fall in food price inflation. Broad money grew rapidly during the latter half of 2004, reflecting mainly the accelerated growth in net foreign assets prompted by the balance-of-payments surplus.

Strong export growth of goods and services in 2004 of 30% contributed to a current account surplus estimated at 8.4% of GDP, the third consecutive year of surplus. Higher world prices for gold and an expansion in energy exports were the main drivers, since cotton export earnings increased only modestly due to the poor harvest in the previous year. Consistent with the reported pickup in investment, import growth accelerated to 28.2%, with higher imports of machinery and equipment, as well as metals. The deficit on the capital account is estimated to have widened as higher FDI inflows were counterbalanced by other capital outflows. Overall, the large current account surplus outweighed the capital account deficit. Foreign exchange reserves were about $2.1 billion at end-2004, providing over 6 months of import cover.

Macroeconomic policy developments

Macroeconomic management has tended to have a short-term focus of addressing individual problems, such as containing the fiscal deficit and reducing inflation, in ways that could generate longer-term problems. In 2004, the authorities further reduced the base rate of the profit tax on enterprises to 18%; effective 1 January 2005, it was brought down further, to 15%. Also, preferential rates and other tax incentives are applied to enterprises included under the revitalized localization program. Consequently, tax revenues from this source fell sharply in 2004. The Government has often equated fiscal reform with tax rate cuts, with insufficient regard to ensuring an adequate tax base and a tax administration system that are capable of sustaining pro-poor spending. It is essential to strengthen the revenue effort and improve revenue buoyancy by keeping exemptions and discretionary rates to a minimum and by improving tax administration.

In order to contain inflation and maintain stability of the exchange rate, cash circulation restrictions remained in force in 2004, a mechanism that raises the risk of liquidity shortages for enterprises and a buildup of arrears (as occurred in 2003). With the pilot phase of the "plastic card" (a type of bank debit card) system of payments ending in 2004, a nationwide rollout is planned in 2005. The Central Bank of Uzbekistan (CBU) has given a commitment that the system will be implemented on a purely voluntary basis, though some in the private sector fear that the system could be used for further restricting cash transactions. CBU cut its refinancing rate twice in 2004, bringing it down to 16% to align it with inflation.

The authorities have ensured a gradual depreciation of the exchange rate in nominal terms (0.7% per month). The track record on currency convertibility remains good according to the findings of a recent IMF review mission, but progress on complementary structural reforms has been slow.

Banks have seen a deceleration in net income growth over the past few years, largely due to the sizable level of NPLs of the large state-owned banks. CBU set up a national institute of credit monitoring in 2004 to improve this area. Despite recent growth of small and medium private banks, the state-owned banks remain dominant. Privatization of Asaka Bank, the second-largest state-owned bank, originally scheduled for 2004, appears stalled for the present. Economy wide, the authorities reported that 966 enterprises were privatized in the first 3 quarters of 2004 but only one large privatization deal was brought to closure.

A presidential decree on the creation of a chamber of commerce and industry was issued in

July 2004 that could pave the way for a dialogue between representatives of the private sector and the Government on measures to improve the business environment.

Uzbekistan's foreign trade regime is characterized by a moderate average unweighted tariff rate (lowered in 2004 to 14.6%), but the four-band system of tariff escalation based on stages of production is geared toward protecting selected domestic industries. Numerous nontariff barriers restricting trade also remain in place, presenting a risk that the efficiency gains from the introduction of currency convertibility may not be realized. Indeed, the regulatory burden on "shuttle" trade was intensified in 2004.

Restructuring loss-incurring cooperative farms (or *shirkats)* into private farms continued in 2004, with the latter increasing to over 100,000 toward the end of the year. Most private farms are required to produce cotton and wheat on 85% of their leased land but have freedom to make their own farming decisions on the remaining 15%. The Government has credited its policy of restructuring *shirkats* with giving a major boost to the efficiency of the rural economy. It does indeed seem that private farms have lower production costs than *shirkats*, as the incentives to divert resources that are common in *shirkats* are absent in private farms. In other respects however, the profitability of private farms is held down by shared disincentives inherent in the state procurement system for cotton and wheat.

The Government recognizes that if it is to make a dent in the poverty incidence, it will need to sustain high rates of growth through structural reform with complementary changes to the provision of human development and social protection services. Its Living Standards Improvement Strategy, completed in June 2004, is now being further developed into an Interim Welfare Improvement Strategy Paper (I-WISP), a framework that sets out the following targets: reduction in poverty incidence from 26.2% in 2003 to 20% in 2010; annual GDP growth of 8.0–8.5% over 2007–2010; inflation in the range of 4–5%; investment growth accelerated to 12% a year with the incremental capital output ratio (ICOR) falling from 5.8 to 3.2; export growth maintained at 10–12%; the share of industry in GDP increased to 20%; the number of employed increased to 13.2 million; and unemployment brought down to 2%. Additional work is required to develop the draft strategy into a coherent and consistent economic program.

Outlook for 2005–2007 and medium-term trends

Sustaining the growth rate achieved in 2004 will not be easy. Some of the key sources of recent growth have an uncertain future, including strong prices for commodity exports—in particular cotton where prices have weakened—but also gold and energy. Key to the medium-term outlook will be the extent to which the Government adopts an accelerated reform program. In the near term however, the growth dividend from an accelerated reform scenario could be small.

In 2005, the external environment is seen as being less favorable. World cotton oversupply is likely to depress demand for cotton fiber exports, gold prices are expected to decline from the record high seen during 2004, and while the outlook for energy prices is positive, it is uncertain. Officially reported consumer inflation is set to remain in the 6–8% range but actual inflation (factoring in prices in markets where consumer goods are traded) is likely to be higher at 12–15%. Adherence to the Government's commitment to assuring enterprises' access to cash will be essential for ensuring that wages are paid and that the purchasing power of the poorer sections of society is maintained. Overall, a moderate deceleration in GDP growth to around 5.0% in 2005 may be expected.

Over 2006–2007, the acceleration in GDP growth to 8.5% envisaged in the I-WISP appears ambitious, but an improvement to around 6.5% is possible if some pickup in structural reforms and a positive global environment are seen.

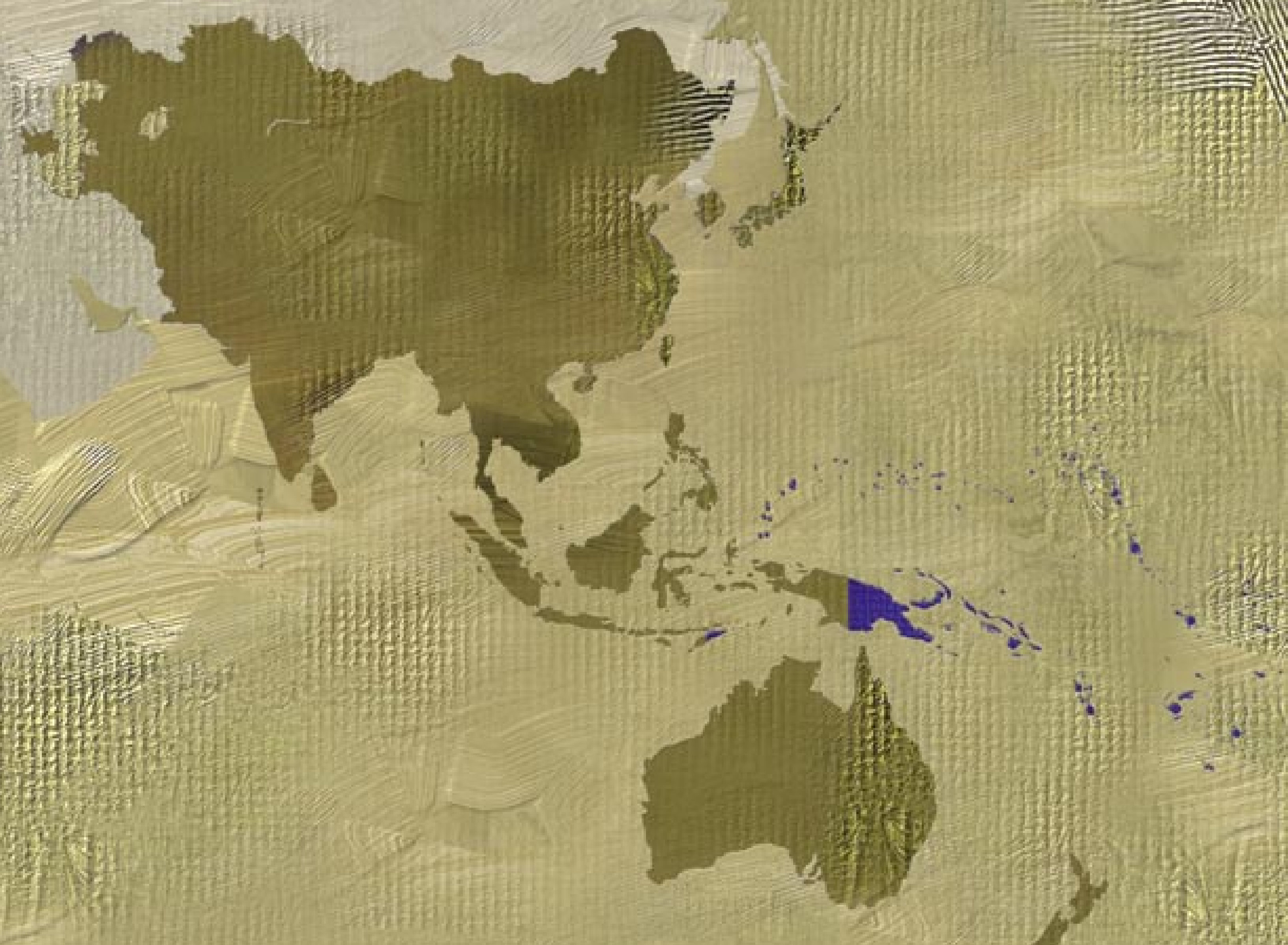
Currently, the investment rate is around 22% of GDP. To achieve a growth rate of 6.5% and assuming an ICOR of 4.4 will require an investment rate of 28–30% of GDP. In the past, the government budget funded investment of around 6% of GDP a year. The ability of the budget to finance higher levels of public investment appears constrained by the anemic revenue mobilization effort. FDI inflows account for less than 1% of GDP, and while the energy

sector has good prospects for FDI projects financed by the Russian Federation, other foreign investors appear lukewarm because of the investment climate in the country. This leaves domestic private investment to fill the gap, which would need to improve from its current level of about 14%.

The current investment climate for both domestic and foreign enterprises makes achievement of this investment target challenging. A lower investment rate with higher investment efficiency could achieve the 6.5% growth target, but the prevailing strategy of import-substituting industrialization would have to be reoriented.

Under this policy, large sectors of the economy are subordinated to the promotion of selected industrial activities—at considerable cost to overall economic efficiency. Moving toward and sustaining the GDP growth target will therefore require a refocus of the development strategy to enable both a higher level of investment and an improvement in its quality.

Assuming acceleration in structural reforms, growth could pick up to around 6.0% and 6.5%, respectively, in 2006 and 2007. The impetus for this growth is expected to come from private investment and exports. The balance-of-payments outlook for 2006–2007 under an accelerated reform scenario is one where both exports and imports are likely to rise to fuel higher investment and growth. The emerging current account deficit of the scenario is likely to be readily financed with additional official development inflows and FDI inflows accompanying reforms. In short, growth over the medium term will depend on whether the authorities adopt a substantially reinvigorated structural reform program or continue with the current direction and pace of reform.



The Pacific

Cook Islands
Fiji Islands
Kiribati
Republic of the Marshall Islands
Federated States of Micronesia
Nauru
Republic of Palau
Papua New Guinea
Samoa
Solomon Islands
Democratic Republic of Timor-Leste
Tonga
Tuvalu
Vanuatu

Cook Islands

Supported by rising tourism activity, a high level of building activity, and firm consumer demand, the economy continued to grow in 2004. The overall fiscal position is sound and the Government's cash reserves increased further over the year. The medium-term outlook remains positive, with tourism expected to continue leading growth, and some rebuilding of other sectors in prospect.

Macroeconomic assessment of 2004

The economy achieved its sixth consecutive year of growth in 2004. Preliminary national accounts indicate that GDP grew by 3.4% in the 12 months to June 2004. It is expected to have remained firm in the quarters to September and December 2004 as tourist arrivals rose and building activity picked up.

Visitor arrivals in the quarters to March and June 2004 were only slightly above the same periods of 2003. Air New Zealand, the main international carrier, introduced cheaper airfares in June, and this led to a sharp rise in visitor arrivals over the second half of the year. Preliminary data suggest that total visitor numbers increased by 6% in 2004.

Like tourism, building activity appears to have leveled off in the first half of 2004. The value of building approvals fell over the first 2 quarters of the year, but approvals for commercial buildings recovered in the third. The total value of building approvals was 9% higher over the first 9 months of 2004 than in the same period of 2003.

Bank lending continued to grow. After rising by 41% in 2003, loans and advances increased by a further 13% by September 2004. Approximately half of the additional lending was provided in the personal services subsector, a reflection of firm consumer demand. Additional lending was also provided to the wholesale and retail trade and to hotels and motels.

Total merchandise export growth is expected to slow in 2004 relative to 2003. A contributing factor is a further contraction in the pearl industry. For the first 9 months of 2004, pearl exports were 28% below their value for the same period of 2003. On an annualized basis, pearl exports are now less than 15% of their peak value seen in 2000, a consequence of low international prices and the ongoing impact of disease that resulted from overcrowding in the main producing lagoon in 2000. In contrast, fish exports have surged in recent years and in 2003 replaced pearls as the main source of merchandise exports. However, adverse weather conditions and financial difficulties reduced their value by 72% in the first 9 months of 2004 compared with the same period in 2003.

Despite a large fall in imports of machines, transport, and equipment, total merchandise imports rose in the first 9 months of 2004 from the same prior-year period, in the process further widening the trade deficit. However, the surplus on the services account attributable to the vibrant tourism sector more than offset the trade deficit.

Inflation was low at 0.3% in 2004, a result of the overall sound fiscal position and the combination of low inflation in New Zealand, the main source of imports, and a nominal appreciation in the New Zealand dollar, the currency used by the Cook Islands. Broad money grew by 9.6% in FY2004 (ended 30 June 2004), slightly lower than the recorded 9.9% growth in FY2003.

The solid economic conditions helped further improve the fiscal position over the year. Revenues from the four main taxes (VAT, income tax, import duties, and company taxes) were 9% higher than in the previous year. Small increases in both the operating surplus and the level of net lending are projected.

Macroeconomic policy developments

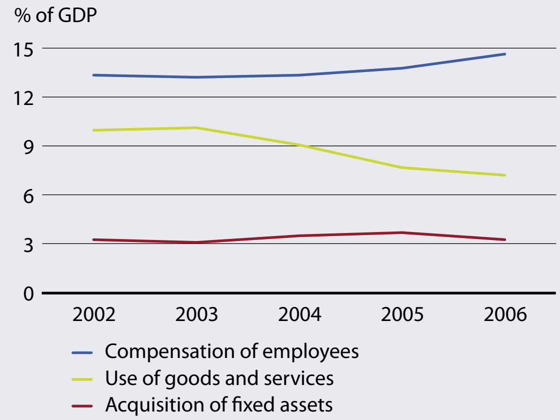
By the mid-1990s, the Cook Islands had accumulated an unsustainable debt position and an excessive wage bill. A wide-ranging economic reform program was adopted to correct these economic imbalances, and the overall objectives of the reform program of economic growth and fiscal stability are now firmly in place. The challenge now facing policy makers is to address the consequences of continued expansion.

The final component of a 1998 debt restructuring was settled in 2004 through the acceptance of an offer of concessions from the French Government. The debt-to-GDP ratio has fallen steadily since the debt restructuring, aided in 2004 by the appreciation of the New Zealand dollar and the continuation of budget surpluses. The gross value of public debt is approximately 40% of GDP, much of which is held on concessional terms. Cash reserves, equal to 14% of GDP, have been built up to cover certain future debt obligations and to be a financial safeguard in the event of a natural disaster or economic downturn.

The overall improvement in the fiscal position was recognized in October 2004 by Standard & Poor's, which raised the long-term rating to BB- from B+. This is the fourth upward revision to the rating since an initial B-/C rating was assigned in 1998. However, the Cook Islands was put on credit watch in early 2005 because of the threat to the economy from cyclone activity.

As part of the debt restructuring, targets were set for the ratio of the wage bill and other expenditures to GDP. There has been some slippage recently in the satisfaction of these targets, and a hoped-for shift in expenditures to capital and essential goods and services is yet to be achieved (Figure 2.25). At the same time, the burgeoning economy is placing greater demands on infrastructure. Roads, airports, water and sewerage systems, and the electricity network are candidates for higher capital and maintenance spending. A rebalancing of outlays toward infrastructure is increasingly important if the economy is to retain the capacity to grow in an ecologically sustainable and balanced manner.

Figure 2.25 Government expenditures, Cook Islands, FY2002–FY2006



Sources: Staff estimates based on data from the Ministry of Finance and Economic Management, and Cook Islands Statistical Office.

Recent episodes of health problems arising from pollution in Rarotonga's lagoon have provided an early warning of the potential consequences of sustained growth. Such episodes may increase in frequency if infrastructure is not upgraded and if land-use planning is not improved. The pressures being placed on the natural environment have the potential to both impair the quality of life of residents and undermine prospects for the tourism industry.

A further challenge facing policy makers is a sustained population decline. High levels of emigration and a rising foreign presence have raised community concerns of a weakening of the Cook Islands–Maori culture. The tourism industry is also concerned that any loss of the uniqueness of the Cook Islands experience sought by visitors will have repercussions for its prospects.

The country's first National Development Plan is in preparation to help provide a national consensus on how to address these and other strategic issues. A national forum was held in late 2003 and sectoral working groups have been formed to prepare strategies for key sectors. Progress was slowed over 2004 by the national

election held in September 2004 and a delay of some months in forming a government. But an economic summit is to be held in early 2005 to take stock of work on the National Development Plan and to assist in budget planning.

Outlook for 2005–2007 and medium-term trends

Visitor arrivals had reached a plateau of some 50,000 a year in the mid-1990s, but subsequent economic reforms and favorable external conditions saw annual tourist arrivals climb to 83,000 in 2004. Investment and consumption have strengthened, and unemployment has fallen to such an extent that low-skilled labor is now being drawn in from neighboring countries. This upward trend in activity is expected to continue. The latest official forecast is for average annual GDP growth of 3.1% over the medium term. GDP per capita is forecast to grow at a similar rate.

In December 2004, air services provided by Aloha Airlines to the US ceased. However, in the same month Air New Zealand expanded its services to the Cook Islands to provide connections to additional airports. In addition, another carrier, Pacific Blue, commenced flights to the Cook Islands in early 2005. These developments will push up capacity while helping maintain downward pressure on airfares. A 13% increase in arrivals is expected over the 12 months to June 2005, slowing thereafter to 4% a year. Although the trend is for additional arrivals to be from lower-spending segments of source markets, tourism is expected to continue generating economic growth over the forecast period.

Hotel capacity continues to expand in anticipation of a rising number of arrivals. Large hotel projects at Vaima'anga on the main island of Rarotonga and on the main outer island of Aitutaki are currently undergoing environmental impact assessment, while small, family-run businesses that have entered the industry to supply bungalow-style accommodation also have considerable potential for expansion. Activity is expected to remain concentrated on Rarotonga and Aitutaki, but increasingly tourism is spreading to other readily accessible outer islands.

Merchandise exports are expected to improve over the medium term. Pearl industry analysts suggest that the main producer of black pearls, French Polynesia, is operating at around break-even. Stabilization in global prices is expected with some prospect of an improvement as supply growth slows. The latest official forecast is for an average annual rise of 20% in the nominal value of pearl exports over the medium term. Fish exports are also expected to improve by 2006 as the predicted El Niño season in 2005 lifts the potential catch in the country's waters.

An expansion of the Offshore Financial Centre is also in prospect over the medium term. This has stagnated in recent years as the Cook Islands remained one of the few Non-Cooperative Countries and Territories listed by the OECD Financial Action Task Force (FATF) on money laundering. Legislative and administrative changes had been made to comply with the requirements of the FATF, including the establishment of a financial supervision commission and new banking and financial transactions legislation. The country was removed from the list in February 2005 but will be subject to strict monitoring for at least 12 months.

Inflation is expected to stay low over the medium term. Local demand pressures have had little effect on the local inflation rate, and inflation in New Zealand and Australia remain the dominant influences. The Reserve Bank of New Zealand has an inflation target of 1–3% per annum, and a similar range is targeted by the Reserve Bank of Australia.

A potential risk is that liquidity constraints may push up interest rates over the forecast period. Deposits in the banking system have normally exceeded loans with the excess funds invested offshore. The very strong growth in loans and advances led to a reversal of this situation in December 2003. The commercial banking sector now needs to borrow offshore to help fund its domestic loan portfolios, and this is adding to the cost of funds and placing some upward pressure on interest rates.

Fiji Islands

Economic growth accelerated gently in 2004, inflation and interest rates remained low, and foreign reserves accumulated. A growth slowdown is expected over the medium term as concessional access to key export markets is lost and fiscal policy is tightened.

Macroeconomic assessment of 2004

Economic growth picked up to 3.8% in 2004 from 3.0% in 2003, stemming from a recovery in the agriculture, forestry, and fisheries sector, which rose by 3.7% after declining in 2003, and from a 7.5% expansion in industry, which in turn was driven by a surge in construction. A key element in the construction boom was private development of tourist resorts and residential complexes for overseas buyers. Mining was also a significant component in industry's strong performance. Though sugar production was stagnant, garment manufacturing grew slowly and mineral water production continued its healthy progress. The services sector as a whole expanded by 1.9%, with the wholesale and retail trade and hotels and restaurants subsectors registering faster growth in response to record tourism levels. Visitor arrivals in 2004 were up by about 13% from the 2003 level, led by an increase in Australian and New Zealand tourists responding to vigorous marketing and the availability of low airfares following greater competition in airline services to the Fiji Islands. On the demand side, economic activity was stimulated by private consumption, which was supported by private remittance inflows and reflected in a 14% rise in VAT revenues in 2004. Investment expenditures on buildings and higher recurrent and capital government spending also contributed to aggregate demand expansion, whereas the contribution of net exports was negative.

Labor market conditions strengthened in 2004, with a 7% increase in the number of newly registered taxpayers, most of whom were in services. Emigration of skilled workers was 4% lower than in 2003, but remained of major concern to employers and the Government. Output and employment growth appear to have been insufficient to reverse intensifying economic hardship for many people. Preliminary analysis of a 2002/03 household survey suggests that the proportion of urban households living in poverty increased from 28% in 1990/91 to 30–40% in 2002/03. Recent studies report community perceptions that hardship has become more prevalent in rural areas.

The domestically financed budget deficit in 2004 was 4.8% of GDP, down from 5.9% in the previous year. This outcome was in excess of the estimated deficit of 3.9% of GDP in the budget, largely because of two additional appropriations for funding costs of flash flooding in April and overbudget spending by three ministries. The level of public domestic debt consequently continued to rise, albeit more slowly, and at end-December 2004 stood at 46.4% of GDP, compared with 45.4% 12 months earlier. The ratio of external public debt to GDP remained low by international standards at less than 5%.

Inflation fell to 3.5% in 2004 from 4.2% a year earlier, largely because the nominal effective exchange rate remained stable and modest wage growth and excess capacity in some sectors helped offset the inflationary effect of higher oil

prices and strong domestic demand. Additionally, monetary policy was tightened in May 2004 in response to buoyant consumer demand, with official interest rates raised by 0.5%. The monetary policy stance was unchanged during the rest of the year, and commercial bank lending rates fell slightly to 7.05% at year-end, contributing to a 16.5% rise in credit to the private sector in the year to November. This additional credit was concentrated in personal loans and lending to the construction, trade, and transport sectors.

Merchandise exports were virtually stagnant in 2004 as reductions in sugar, fish, and "other" exports offset stronger gold, timber, and garment exports. Growth in aggregate demand generated a 2.6% broad-based rise in imports from the 2003 level, widening the trade deficit. Further, the deficit on the income account grew, such that the current account deficit widened to 5.3% of GDP. The balance on the capital and financial account was positive, though FDI remained subdued. At end-December, foreign reserves were US$456 million, sufficient to cover 3.5 months of imports of goods and nonfactor services. This was the first year since the 2000 political crisis in which foreign reserves had increased. Foreign exchange controls remained in force, but were relaxed slightly during the year.

Table 2.23 Major economic indicators, Fiji Islands, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	3.8	1.5	0.7	1.0
GDI/GDP	17.0	-	-	-
Inflation (CPI)	3.5	3.0	3.0	3.0
Money supply (M2) growth	7.3	7.3	7.3	7.3
Fiscal balance/GDP	-4.8	-4.3	-2.4	-1.4
Merchandise export growth	0.5	3.2	-5.0	17.5
Merchandise import growth	2.6	2.0	-0.2	4.6
Current account/GDP	-5.3	-4.1	-3.3	0.6

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

Sources: Ministry of Finance, *Economic & Fiscal Update: Supplement to the 2005 Budget Address*; staff estimates.

Macroeconomic policy developments

After years of running substantial budget deficits and accumulating domestic debt, the Government has adopted a policy of fiscal tightening for 2005–2007. The policy target is to reduce the budget deficit to less than 2% of GDP by 2007, largely by cutting expenditures (Figure 2.26). Most of the progress toward the target is projected to be made in 2006–2007, with the 2005 annual budget estimating a budget deficit of 4.3% of GDP. Total expenditures and net lending at current prices are forecast to rise by 4.4% and revenues (exclusive of asset sales) by 6.3%.

The ratio of operating to capital expenditures is expected to fall slightly to 82:18 as the Government pursues its objective of contributing to a rise in the ratio of gross investment to GDP. However, this reallocation away from operating expenditures will not be achieved by reducing the relative size of the public service wage bill, which is estimated to actually increase its share of operating expenditures, marginally, to 49.4% in 2005 from 49.3% a year earlier. The Government plans to achieve control of the wage bill over the medium term, requiring it to be successful in replacing automatic cost-of-living adjustments with smaller, productivity-based wage increases. Improved controls on the engagement of staff by the education and health ministries and cuts in the size of the military are also programmed. If all of these plans are realized, the wage bill should fall to 47.9% of operating expenditures in 2007 or 9.8% of GDP, compared with 11.1% in 2005. Public domestic and external debt would be contained to a fiscally sustainable level of about 50% of GDP, though this is still well above the Government's target of 40%.

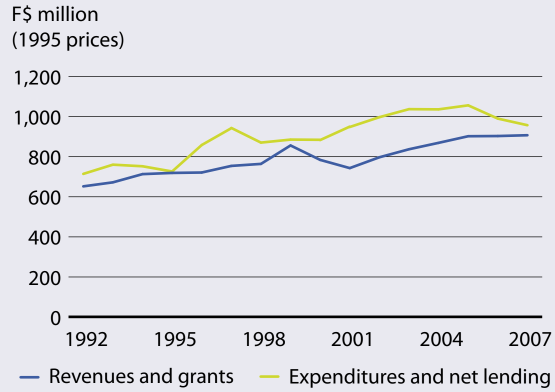
Most of the growth in revenues in 2005 is expected to come from indirect taxes, both VAT and customs duties. In addition to the revenue pickup occurring automatically as the economy expands, receipts are forecast to pick up as a result of improvements in tax administration and strengthened compliance, which are to be supported by amendments to the Income Tax Act and the Valued Added and Gambling Turnover Tax decrees. The 2005 budget lifted the income tax threshold from F$7,500 to F$8,840 and extended the Employment Taxation Scheme, which allows 150% tax deductions for first-time employees. More generally, measures are being taken to raise the efficiency of the civil service,

including the medium-term implementation of the 2004 Financial Management Act, which encompasses measurement of the performance of ministries and departments in delivering their core outputs. The Public Service Commission is also developing mechanisms for overseeing the performance of chief executive officers.

Following the monetary policy tightening in early 2004, the Reserve Bank of Fiji signaled its intention of maintaining a low interest rate regime to stimulate private investment, subject to the paramount aims of low inflation and balance-of-payments stability. The Reserve Bank also emphasized the importance of shifting the demand-side impetus for economic growth from consumption to exports. To facilitate such a shift, it began assessing small exporters' access to the credit export facility operated through the commercial banks and started investigating the viability of an export credit guarantee scheme. Deregulation of the superannuation industry is to be examined and, possibly, undertaken in the medium term, and an application for a commercial bank license from the Fiji Development Bank is to be assessed in 2005. The passage of the Financial Reporting Transactions Bill strengthened the country's antimoney laundering framework, and formalized the existence of the Reserve Bank's Financial Intelligence Unit.

The ratio of gross investment to GDP reached 17% in 2004, the highest level for 17 years but still well below the government target of 25%. Further and substantial progress toward the target requires growth in private investment alongside the Government's shifting of expenditures from operating to capital expenditures. Policies aimed at facilitating private sector development have been presented in the current strategic development plan and the 2001–2020 affirmative action plan, and some actions were initiated in 2004 in the areas of foreign investment legislation and regulations, labor market reform, civil service reform, and restructuring of the sugar industry. However, the Government acknowledges that further improvements are needed in these areas, as well as in physical infrastructure, reliability and pricing of utilities services, and public enterprise performance. There is also room for reducing the costs of doing business through improving institutional infrastructure: according to the World Bank's Doing Business Indicators for 10 Pacific island states, the Fiji Islands ranks second highest in days taken to start a business, joint highest in rigidity of employment, and third highest in time to enforce a contract.

Figure 2.26 Government revenues and expenditures, Fiji Islands, 1992–2007



Sources: Ministry of Finance and National Planning; Reserve Bank of Fiji.

Government commitment to trade liberalization was evidenced by continuing work on the implementation of the Pacific Island Countries Trade Agreement and the Pacific Closer Economic Relations, which includes Australia and New Zealand. An Economic Partnership Agreement is also being developed with the EU by the African, Caribbean, and Pacific nations, with negotiations scheduled to end in 2007.

Outlook for 2005–2007 and medium-term trends

Economic growth will slow substantially in the medium term, to less than half the rates achieved in the past 3 years. The major reason for the deceleration is a contraction in manufacturing, which accounts for about 16% of GDP. The largest garment producer, which generates 40% of garment exports and employs 5,000 people, is expected to close over the forecast period because preferential access to the US market ended on 1 January 2005. Preferential access to the Australian clothing and footwear market was extended for another 7 years in 2004, but the value of the preference is declining as Australian tariffs drop, and competition from the PRC

intensifies. The sugar industry, which provides a direct source of employment for more than 10% of the economically active adult population, is also expected to contract further in 2005. It faces various issues: the single sugar-milling company is insolvent and requires significant investment and government guarantees to continue operating; problems remain in managing the expiry of leases of sugarcane land; production practices are inefficient by world standards; and a fall in EU price subsidies can be expected in the next few years. The official forecasts factor in a recovery in sugar production in 2006 that is expected to result from externally assisted industry reforms begun in 2004. This expectation may not be realized in full.

The economy-wide impact of the manufacturing contraction in 2005 will be offset to a degree by a further surge in construction, forecast to expand by almost 18% before easing in 2006 and contracting in 2007. Mining, too, is expected to strengthen, by almost 8% in 2005 before slowing in 2006 and 2007. Expansion in agriculture, forestry, and fisheries is forecast to be modest in 2005, before a 2006 acceleration driven by increased sugarcane production, and then to slow in 2007. Forestry production is expected to grow at a strong and sustained rate, while production of other crops (including kava) could exceed expectations if recent health concerns in the EU are allayed and market access is renewed

The services sector is forecast to grow at annual rates of under 2% as contraction of the Government's wage bill has a negative impact, although the sector will still be the major contributor to aggregate growth in 2006–2007. The fastest-expanding subsector is expected to be transport and communications, with modest strengthening in finance and business services, wholesale and retail trade, and hotels and restaurants. Services will be underpinned by tourism: visitor arrivals are projected to increase by 7.2% in 2005 as the industry continues to benefit from airline deregulation; and as PRC; Hong Kong, China; and India emerge as source markets. Accommodation capacity is likely to set the ceiling on visitor numbers.

Whether the economy can do better than the official forecasts rests heavily on the rate at which structural obstacles to the growth of private sector activity are relaxed and on the subsequent private sector response. Key areas for immediate attention include means of slowing and correcting the ongoing emigration of skilled labor and resultant labor shortages, the performance of government utilities (the rate of return from government-controlled companies is less than 1%), and the regulatory environment for labor and product markets.

Some uncertainty hangs over the extent to which the Government will be able to successfully implement its medium-term fiscal strategy. The target of an 8% reduction in the level of expenditures and net lending by 2007 should be seen against an average annual increase of 4% over the past 10 years. The Government does not fully control the public service wage bill at present, with cost-of-living adjustments being decided by an independent arbitrator; and developing the systems to control expenditures in the military, education, and heath portfolios may take some time. Perhaps most important, an election is to be held in 2006 in an uncertain political environment. It is therefore possible that budget deficits and public debt will not be reduced as planned.

The foreign reserves level is likely to drop over the medium term as a result of the declining value of sugar and garment exports, which will more than offset projected growth in gold, mineral water, and timber exports. Tourism growth will bolster foreign exchange earnings, but an increase in the current account deficit is expected and a fall in foreign reserves may place downward pressure on the exchange rate.

The growth slowdown, and the imminent loss of jobs in manufacturing in particular, will cause a reversal in the reductions in the unemployment rate achieved between 2000 and 2004. Most probably therefore, the rise in both rural and urban poverty will continue, since accessible alternative occupations for all those displaced from the sugar and garment industries and expansion in formal employment will not keep pace with the population drift to urban areas. Job opportunities will appear in tourism, but significant training and retraining of the local labor force are required before these opportunities can be seized.

Kiribati

Economic growth in 2004 was lower than in the previous year, when growth was marked by the presidential election. Inflation remained low, and earnings from the Revenue Equalization Reserve Fund increased. For the next few years, effective implementation of the National Development Strategy will be key to sustainable economic growth.

Macroeconomic assessment of 2004

The domestic economy is estimated to have grown by 1.8% in 2004, a slowdown from 2.5% a year earlier when economic growth was driven by the presidential election and some large construction projects. Modest GDP growth in 2004 was backed by high copra prices and reasonable fish exports. Economic growth is limited by a shortage of skilled workers and a narrow production base consisting largely of subsistence agriculture, copra, and fish. Weak infrastructure is also an issue, especially since all islands are very remote from international markets.

Inflation has been low, owing to Kiribati's use of Australian dollars as its currency and the effective use of the Revenue Equalization Reserve Fund (RERF). Indeed, among the Pacific island countries, only Kiribati and Tuvalu have successfully managed to increase the real per capita value of their trust funds.

Kiribati's external sector is characterized by a large merchandise trade deficit; virtually all manufactured goods are imported. In 2003, this deficit came to US$69.5 million, and in 2004, US$51.1 million. Despite this, official reserves remain substantial, amounting to an estimated US$359.6 million or an equivalent of 4.7 years of import cover.

ANZ bank owns the only retail banking operation in the country. Foreign financial aid is a critical supplement to GDP. Japan and Australia, the country's two major donor countries, provided assistance valued at US$8.8 million and US$7.3 million, respectively, in 2002. Remittances from i-Kiribati are also sizable: receipts from those working on foreign fishing vessels or in foreign countries reached almost US$6.3 million in 2003.

Since Kiribati has a vast exclusive economic zone of about 3.5 million square kilometers, a major source of foreign income is fishing license fees. These fees were estimated to be equivalent to 35.2% of GDP in 2003, though they had started to decline in 2002.

Earnings from the RERF are an additional large source of income. The RERF was valued at A$513.3 million at end-2003, a figure that has been growing steadily since the new Government came into office on 10 July 2003. Due to its large foreign holdings in the RERF, Kiribati is a net creditor nation, and enjoys a strong international financial position. The large income from the RERF makes it possible for the Government to buffer year-to-year movements of the current account and to cover deficits on the fiscal balance. Investment income from the RERF, together with fishing license income and workers' remittances, makes GNP almost double GDP.

Most economic activities involve subsistence agriculture. Traditional land tenure, poor soil, and frequent droughts prevent the i-Kiribati from engaging in large-scale agriculture. Services dominate GDP at 84%. Vocational schools

train commercial seafarers and fishers, though opportunities for occupational training as well as employment for women are limited. Due to minimal employment opportunities on the outer islands, many people have migrated to South Tarawa, which is congested and polluted.

Macroeconomic policy developments

The Government met with its development partners on 24–25 August 2004 to discuss its development strategies and project funding requirements contained in the National Development Strategy 2004–2007, which was released in November 2003. The strategy contains six key policy areas: economic growth, fair distribution, public sector performance, equipping people to manage change, conservation of physical assets, and sustainable use of financial reserves by the ministries.

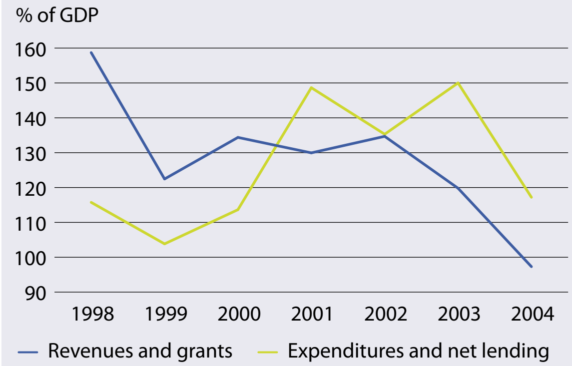
Fiscal policy has remained firm and conservative (Figure 2.27). As formulated in the National Development Strategy, private sector development is a key area. In general, donors share much concern over a lack of government support for competitive private sector development, a poorly performing public service, and a heavily subsidized, inefficient, and extensive SOE sector. Economic development policy needs to be prioritized and focused for Kiribati to realize its domestic potential.

Outlook for 2005–2007 and medium-term trends

Prospects for sustainable economic growth are greatly hampered by overdependence on the Government and on inefficient SOEs, by lack of private sector development, and by pressures of population growth and the associated sparse youth employment opportunities. There are few signs that these factors will be improved immediately, and low per capita GDP growth and dependency on the Government will likely continue in the medium term. Short-term prospects for economic activity and employment are determined by externally funded public sector projects.

GDP is projected to grow by 1.5% in 2005, which is roughly equivalent to the rate of population growth. Increasing youth unemployment is likely. Growth in GNP will continue to depend heavily on receipts from fishing licensing fees and the RERF.

Figure 2.27 Government revenues and expenditures, Kiribati, 1998–2004



Sources: Staff estimates based on data from the Kiribati Statistics Office, *Kiribati Statistical Yearbook 2002*; International Monetary Fund, *Staff Report for the 2003 Article IV Consultation*; Reserve Bank of Australia exchange rate statistics.

Donors are interested in Christmas Island (Kiritimati), where game fishing and bird watching have been attracting tourists, as a potential economic growth center. In a different context, Japan is contributing to the development of Christmas Island: in 1999, its former National Space Development Agency, superseded by the Japan Aerospace Exploration Agency, announced that it would lease land there for 20 years to build a spaceport. According to the agreement, Japan will spend US$12.9 million over 13 years from 1999. In addition, the Japanese Government has announced that it will aid Kiribati's fishing industry by funding the construction of a new storage and handling area at Christmas Island's fishing port from January 2005.

Kiribati's potential for sustainable economic growth is constrained by its traditional land tenure, by weak policy and institutions, and by lack of resources. Policies for private sector development, as formulated in the National Development Strategy, need to be implemented for people to move away from overdependence on government-led projects and economic activities. New employment, especially for the younger generation, and new investment opportunities are badly needed.

Republic of the Marshall Islands

The economy contracted in 2004 because of delays in implementing an upgraded public works program and the closure of the single largest private sector employer. A large step-up in central government expenditures and net lending, funded through increased US grants, has been budgeted for the medium term. This has the potential to support the economy over the coming years.

Macroeconomic assessment of 2004

A new financial agreement with the US Government under the Compact of Free Association was effected in FY2004 (ended 30 September 2004). This increased government allocations to additional recurrent and capital expenditures by 20%. The US commitment to long-term financial support after an extended period of negotiation was also expected to raise the confidence levels of households and private businesses. Apart from this, a major hospital upgrade funded by a grant from the Japanese Government was under way in the capital, Majuro. These positive factors were initially projected to increase GDP over 2004. However, delays in implementing government capital projects and the closure of a tuna loining plant—the single biggest source of private sector employment—outweighed the expected boost in GDP, resulting in an overall contraction of the economy.

The main government projects to fall behind schedule were in education. The sector should have received 60%, or $12 million, of the year's capital and maintenance budget for work on four high schools and an elementary school. However, government departments had some trouble in adapting promptly to new procedures designed to strengthen accountability and increase value for money, which resulted in a large carryover of work to FY2005. The tuna loining plant closed in August 2004 because of financial difficulties. The plant had unsuccessfully pursued a switch from the production of tuna loins to tuna steaks, which would have reduced the workforce by about 50%. The closure will see the loss of annual exports that were worth $3.4 million in 2003, representing more than half of merchandise exports (excluding reexports). Employment at the plant ranged between 500 and 600 people, some 5% of the economically active population, most of whom were women. It is estimated that, once indirect linkages are taken into account, the plant contributed as much as 3% of GDP.

Another contractionary impact on the economy came from a decline in visitor arrivals to 74% of the 2003 level. Projected annual tourist arrivals of 1,400 people in the year to September 2004 continued to be less than the number of business travelers, which is estimated to have reached 2,250 people in 2004. A positive contribution to growth was made by copra, which provides one of the largest sources of merchandise exports and cash incomes for the outer islands. Copra export volumes rose by 14% over 2004 and, with producer prices rising slightly, producer income rose by 16%. Total producer income from copra of $1.2 million contributed approximately 1% of GDP.

Following budget surpluses in FY2002 and FY2003 aimed at generating savings for investment in the Marshall Islands Intergenerational Trust Fund, the Government planned

a substantial increase in expenditures and net lending in FY2004 and projected a small budget deficit of 0.6% of GDP. However, delays in capital works resulted in a budget surplus. Domestically raised government revenues, which accounted for a quarter of total revenues and grants, fell by 5% in FY2004 as income taxes and import duties declined by 12% and 6%, respectively, and receipts from the sale of fishing rights plummeted by 47%. These falls were offset by an increase in grants from the US and Taipei,China; but total revenues and grants nonetheless fell by an estimated 1% over FY2004.

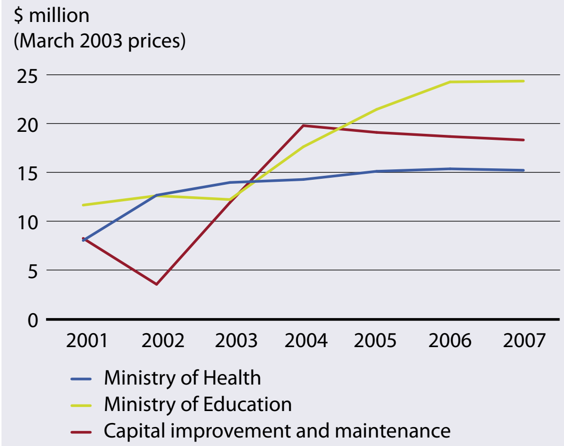
Inflation for the 12 months to September 2004 picked up slightly from the previous year but only to 2.4%. The increase was mainly a result of higher fuel costs and, to a lesser extent, higher alcoholic beverage prices following a rise in import duties. Commercial bank lending strengthened by 8% to $45 million in 2004, but remained substantially less than deposits, which rose by 3% to $81 million. Lending rates at the two commercial banks remained steady at approximately 20% for consumer loans and 15% for business loans, while deposit rates of 3% provided for a very large interest rate margin.

Macroeconomic policy developments

The amended Compact of Free Association financial assistance package as formally agreed with the US Government in December 2003 represents a major change in financial relations between the two countries. It affects the level of funding, the allocation of funds, and internal systems for managing public funds. With regard to allocation, the package provides for a large shift of expenditures toward the main sectors of health and education as well as for capital improvement and maintenance (Figure 2.28).

The environment and the private sector are also priority areas. This marks a substantial change in direction for the public sector and reflects concerns held in the Marshall Islands and the US as to the development impact of the initial assistance package provided under the Compact. Even with the additional grants provided by the new assistance package, funding to the priority areas must level off in FY2006 to stay within the budget constraint.

Figure 2.28 Government expenditures on priority sectors, Republic of the Marshall Islands, 2001–2007



Source: Staff estimates based on data from the Republic of the Marshall Islands Ministry of Finance and Economic Policy, Planning and Statistics Office.

The large increase planned in capital expenditures is important to correct for a backlog of projects. Capital spending has been curtailed for the past 5–6 years, initially by the need to repay high-cost government bonds and then by the need to save for investment in the Intergenerational Trust Fund. The rapid increase in capital expenditures requires an accompanying increase in recurrent funding (e.g., for teachers, medical staff, and medications) to make effective use of the facilities. The additional recurrent needs are yet to be fully factored into the medium-term fiscal framework, and some adjustments may be required to expenditure plans or internal revenue collection over the medium term to do this.

The amended assistance package provides for the adoption of financial accountability and management standards similar to those expected of US state and local governments. The Government recognizes that meeting these standards will require a sustained effort both to tailor systems and procedures to the circumstances of the Marshall Islands and to upgrade the capacity of its staff. Implementation of a government decision to move to performance-based budgeting is in its second year, with an initial emphasis on the ministries of Education, Health, and Environment. A medium-term budget and investment framework has also been established to shift budget planning to a 5-year rolling basis.

The Intergenerational Trust Fund had a balance of over $30 million at the end of FY2004, and this is to be built up in future years through $7 million in annual contributions by the US and ongoing contributions by the national Government. Ultimately, it is intended that the fund will provide a source of income sufficient to replace US grants. Against the assets in the fund, the Government held a debt of $100 million at end-FY2004, most of which was on concessional terms with ADB. The net debt of 65% of GDP should decline quickly over the medium term, as additional savings are made in the fund.

Outlook for 2005–2007 and medium-term trends

As the projected ratio of expenditures and net lending to GDP is more than 80%, the public sector will remain the dominant influence on the economy. Sufficient grants have been secured to maintain the high level of expenditures budgeted for FY2004, and this is expected to support the economy over the next few years. The Government's change in focus to the priority areas for development is also expected to enhance growth potential and help lift activity.

A planned catch-up in capital works in 2005, in addition to the ongoing upgrading program, has the potential to provide a short-term boost to the economy. However, there is some risk that the tighter procedures now applied to capital works will result in continued project delays. Feasibility studies are now being conducted for major projects. External project managers are appointed to oversee work, and new tendering and contracting processes are in place. The new procedures have already resulted in benefits such as the contracting of major works at figures substantially below estimated costs. However, the downside is the slow rate of project implementation.

Action is being taken to reopen the tuna loining plant. As guarantor of a $2 million loan to the business, the Government acquired control of the plant after its closure and began investigating potential market interest in reopening it. The previous operator argued the plant was only commercially viable with tax concessions and a wage below the legislated minimum. If a prospective operator shares this assessment, it may take some time to negotiate a new commercial arrangement and recommence operations.

In January 2005, Aloha Airlines of Hawaii canceled its services to the Marshall Islands as part of a wider withdrawal from the region. While the country is still serviced by three international carriers, this reduction in capacity and competition on the major US route is a setback for tourism. This follows the recent withdrawal of the international Outrigger Group from the operation of the country's main hotel.

The commercial banking sector remains constrained by the small private sector and an inability to use land and other assets as collateral for loans. However, revised land registry legislation and a strengthening of land management and administration are being pursued to ease the constraints faced by the sector.

Vocational training faces an uncertain future. A 2-year probation period set by US accreditation agencies for the College of the Marshall Islands was extended in January 2005 by 6 months, over which time the College must continue to correct shortcomings in financial management and strategic planning. If accreditation is removed, the College would lose approximately half of its revenues (via the loss of US grants) and require a substantial increase in local financial support to remain in business. Even if operations were continued, the loss of accreditation would reduce the ability of locally trained nurses, teachers, and business administrators to gain employment in the US.

Federated States of Micronesia

A reduction in foreign grants triggered a large contraction in the economy in 2004. Conditions are expected to improve in 2005, but prospects further out are highly uncertain. Foreign grants available for government expenditures are on a downward trend, and economic growth will be increasingly dependent on expansion of the small private sector.

Macroeconomic assessment of 2004

The economy contracted in 2004 as it adjusted to new arrangements with the US under the Compact of Free Association, as amended. GDP is estimated to have declined by 3.3% in FY2004 (ended 30 September), likely almost all attributable to a contraction in the public sector of 8.4%. Other sectors are also expected to have shrunk, but by less than 1% in aggregate. Dive tourism was firm, with the three main dive hotels reporting occupancy rates of more than 80%. However, other tourism activity was weak and occupancy rates at other hotels were typically less than 40%. Tourist arrivals in 2004 are estimated at more than 10% below the previous year's level and substantially below recent highs. The high cost of airfares relative to other regional destinations remains a major constraint on tourism. Even though airfares were reduced in the second half of 2004 following the July entry of a new carrier, Air Palau Micronesia, the existing operator matched these lower fares and the new operator had ceased flights by December.

The weak economic environment resulted in a poor revenue outcome for the year. Total tax receipts slipped by 2.3% in 2004, with import duty collection falling by 7% and revenues from the wages and salary tax weakening by 5% (in nominal terms). Improved enforcement led to a slight rise in revenues from the third-largest tax, a turnover tax. The declines in tax revenues were greatest in the states of Chuuk and Kosrae, of 15% and 7%, respectively, from the 2003 levels. In contrast, collection in Yap and Pohnpei rose by 3% and 4%, respectively. This pattern is consistent with the relatively larger fiscal adjustments that were required in Chuuk and Kosrae in 2004.

Grants also fell substantially during the year, stemming primarily from the end of a "bump-up" in funds provided by the US for the final 2 years of the previous Compact. The 27% fall in revenues and grants exceeded a 12% cut in expenditures and net lending, and the consolidated budget moved into deficit (Figure 2.29). This followed 2 years of surpluses, which had been achieved to meet a government commitment to invest in a trust fund, negotiated as part of the amended Compact.

Inflation is estimated to have stayed low in 2004 at 1.5%, as a result of the US dollar's use as a base currency and the low inflation rates in the country's main trading partners. Commercial bank lending remained low over the first half of 2004. Total lending was $53 million as of December 2001, but had fallen to $22 million by December 2003 following the closure of the operations of the Bank of Hawaii in the country and a tightening in the lending policies of the two remaining banks. Lending fell by a further 8% by end-June 2004. Commercial loans recorded a 23% rise over the first half, but this was more than offset by a fall in consumer lending. Lending by the other main source of finance, the FSM Development Bank, was stable. Indicative interest

rates on business loans from the commercial banks remained close to 7% while interest rates on consumer loans rose slightly to just above 15%. Deposit rates continued to hover around 1%. Deposits at the commercial banks of $110 million as of June 2004 remained well above total lending.

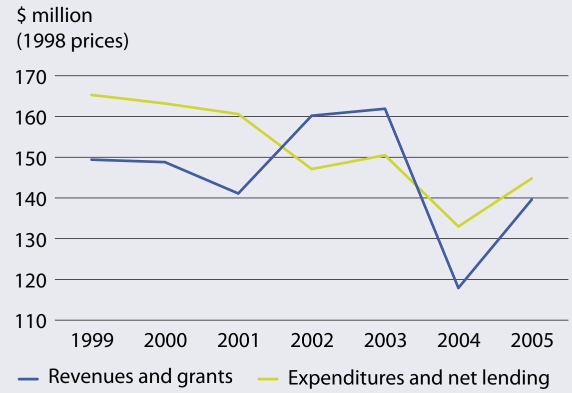
It is expected that exports were stable in 2004, representing about 15% of imports. While the easing in domestic demand is likely to have lowered non-oil imports during the year, higher fuel prices will have countered this, and the trade deficit is forecast to come in at close to recent levels. The large decrease in grants for 2004 is likely to have resulted in an overall deficit on the balance of payments.

Macroeconomic policy developments

The amended Compact with the US will provide $92 million in grants annually until FY2023. This is substantial, at the equivalent of 40% of current GDP, and will underpin the economy over the long run. The grant is only partially indexed to inflation and, what is more important for fiscal management, a portion of the grant is to be saved in a trust fund. Initially $16 million is to be saved each year, but from FY2006 this will rise by $0.8 million a year. The consequence is that grants available for general government expenditures are significantly below the $84 million received toward the end of the previous agreement (excluding the bump-up). The real value of grants available for the budget will continue to decline.

The Third FSM Economic Summit was held in early 2004 in Palikir, Pohnpei to build awareness of the new arrangements with the US and to develop consensus on an overall development strategy. The summit was attended by more than 400 people, representing the traditional leadership, the private sector, national and state governments, NGOs, churches, women's and youth groups, the civil service, and international donors. A consensus emerged at the summit to pursue a high economic growth strategy based on agriculture, fisheries, and tourism with the objective of achieving self-reliance over the term of the amended Compact. The summit also emphasized the importance of ensuring that Micronesians receive an equitable share of the benefits of growth.

Figure 2.29 General government revenues and expenditures, Federated States of Micronesia, FY1999–FY2005



Sources: Government of the Federated States of Micronesia, *Strategic Development Plan (2004–2023), The Next 20 Years: Achieving Economic Growth and Self-Reliance*; staff estimates.

The summit recognized that achieving the strategy would require a major public sector reform program, and agreed that a key element of the program would be the generation of revenues required to protect essential public services and investment. A redirection of expenditures to priority areas was also envisaged, including increased investment in airports, electricity, roads, and health facilities. It was also agreed that performance-oriented planning and budgeting systems would be adopted. The summit endorsed action to generate domestic and foreign investments through revised rules and laws, including the implementation of regulations to facilitate employment of the foreign technicians and managers needed for rapid growth. The overall intention of the public sector reform program will be to create a competitive investment environment to buttress private sector expansion.

Outlook for 2005–2007 and medium-term trends

The amended Compact provides for the adoption of a range of new performance requirements. These include new procedures for the specification, tendering, and contracting of major public works. The FY2004 budget anticipated administrative problems in adjusting to the new procedures and only budgeted for relatively low levels of

public investment. However, it was expected that these problems would be overcome by FY2005, when there would be a large expansion in the public works program. This boost in investment is expected to help the economy recover, and growth in GDP of 2.3% is projected in FY2005.

The revenue position is expected to improve in FY2005 as the firmer domestic economy pushes up tax revenues and $13 million is received from a US Special Education Grant (in addition to Compact funds). A small deficit is projected for the consolidated general government sector for the year. Despite a second consecutive year of deficits, gross external public debt is expected to remain low at approximately 26% of GDP, or less than 20% in net terms once offshore financial assets are taken into account.

The consolidated general government sector faces an ongoing need to control operating expenditures. In addition to the decline in grants available for general government spending, transition arrangements require a shift from operating to capital spending. Over the 5 years to FY2009, $6.3 million is to be redirected from operating expenditures. While the required correction is small relative to total expenditures and net lending, it is large relative to the expenditure base from which compensating cuts could be made. In the case of the state governments, the cut in locally funded operating expenditures would range from 16% to 37% if all the adjustment is to be made on the expenditure side.

The economic summit favored the pursuit of revenue reform to help alleviate fiscal constraints. A commitment was made at the summit to a revenue-neutral shift to a modern tax system within 2 or 3 years. Adjustment to existing taxes could cover the $6.3 million revenue shortfall—most of it, for example, by an increase in the gross revenue tax from 3% to 5% and in the general import duty rate from 4% to 10%. The introduction of a VAT to replace the gross revenue tax is also being considered. A VAT is also recognized as having the advantage of providing a sound basis for raising overall revenue collection.

A quick buildup in private sector activity is unlikely given its current low level. The economy is heavily consumption oriented, and export activities have been slow to establish themselves. Most families meet their own needs with regard to locally produced items, and consequently local trade in agricultural products is limited and agricultural exports are few. Attempts to establish export-based fishing operations have met with little success—any exports are almost entirely attributable to the efforts of distant-water fishing nations.

Tourist arrivals are now low at around 10,000 people a year, and there seems to be no ready solution to the hurdle imposed by a monopoly airline. This low base of private sector activity highlights the major effort required to raise the standard both of infrastructure and of the policy environment, if high growth is to be achieved.

Nauru

Nauru continued its reliance on Australian financial and technical assistance in 2004 as phosphate production contracted and trust fund assets went into receivership. A reformist administration elected in October has a strong public mandate to implement economic reforms but, in the absence of an alternative to phosphate mining, the medium-term outlook is for continued dependence on external assistance.

Macroeconomic assessment of 2004

Macroeconomic analysis of the economy is severely hampered by the virtual absence of economic statistics, but it was clear that the economy remained in a critical condition in 2004. Phosphate production, which historically has been the only significant domestic economic activity, was at an almost negligible level following years of exploitation and mismanagement, and allowed for only limited exports of relatively low-quality product to Asian markets. Agricultural output was stagnant, constrained by inadequate rainfall and low fertility of the limited arable land area. Coconut, breadfruit, and a few fruits and vegetables were harvested for household consumption. Fishing output was largely confined to subsistence harvesting, and was held back by a lack of equipment. Services sector activity recorded no growth, with public sector wages in arrears, tourism virtually nonexistent, provision of power and water dependent on external assistance, and returns on overseas investments dried up. Net assets in the trust funds administered by the Nauru Phosphate Royalties Trust (NPRT) had been valued at A$1,300 million in 1991, but the combined impact of excessive consumption spending, poor investment advice, and mismanagement reduced the value to an estimated A$138 million in 2002. Continued mismanagement culminated in early 2004 with the placement of the asset portfolio into receivership, following the Government's failure to meet the repayment deadline on a loan from General Electric Capital Corporation. Sale of NPRT's Australian property portfolio reportedly covered the $188 million owed on this loan, and left a relatively small pretax amount of about $78 million with which to meet other debt-repayment obligations.

In the absence of phosphate and trust fund revenues, the economy remained reliant on income from fishing licenses and foreign aid. The established Australian bilateral assistance program continued, as did the provision of project assistance under Australia's Rehabilitation and Development Cooperation Program begun in 1993. Additionally, assistance in health, education, and maintenance of public infrastructure was provided in return for Nauru hosting processing centers for asylum seekers, which held 82 people in September 2004. Under a February 2004 memorandum of understanding between the governments of Australia and Nauru, the former agreed to provide an A$22.5 million package of assistance to June 2005, which included the placement of Australians in three in-line positions in the Ministry of Finance (including the secretary) from late July. Australians also took up positions as director of police and special police advisor from late October. The finance team was tasked with improving public financial management, assisting in the formulation of the 2004/05 budget

and assessing Nauru's assets and liabilities. Assistance was also provided in late 2004 by the Pacific Islands Forum, which gave a cash grant for salaries and offered support for the judiciary, financial auditing and planning, and the health and education sectors.

Political instability in late 2003 disrupted the approval process for the 2003/04 budget, which was in any case quite unrealistic in its revenue and expenditure projections. Dividends to the Government from the state-owned Nauru Phosphate Company (NPC) ended in 1991 and the virtual standstill of phosphate production in 2004 prevented the Government from borrowing against phosphate sales revenues. Checks drawn on government accounts with the state-owned and technically insolvent Bank of Nauru remained worthless; and the shrinking of the NPRT investment portfolio meant that the Government could no longer rely on direct drawdowns from trust funds and collateralization of their assets as the principal means of funding a budget deficit.

In the event, government spending in 2003/04 was limited by the availability of revenues and authorized by the passage of three supply bills, with the result that a small surplus of A$37,600 was recorded. Actual expenditures were 35% of the budgeted level and involved a substantial shortfall in public service wage payments: only A$5 million was paid, compared with a salaries liability of A$13 million. The consequences for public service delivery were evident in education: the sector fell into crisis as expatriate teachers left Nauru without their back pay or their superannuation entitlements. Nauruan teachers were receiving incentive payments from the Australian Agency for International Development of $10 per week; but, like all government employees, they were receiving less than their full salaries and their productivity was reduced by inadequate supplies of complementary inputs such as teaching materials. Salaries for public enterprise employees were also in arrears, notably in NPC, which could neither pay nor immediately repatriate its foreign contract workers. Since almost all Nauruans in formal employment are in the public sector, economic hardship increased in 2004, with people using any public sector wages received, savings held offshore, and private remittances from relatives overseas to purchase essential supplies of rice and flour.

Given the use of the Australian dollar as the currency and Australia's position as the major supplier of imports, the inflation rate in the first 3 quarters of 2004 was probably around the Australian rate of 2.3%. With the Bank of Nauru insolvent, no effective commercial banking services were available; the contraction of economic activity inevitably discouraged financial development beyond cash-only exchange and barter. The merchandise trade deficit was covered primarily by official and private transfers.

Macroeconomic policy developments

Past budgets in Nauru have been characterized by overoptimistic revenue projections, underestimation of expenditure needs, and nontransparent funding of unsustainable deficits. The 2004/05 budget approved by Parliament in late October 2004 represents a fundamental change in approach to fiscal management. It explicitly acknowledges that the country is in financial crisis and accordingly aims at ensuring that expenditures are reduced and controlled within limits set by realistic, medium-term projections of revenues and grants.

Expenditure reduction is to be achieved through reducing the public service wage rate to an average of $75 every 2 weeks (pending completion of a review of public service salaries); cutting by 75% payments to landowners leasing land to the Government; scaling down diplomatic representation in Australia and the US; cutting expenditures on residential accommodation for Nauruans receiving medical treatment and studying in Australia; and transferring overseas Nauruan students from Australian to Fiji Islands institutions in 2005. Public service wages will account for 44% of reduced aggregate expenditures and there is provision for some reallocation of resources to education and health, as well as for the establishment of a price control board to prevent profiteering by merchants with monopoly power.

Revenue-raising measures include the introduction of a 10% import duty on goods (except for rice, flour, and fresh fruits and vegetables) previously imported free of duty; increased import duties on alcohol and tobacco; the transfer of fishing license fees from the Nauru Fisheries and

Marine Resources Agency to the Government; and increases in various fees and charges.

Income from investments, dividends, and fishing license fees and from customs and excise duties is estimated to account for 35% and 26%, respectively, of total revenues. A budget deficit of A$497,000 is projected for 2004/05, to be followed in the next 2 years by budget surpluses in excess of A$2 million. The 2004/05 budget papers are silent on how the projected deficit is to be financed, implying that, in the absence of a revenue windfall, expenditures will have to be reduced to ensure budget balance. The probability that the 2004/05 budget and associated economic reforms will be implemented effectively is high because of the strong parliamentary majority held by the reformists and because technical assistance will help ensure sound cash management as well as expenditure control.

A key element in introducing responsible public financial management was the initiation of an assessment of assets in the trust funds administered by NPRT. Remaining trust fund assets will need to be restructured away from a heavy property orientation toward a properly managed portfolio of secure income-generating financial assets. The task of restructuring is complicated by the fact that the various trusts are owed millions of dollars by the Government and by the state-owned Republic of Nauru Finance Corporation (RONFIN), which has been technically bankrupt for at least a decade. The reform of the 11 major SOEs other than NPRT itself is a demanding medium-term requirement and will need to include an assessment of the state of NPC's finances and future prospects. The 2004/05 budget affirms the Government's commitment to public enterprise reform, beginning with the winding up of RONFIN.

Following the decision to close Nauru's internationally notorious offshore banking sector, antimoney laundering legislation was passed in 2004. This is expected to culminate in Nauru's removal from the Non-Cooperative Countries and Territories (NCCT) list of OECD's Financial Action Task Force (FATF) on money laundering. In October 2004, FATF withdrew countermeasures against Nauru because of the passage of the legislation, but awaits evidence of implementation before complete removal from the NCCT list. The 2004/05 budget provides funding for the establishment of a financial investigations unit to support the implementation process. Setting up a viable domestic banking system is another major task to be addressed in the economic reform program.

Outlook for 2005–2007 and medium-term trends

Continued exploitation of phosphate deposits, which are almost exhausted, offers no prospect of medium-term economic growth. Even the extraction of remaining reserves is hampered by the deterioration of infrastructure and equipment due to past neglect of maintenance. Aid-funded rehabilitation of mined land will generate economic activity at a relatively low level over the medium to long term, and will thus indirectly generate some government revenues, as will other aid-funded projects. However, there is no obvious alternative to phosphate mining as a means of creating GDP. National income will be heavily reliant on external sources. Pelagic fish are abundant in Nauru's exclusive economic zone, and revenues can be expected from fishing licenses issued to several deepwater fishing nations, though this is an inherently volatile revenue source that is difficult to predict. Revenues could also be generated by restructured trust funds, though the authorities do not expect them to be substantial.

The Government acknowledges that fiscal reform entails increased financial hardship for the population in the medium term. Nauruans employed in the public sector—almost everybody in formal employment—will bear the brunt of unavoidable wage cuts that will have flow-on effects in the rest of the economy. The mostly ethnic Chinese retailers who depend on public servants' purchasing power will experience further reductions in business, and some may join other expatriates departing the country on Air Nauru's solitary aircraft, which offers the only available commercial service and which will continue to struggle for financial viability.

Republic of Palau

Economic growth accelerated slightly in 2004 as a result of strong tourism expansion. However, the economy remains heavily dependent on US assistance and the Government needs to curb public expenditures. This is a key element of a general reorientation toward encouraging private sector-led development, which is essential to sustainable economic growth in the post-Compact era starting in 2009.

Macroeconomic assessment of 2004

Palau became independent on 1 October 1994 in free association with the US, and joined ADB on 29 December 2003 as the 63rd member. Historically, Palau was a part of the UN Trust Territory of the Pacific under US administration. A Compact of Free Association—an economic, political, and strategic treaty between Palau and the US—was approved in 1986 but was not ratified until 1993. Under this Compact, which covers the 15-year period FY1994–FY2009, Palau conducts its own domestic and foreign affairs, while the US retains control of defense and security matters (for which it has exclusive access to Palau's waterways); pays for health services; and provides about $600 million in economic development assistance, including grants for direct budget support (of around $13 million annually) and disbursements for the creation of a Compact Trust Fund (CTF). Palau consequently has enjoyed one of the highest living standards in the Pacific, though this has largely been generated by an aid-dependent public sector.

Based on the limited data available, Palau's GDP increased by 2.0% in 2004, compared with contraction of 0.1% in 2003 and 4.7% in 2002. The growth was attributable to the continued revival of tourism following the downturn induced by the 1997–98 Asian financial crisis. In FY2003 (ended 30 September), visitor spending almost reached the precrisis level, and in FY2004 visitor arrivals grew to a record of nearly 80,000. This tourism growth boosted the retail trade sector, which continued to benefit also from expansion in public sector activity. The relatively small agriculture sector generated some subsistence income, but its development has been hampered by lack of infrastructure, while revenues from fishing license fees remained at the fairly low level of recent years. Tuna harvesting by fishing fleets from Japan; US; PRC; and Taipei,China failed to produce the catch levels characteristic of the late 1980s.

With GDP and population growing at almost the same rate in 2004, per capita income grew slightly but remains at 6% below the 2000 level. Moreover, income disparities have reportedly widened in the last 5 years. According to census figures, the share of the non-Palauan resident population increased from 16.8% in 1990 to 25.6% in 1995 before reaching 30.1% in 2000. The 1990–2000 increase accounts for four fifths of the increase in the country's total population.

Government expenditures increased to 66.3% of GDP in FY2004 from 57.5% in FY2003, and revenue collection was poor. The overall budget deficit was estimated at 9.9% of GDP and was again financed by drawdowns from the CTF. The balance of the CTF had already dropped from a peak of $162 million at end-FY2000 to $136 million at end-FY2003.

The high level of consumption relative to domestic production was reflected in a large trade deficit equivalent to almost two thirds of GDP: merchandise exports were estimated at $11.9 million in 2004, compared with merchandise imports of $108.8 million. The current account deficit increased from $5.3 million in FY2003 to $22.5 million in FY2004. Use of the US dollar as the currency precludes an independent monetary policy and means that inflation tends to track that in the US, which has been low over the last 3 years.

Macroeconomic policy developments

Fiscal deficits in most recent years have been the highest among Pacific island economies and have been a major drain on the CTF, which has also been adversely affected by trends in international equity markets. FY2005 marks the 11th year of the Compact and Palau will receive $12.8 million in direct assistance during the year, but Compact grant disbursements are expected to decline over the remainder of the Compact period. There is therefore an urgent need to formulate and implement a medium-term fiscal strategy that ensures long-term fiscal sustainability. This strategy must involve a reprioritization of a reduced level of government expenditures and augmentation of the CTF as a source of sustained revenues. The policy challenge is substantial, given that the Government provides utilities, communications, and health services in addition to the usual public services, making it the single largest service provider and employer in the country. It is critical that the Government improve its management of service provision, including the adoption of innovative financing options and mutually beneficial partnerships with the private sector.

Additionally, the Government will need to promote private sector-led development that generates greater benefits to the domestic economy. At present, it relies heavily on grant-funded public sector construction activities that have limited multiplier effects on total output: many construction workers are temporary foreign workers, largely from the Philippines (61% of foreign workers) and the PRC, who remit their salaries to their home countries. Economic activities with greater output and employment multiplier effects need to be promoted through structural reforms, including the creation of a leaner, results-oriented civil service, tax and tariff reform, and public enterprise reform. The costs of doing business in Palau are generally high by international standards, as is the case in other Pacific island countries, and are especially high for closing a business. Bringing these costs down is an essential component of an improved enabling environment for the private sector.

Outlook for 2005–2007 and medium-term trends

In the medium term, growth is forecast to be about 2% and to occur in a low-inflation environment, with a large trade deficit offset by inflows on the services, income, and transfers accounts. This growth will be driven in part by tourism, with economic recovery in Japan and continued economic growth in the PRC ensuring that tourist arrivals and spending exceed the 2004 level. Public sector infrastructure projects will be the other driver of growth, as two major construction projects will be completed in 2005 to early 2006.

The larger project is the construction of a 53- mile two-lane highway on the island of Babeldaob, which will be the second longest after a highway in Guam in the Micronesian region. Included as a special economic development project in the Compact financial package from the US, this project is known as the Compact Road. Substantial delays have occurred due to problems with the technical implementation design and bad weather, but completion is expected by mid-2005. This will make tourist attractions and many commercial facilities more accessible, strengthening the foundations for future private sector growth.

The second major project is the construction of the new national capital complex at Melekeok, again on Babeldaob. The project is funded by a $23 million concessional loan from Taipei,China and will be completed in early 2006 when the Government will move about half of the administration from the highly populated and urbanized center of Koror on Babeldaob, which will retain health and policy development among other

functions. The development of a new, modern capital symbolizes Palau's emergence as an independent state, but this has significant implications for the budget. It is estimated that the recurrent cost of the new facilities will add $2 million a year to government spending.

A third project that will contribute to growth is the establishment of a central market in Babeldaob, which is intended to support agricultural development by improving marketing facilities. A feasibility study by the Bureau of Agriculture with the Food and Agriculture Organization of the United Nations included an investigation of central market systems in several Pacific countries and concluded that, once completed, the central market will have a capacity to handle an annual output of some 420 tons of fruits, vegetables, and root crops, and 160 tons of fish. Construction is scheduled to start in April 2005.

Over the medium to long term, the Government faces the twin economic challenges of managing the fiscal adjustment to a decline in sector grants and encouraging broad-based private sector development in a small domestic economy. At present, there is an overdependence on aid and tourism and a consequent uncertainty about sustained growth prospects in the post-Compact period.

Papua New Guinea

The economy grew at a modest rate in 2004, inflation fell substantially, and financial conditions improved. The outlook is for continued modest economic growth, provided that fiscal gains are consolidated and structural reforms aimed at stimulating private sector-led growth in nonminerals are implemented.

Macroeconomic assessment of 2004

GDP increased by 2.6% in 2004, slightly down from 2.8% in 2003. The agriculture, forestry, and fishing sector was the primary engine of growth, expanding by 3.0% as weather and commodity prices remained generally favorable. Within the minerals sector (mining plus oil and gas), the mining subsector grew by 3.3%, stimulated by higher gold and copper prices and aid-funded road maintenance and upgrading projects. However, the oil and gas subsector contracted by 5.8% despite higher oil prices because reserves extraction fell. The minerals component of GDP therefore increased by just 0.1%. Manufacturing expanded by 2.8%, construction by 3.2%, and electricity, gas, and water by 2.5%. The services sector as a whole grew by 2.0%, but there was variation in subsector performances: transport grew fastest at 3.0%, followed by trade at 2.6%, finance, real estate, and business services at 2.5%, and community, social, and personal services at 1.5%.

Economic growth barely kept pace with that of the population. Similarly, although the relatively labor-intensive nonminerals component of GDP rose faster in 2004 (2.8%) than in 2003 (1.7%), job growth did not match the growth in labor supply. Formal private sector employment in the quarter to June 2004 was barely 0.1% higher than that in the year-earlier period. The only significant expansion in nonminerals employment was seen in the manufacturing, retail and finance, and other business sectors, with declines in all others. Minerals sector employment increased by 8.2%, but this was entirely because of expansion at one gold mine. On a regional basis, the most worrying outcome in 2004 was the decline in employment in the two rural regions (Momase and the Highlands) that together hold approximately three quarters of the poor in Papua New Guinea.

The 2004 budget balance officially was expected to be a surplus of 1.1% of GDP, compared with an original budget target of a deficit of 1.5%. Total revenues and grants exceeded the budget projection by 11.6%, largely because of unexpectedly high mining and petroleum tax and dividend receipts. The temporary 1% import levy introduced in the 2004 budget also raised more revenues than anticipated, but only partly offset a decline in receipts from log export duties. Total expenditures and net lending exceeded the original budget estimate by 2.4%, with total recurrent spending in line with the budget projection, and development spending exceeding the projected level by 7.0%. Lower interest rates meant that government servicing of its debt was 40% below the budget projection. The consequent savings permitted a reallocation of public resources toward development expenditures, and were also used to pay off arrears and cover the costs of certain verified legal claims against the Government.

Spending on goods and services was over a

third higher than the budget projection, while, accounting for 42.9% of total recurrent spending, the wage bill was 2.9% above the projected level. In accordance with the Public Finances (Management) Act, 90% of the unexpectedly strong mining and petroleum revenues were used to retire government debt. Total public debt was projected to be 54.6% of GDP at the end of the year, compared with 59.7% at the end of 2003. Domestic debt fell to 22.5% of GDP at end-2004, with a lengthening of the maturity of the debt as the Government implemented its Inscribed Stock Issuance Program and retired short-term treasury bills. External debt fell from 35.5% of GDP at end-2003 to 32.1% at end-2004, reflecting the valuation effect of currency appreciation and an outflow on net external financing.

Inflation in 2004 fell sharply to 2.9%, compared with 14.7% in 2003. This drop was largely attributable to the lagged effects of currency appreciation in late 2003 and, in 2004, the combined effect of higher commodity prices and tighter fiscal management on the exchange rate, which appreciated further (with the latter damped by central bank intervention). The strengthening of the kina prompted Standard & Poor's to raise its country rating from stable to positive at year-end. Falling inflation in the context of balance-of-payments strength encouraged the Bank of Papua New Guinea (BPNG) to ease monetary policy through the first 10 months of 2004. Official interest rates dropped substantially, with interest rates on 182-day treasury bills down from 17.0% in January 2004 to 3.1% in November. However, commercial bank lending rates declined only marginally from 13.9% to 13.1% during this period, indicating a lack of competition in the banking sector. Broad money supply increased by 17.7% because of a rise in net foreign assets. Domestic credit fell by 1.0% because of a 2.5% decline in credit to the private sector, suggesting a lack of effective demand for funds from business.

Official budget projections show a 15.1% rise in the trade surplus in 2004 and the current account surplus remaining virtually unchanged as a share of GDP at 3.7% against 3.8% in 2003. Balance-of-payments data for the first 3 quarters suggest that the projections may have overestimated the trade and current account surpluses because of unexpectedly strong growth in general imports and mining-related investment expenditures. The current account in the first 3 quarters recorded a small deficit of US$18 million, equivalent to approximately 0.5% of GDP, though during this period there was a net inflow on the financial account of US$61 million, as mineral producers drew down their foreign currency accounts, trade credits to domestic residents rose, and foreign investment flowed into a mining venture. The overall balance-of-payments surplus in the first 3 quarters thus increased over the corresponding period in 2003, and foreign reserves rose to US$589 million at end-September, equivalent to 4.6 months of total import cover and 5.3 months of nonmineral import cover. The domestic currency, the kina, appreciated by 2.5% against the US dollar and 1.2% against the Australian dollar in 2004.

Table 2.24 Major economic indicators, Papua New Guinea, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	2.6	2.9	1.7	2.6
GDI/GDP	-	-	-	-
Inflation (CPI)	2.9	3.8	4.8	4.9
Money supply (M2) growth	17.7	-	-	-
Fiscal balance/GDP	1.1	-1.0	-0.6	-0.2
Merchandise export growth	12.7	5.1	-7.1	3.5
Merchandise import growth	10.7	6.2	-2.9	5.6
Current account/GDP	3.7	2.5	0.5	-0.8

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

Sources: Government of Papua New Guinea, *2005 National Budget*; staff estimates.

Macroeconomic policy developments

The 2005 budget passed by Parliament in November 2004 continues the implementation of the Government's medium-term fiscal strategy, which aims at progressively reducing the deficit until budget balance is achieved in 2008, and at reallocating expenditures to the five priority areas identified in the Medium Term Development Strategy, 2005–2010, namely rehabilitation and maintenance of transport infrastructure, generation of income-earning activities, basic

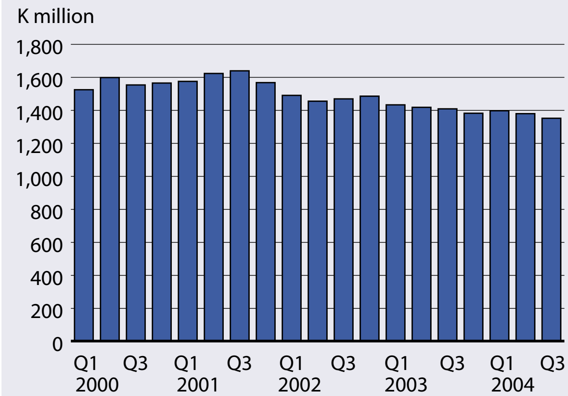
education, primary and preventive health care, and law and justice. The fiscal strategy also aims at reducing the Government's outstanding liabilities, maintaining existing tax levels without introducing new taxes, and sustaining institutional and policy reform.

An overall budget deficit of 1.0% of GDP is targeted for 2005, and is to be funded by domestic borrowing, with the Government continuing to shift the debt balance from short- to longer-term securities. Net external financing is an outflow equivalent to 1.3% of GDP, with anticipated new concessional and commercial loans more than offset by amortization on existing loans. Revenues (including grants) are projected to be 8.3% greater than in 2004, primarily because of an anticipated increase in project grants mainly associated with the Enhanced Cooperation Program with Australia. Nontax revenues are projected to rise as dividends from BPNG and the National Fisheries Authority accrue, but tax revenues are projected to fall by 4.6% because of the ending on 1 January 2005 of the temporary import levy as planned, the continuing phased reduction of the mining levy, and lower oil and copper prices. There are no asset sales included in the budget projections, but if any occur, the proceeds would be used to retire debt and rehabilitate state assets. The sale of 51% of Telikom PNG Limited that was to occur in 2004 was delayed and then canceled in mid-December, signaling some government hesitancy in the implementation of the privatization policy and provoking a legal response from the overseas tenderer.

Total expenditures and net lending are projected to rise by 15.7% in 2005. Total recurrent expenditures are budgeted to go up by 4.6% from the 2004 level, largely because of a 9.2% rise in the wage bill, which is presented as a calculated and responsible component of the public expenditure review and rationalization program. Expenditures on goods and services are projected to increase by less than 1% from the unusually high level of 2004, when outstanding state liabilities were settled; but there is provision for structural adjustment payments arising from public sector reform and for increased resource allocation to provincial departments so as to improve service delivery.

Development expenditures are projected to rise by 38.3% from the estimated 2004 level as a result of grant-funded expenditures under the Enhanced Cooperation Program, project grants from the Japan International Cooperation Agency, increased government drawdowns of concessional loans, and increased provision of tax credits for infrastructure expenditures. As in the past, the real issue is whether the budget is implemented as planned in a fragile political environment characterized in 2004 by threats of no-confidence motions in the prime minister, suspension of Parliament, and major cabinet reshuffles.

Figure 2.30 Credit to the private sector, Papua New Guinea, March 2000–September 2004



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, September 2004.

In 2004, BPNG continued to demonstrate its capacity to conduct an independent and prudent monetary policy aimed at protecting foreign reserves and stabilizing the kina. The kina's stabilization contributed to an increase in business confidence, according to an independent business survey *(Economic Insights 2004)*, but midyear BPNG predictions of significant growth in private sector credit during the second half of 2004 seemed overoptimistic. Correspondingly, excess liquidity likely did not pose an imminent threat to exchange rate stability. Nonetheless, BPNG strengthened its capacity to control liquidity through open-market operations by introducing an additional policy instrument in August. The new "central bank bill" has the same features as treasury bills and is traded at weekly auctions. The insolvent Rural Development Bank underwent a change of management and an external review in 2004, with the intention of formulating and implementing a financial recovery plan.

Reversing the decline in lending to the private sector is crucial to improving medium- to long-term growth prospects (Figure 2.30). A reduction in lending rates in line with official interest rate falls would facilitate such a reversal, as would reductions in the costs of doing business. According to the World Bank's Doing Business Indicators, the country rates poorly in the time taken to start a business (56 days), the costs of establishing a business (30.7% of per capita income), the time to enforce a contract (295 days), and the time to process an insolvency (2.8 years).

More fundamentally, it is likely that a sustained turnaround in private sector borrowing requires political stability and significant progress in addressing long-standing law-and-order and governance problems. The survey referred to above showed that the cost of finance was seen as a constraint to business, but one that rated below weak private sector demand, poor security, and general uncertainty. Major new natural resource development projects would also boost investment. The presence of Australian police, defense personnel, and technical advisors under the Enhanced Cooperation Program is expected to reassure investors, but how much this reassurance will translate into actual borrowing and investment remains to be seen.

Outlook for 2005–2007 and medium-term trends

On the assumptions that global economic growth will slow in the medium term, that commodity prices generally will weaken from the historical highs of 2004, and that the Government's economic and public sector reform strategies will be implemented successfully within a stable macroeconomic and political environment, GDP growth is forecast to be 2.4% over 2005–2007, though subject to volatility because of the vagaries of weather, commodity prices, and natural resource discoveries. This aggregate growth forecast was made by government officials in the 2005 budget papers and by external agencies, including IMF and ADB.

Export-led growth in agriculture is expected to accelerate to over 3% a year as improved law and order and transport infrastructure increase producers' access to markets; and fisheries production is forecast to grow in response to expanded domestic processing capacity. However, log exports are likely to decline as governance of the sector improves, so that agriculture, forestry, and fishing as a whole is forecast to grow at an average annual rate of 3.2% in 2005–2007.

The oil and gas subsector is expected to recover from its 2004 contraction in 2005 as investment in the Moran oil field increases access to resources. Thereafter, depletion of reserves at the Kutubu and Gobe fields will cause a drop in production, with the impact of any new projects likely to be felt in the longer term. The decision by Exxon Mobil to proceed with a US$100 million front-end engineering and design study of the Southern Highlands gas project is encouraging, but there are still insufficient customers at the Queensland, Australia end of the proposed gas pipeline to ensure project viability. In the absence of this project, oil and gas is forecast to decline at an average annual rate of 4.0% in 2005–2007.

Mining production is expected to stagnate over the medium term after expanding significantly in 2005 as a result of increased production of copper and gold, the latter reflecting the start of production at two new, relatively small gold mines and the expansion of existing mines (except Misima). In 2006, reserves depletion at the Porgera gold mine and Ok Tedi copper mine, and the impact of an expected declining copper price, are forecast to cause a contraction in sector output.

The net result for the oil and gas and mining subsectors together is that output in 2007 is expected to be 0.6% below the 2004 level.

Manufacturing is forecast to grow at annual rates of just below 3% in 2005–2007, on the basis that domestic demand will strengthen in the context of a stable macroeconomic environment and improvements in law and order and governance. Construction is forecast to grow at rates slightly in excess of 3% annually as a consequence of increased public expenditures on transport infrastructure development and a pickup in private investment. The electricity, gas, and water subsector in services is also expected to make a positive contribution to growth as SOEs invest in the rehabilitation and expansion of infrastructure. The services sector as a whole is forecast to grow at an average annual rate of 2.3%, with growth in transport heavily reliant

on an increase in agricultural production for domestic and export markets.

The main risks to the growth forecasts are that the macroeconomic policies, public sector reform plans, and development strategies of the incumbent administration will not be implemented for political reasons, or will not elicit the expected response from the private sector. The Enhanced Cooperation Program offers some insurance against economic mismanagement and further deterioration in the law-and-order situation, but cannot by itself guarantee the private investment that underpins sustained and broad-based economic growth. These forecasts may be exceeded on the upside if commodity prices turn out higher than expected, and if major natural resource development projects such as the Ramu nickel and cobalt project are under way within the forecast period.

The official government medium-term fiscal outlook is for a reduction in the budget deficit to 0.2% of GDP in 2007. A fall in tax revenues from the oil and gas sector is the main reason for a projected drop in revenues and grants from 31.2% of GDP in 2004 to 29.7% in 2007, while expenditures and net lending are projected to fall from 30.1% of GDP in 2004 to 29.9% in 2007. The latter fall requires substantial savings still to be identified through the public service rightsizing and public expenditure review process, so that there is a possibility that budget targets could be overshot. However, provided that the targets are met, total public debt is forecast to decline to 50.9% of GDP in 2007, with declines in domestic public debt to 23.3% and external public debt to 27.6%.

Monetary policy is expected to remain broadly accommodative in the medium term, on the assumption that sound fiscal management and modest wage rises underpin exchange rate stability and inflation below 5%. The current account on the balance of payments is forecast to weaken in the medium term as merchandise import growth outpaces export growth, and increased deficits on the services and income accounts outweigh a rise in transfers. Export growth will be reduced by the impact of lower oil and copper prices and production, and would be even lower in the absence of an increase in agricultural exports, which are forecast to exceed mineral exports by 2007. Forecasting capital account transactions is difficult because of uncertainties over flows of concessional finance, but it is expected that balance-of-payments strength will be maintained and that foreign reserves will remain high enough to provide at least 4.5 months of nonmineral import cover.

The ability of the economy to generate agricultural growth in the context of declining petroleum output is crucial to the macroeconomic outcomes forecast for 2005–2007. Nonmineral output growth is essential for employment generation, but even if the forecasts prove accurate, growth remains too slow for substantial inroads to be made into the un- and underemployment problems. The country's growth rate needs to at least double before this can happen.

Samoa

The economy expanded by more than 2% in 2004 as construction strengthened and tourism continued to grow, though the loss of agricultural production due to cyclone Heta pushed inflation up to 16% by year-end. The FY2005 budget provided for a 60% increase in expenditures and net lending, much of which is allocated to additional public works. Continuing high levels of construction activity are expected to support the economy over the medium term.

Macroeconomic assessment of 2004

The year got off to a bad start due to the widespread damage wrought by cyclone Heta in January. While the destruction was not as severe as in earlier cyclones, it had an immediate adverse effect on the supply and price of agricultural products. In the quarter to March, the overall volume of supply to the main fresh produce market fell by 52% and the overall price index at the market rose by 71%. Fishing activity was also adversely affected and the need to repair damaged infrastructure impacted the budget, requiring reallocation of funds.

The economy recovered quickly though, and GDP over the first 3 quarters of 2004 came in at 2.3% higher than in the same period of 2003. While agriculture and fishing declined by 9.2% over the period, industry expanded by 2.6% and services rose by 5.2%. Growth for the whole year is estimated at 2–3%.

Greater construction activity led growth in the industry sector in 2004, supported by several large private and public sector projects, in addition to reconstruction work required by the cyclone. New office buildings were under construction for the government-owned telecommunications operator and the Development Bank of Samoa. Preparations continued for the hosting of the 2007 South Pacific Games. Construction of roads, bridges, seawalls, and schools continued, and work was under way for a new 140-room hotel at Faleolo, a temple, and a shopping mall. The increase in construction more than offset a drop in manufacturing as output from the automotive wire harness plant fell and a garment factory closed temporarily to relocate premises. The growth in services was attributed mainly to increased output from financial and business services and from personal and other services.

Visitor arrivals continued to rise in 2004, in part due to the holding of Pacific Forum meetings in Apia. Preliminary estimates are that arrivals increased from 93,000 in 2003 to 97,000, and that total tourism revenues picked up by some 20%.

Merchandise exports declined in 2004. Preliminary data indicate that the value of fish exports, which is the main commodity export, weakened by more than 10% following a 46% fall in 2003. Exports of garments, which are the second-largest commodity export, fell by more than half over the year. International reserves remained above the Central Bank of Samoa's target of approximately 4 months of imports (Figure 2.31). As of end-November 2004, international reserves were the equivalent of approximately 5.2 months of import cover, down from 6.0 months as of end-2003.

Despite the extra costs imposed by cyclone Heta, the budget deficit for FY2004 (ended June 2004) was less than budgeted at 0.9% of GDP. A similar deficit is targeted for FY2005. If this target is achieved, it would represent the

third year of a tight fiscal position. The ratio of official government debt to GDP (excluding government guarantees) has fallen from 62% in 2001 to 46% as of end-September 2004. Debt service costs accounted for 5% of FY2004 expenditures and net lending.

Inflation rose over the course of 2004 as the full effect of the cyclone on local produce supplies fed through to retail prices, and as higher international fuel prices raised transport costs. The annual inflation rate was 11.7% as of end-September, reflecting a 26.8% increase in the price of local goods and services and a 2.7% increase in the price of imported goods.

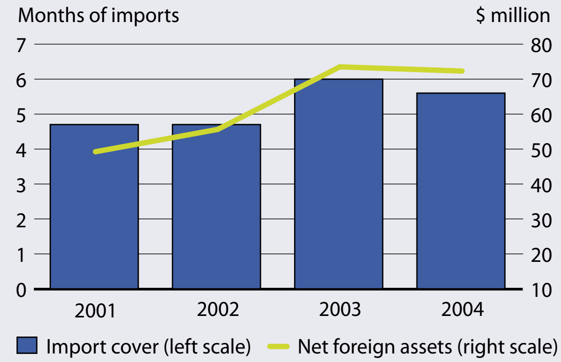
The central bank adopted an accommodative stance in 2004 in an effort to generate economic growth. The one-time inflationary effect of the cyclone was allowed to pass through the economy without any offsetting action. The combination of a slight fall in interest rates, an easing in May 2004 of foreign exchange controls on capital transactions, and a firm economy led to a 14.2% increase in credit to the private sector in 2004. Money supply (M2) grew by 12.7% by end-September compared with the same period in the previous year.

Macroeconomic policy developments

The FY2005 budget provided for a tripling of grant-funded development spending to $259 million. Combined with an 8% increase in other expenditures, a 59% increase in expenditures and net lending is budgeted for FY2005. The additional outlays provided in the budget are very large at the equivalent of 20% of GDP. Some of the increase in development spending is due to the recording of on-budget scholarship assistance provided by bilateral donors and additional outlays on institution-strengthening projects. However, much of the additional spending is for construction.

Long-standing problems remain in implementing capital programs in line with budget schedules. Acknowledging these problems, the Central Bank of Samoa has prepared a revised forecast of development spending for FY2005 of $57 million. This alternative forecast is for a 28% increase in total expenditures and net lending during FY2005, an increase equivalent to 9% of GDP. If all currently budgeted projects are to be pursued, carryover spending would continue the high level of public expenditures in FY2006.

Figure 2.31 Net foreign assets and import cover, Samoa, 2001–2004



Sources: Central Bank of Samoa, Selected Economic Indicators, January 2005; Ministry of Finance, *Quarterly Economic Review*, issue 26, July–September 2004.

Although inflation rose in 2004, the underlying rate remains low and is forecast by the central bank to be 2.1% by end-FY2005. The low underlying rate, together with small budget deficits and a secured foreign reserve position, has allowed the central bank to retain its accommodative monetary policy stance. In its September 2004 monetary policy statement, the central bank advised that interest rates should be maintained at prevailing levels in FY2005, if not reduced further; it also targeted a 13% increase in bank credit to the private sector and a 9% rise in the money supply for the year.

Outlook for 2005–2007 and medium-term trends

A boom in construction is expected to support the economy through 2005 and into 2006. Most major projects under way in 2004 have continued into 2005 and construction of a new hotel at Taumesina is envisaged. The hosting of the South Pacific Games is providing an ongoing source of construction activity, including a new aquatic center to be built with assistance from the PRC Government. Also to commence in 2005 is construction at the National University of Samoa and Samoa Polytechnic, with assistance from the Government of Japan.

The economy is expected to benefit as well from an expanding tourism industry and rising remittances from the large Samoan communities in Australia, New Zealand, and US. In real terms, remittances have risen by 10% a year since 2001 and are now equivalent to 20% of GDP. Remittances provide the single largest source of foreign exchange and are expected to reflect the economic expansion of the source countries. The latest official projection for remittances is growth of 3% in FY2005.

Visitor arrivals have advanced steadily in recent years, at an average annual rate of 3.1% since 2001. The rising demand for tourism across the region and expanding hotel capacity in Samoa underlie forecasts of continued expansion in tourism. The latest official forecast is for net travel earnings to grow by 15% in FY2005. The hosting of the South Pacific Games is likely to lead to a temporary surge in visitor arrivals.

A further boon for tourism is a proposed joint venture between Polynesian Airlines and an Australian airline, Virgin Blue. The joint venture would operate as Polynesian Blue on the existing international routes of the national carrier. The new arrangements are potentially important for tourism if they help retain capacity in Samoa, as well as competition. The joint venture is also important to the budget as Polynesian Airlines has been operating at a loss since 2001 and has required subsidies to sustain operations: its FY2004 subsidy of $7 million accounted for 6% of expenditures and net lending.

An improvement in commodity exports is forecast over 2005 relative to 2004 following the reopening of the relocated garment factory in the quarter to September 2004 and the expected reopening of a desiccated coconut plant in early 2005. A new heat treatment plant for fruit such as papaya recently received its certification and will likely help expand a range of exports over the forecast period. There is also some prospect of continuing rapid growth of exports of nonu and a rebuilding of kava exports to Europe based on improved consumer sentiment there, following a positive report on the health impact of kava. Some improvement in the fishing catch is also expected, given better weather conditions. Despite these potential gains, commodity exports are likely to remain a relatively minor part of the economy.

The longer-term sustainability of the current high levels of construction is open to question. Most major developments have a substantial public sector role or, in the case of the hotel at Faleolo, rely heavily on funding from the National Provident Fund. Construction's sustainability would be more assured if there was a larger role for the private sector, with its ability to draw on overseas capital. The presence of large government-backed projects also carries the risk of crowding out the private sector.

Inflation is expected to ease in 2005 as agricultural production returns to normal patterns. However, a slow rate of adjustment has led to official projections of inflation remaining as high as 8% in June 2005, well above the central bank's target of 3%. The large increase in government expenditures under the FY2005 budget and the accommodative monetary policy stance present some risk that inflationary pressures will remain higher than targeted over the medium term.

Solomon Islands

Against a background of improving political stability, primary product exports led economic growth of almost 5% in 2004, while inflation fell to single digits, public finances improved further, and financial sector stress declined. However, the short-term outlook is for a growth slowdown followed by an acceleration in 2007.

Macroeconomic assessment of 2004

GDP decelerated slightly to an estimated 4.6% growth in 2004 from 5.3% in 2003. Agriculture, forestry, and fishing (inclusive of subsistence production) was the major source of the expansion, contributing 63% of the aggregate figure. Logging of the natural forests continued (at an unsustainable rate), and fisheries, cocoa, and copra production all grew. The small industry sector was driven by construction, as externally funded infrastructure rehabilitation and development began, while there was no recovery in mining, slow growth in electricity and water, and a modest pickup in manufacturing.

Services contributed 24% of the aggregate growth rate, with the trade subsector in particular responding to increased consumer demand within the context of improved law and order under the ongoing (and largely Australian) Regional Assistance Mission for Solomon Islands. The rise in consumption was fueled by the Government's payment of arrears to trade creditors and public service employees, and by public servant pay rises. The consequent favorable impact on labor demand was augmented by the ending of a freeze on public service recruitment, but the rapid growth in labor supply, especially in urban areas, and the mismatch between required and available skills remained problematic.

With the population expanding at roughly 3% each year, income per head rose by 1.6% in 2004. However, the average figure conceals considerable inequality of income distribution. According to studies from the early 1990s, urban household incomes were almost four times as high as those in rural areas. More recent research by the Solomon Islands Development Trust (a nongovernment organization) reports the perception of villagers and the urban poor that living standards have not improved since the Regional Assistance Mission arrived in July 2003, though it acknowledges that the restoration of peace is a fundamental achievement. For the 85% of the population living in villages, hardship appears to have increased as cash income generation has been outpaced by rising costs of basic goods and services such as salt, rice, soap, kerosene, school fees, and ship transport.

The fiscal objective of ensuring a recurrent budget balance was achieved in 2004. Domestically sourced revenues rose by 36.2% from the 2003 level to SI$497 million, largely because of better than expected tax compliance, though the granting of goods tax exemptions reduced the potential tax take. Revenues from customs and excise also exceeded original 2004 budget expectations, partly because logging companies accelerated their activities in anticipation of new legislation aimed at reducing the rate of exploitation of natural forests. Strong domestic revenue growth was supplemented by budget support of SI$111.1 million, bringing total revenues to SI$608.1 million. Total recurrent expendi-

tures in 2004 were estimated at SI$559 million, or 1.6 times the 2003 level. Expenditures on goods and services accounted for the bulk of the rise, with spending concentrated as planned in education, health, and law and justice. Debt service expenditures increased almost threefold, while the public service wage bill rose by 14%. In addition to recurrent spending, an estimated SI$300.2 million was available in 2004 for funding development expenditures: 94.3% of this amount was from external cash grants and 5.7% from overseas loans, with a negligible amount funded by the Government. (No details are available on implementation of this development budget.)

The Government continued to address current and future debt obligations in 2004. Total public domestic and external debt was estimated to be about SI$2.1 billion at the end of 2004, down slightly from the level of SI$2.2 billion in late 2003. The public debt consisted of about SI$1.6 billion in “official” public sector debt and SI$0.5 billion in contingent liabilities and guarantees and informal debt obligations (e.g., unpaid superannuation contributions, debts to trade creditors and public enterprises, and payments to the National Provident Fund). The official debt was reduced from the 2003 level as a result of debt servicing, exchange rate stability, and domestic debt restructuring. The Australian Government’s servicing of ADB and World Bank loans ended at midyear and was taken over by the Government. Under the domestic debt restructuring, the three commercial banks and the National Provident Fund agreed to forgive 60% of the Government’s interest arrears on treasury bills and to accept long-term amortizing bonds in their place. These bonds carried much lower annual interest rates and provided for a grace period of 7 years on half of the principal amount, but offered a monthly repayment of interest and principal where none had been forthcoming in recent years. The Government also made a partial payment of trade creditor arrears and unpaid public service pay contributions owed to trade unions, insurance companies, health funds, and the Home Finance Corporation.

Inflation in 2004 was estimated at virtually half its previous year’s level, at 6.5%; the inflation rate for domestically produced food slowed as a result of the supply of fresh fruit and vegetables to the Honiara market continuing to improve, and of the relative stability of the exchange rate, which ensured that low inflation in the major source countries for imports flowed through to the domestic economy. The Solomon Islands dollar depreciated by just 4% against a strengthening Australian dollar in 2004 and by 1% against the Japanese yen, while remaining steady against the US dollar. Broad money supply expanded by 21.2% in 2004, with an increase in net foreign assets more than offsetting a decline in net domestic assets that resulted from a fall in net credit to government (Figure 2.32). Credit to the private sector rose by 8.6%, mainly in telecommunications, distribution, and professional services. The commercial banks’ weighted average interest rate margin edged down from 13.71% to 13.69%, but was still high by regional standards, indicating limited competition in the banking sector.

Strong export growth in the first half of 2004 and a rise in official transfers lifted foreign reserves to US$57.8 million by June, enough to cover 5.6 months of imports of goods and services. This balance-of-payments improvement was maintained in the second half of the year, with foreign reserves reaching US$73.2 million in December, equivalent to about 7 months of import cover.

Macroeconomic policy developments

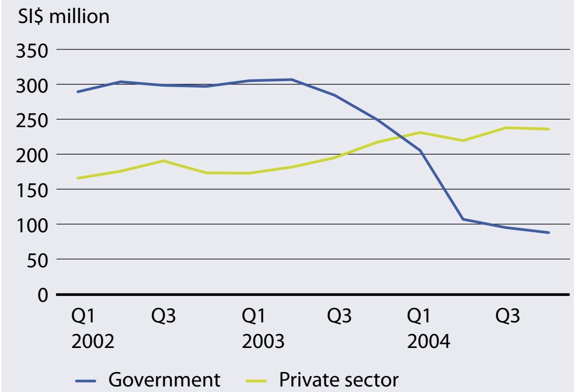
The 2005 recurrent budget estimates a deficit of SI$80 million to be funded out of cash balances accumulated in 2003–2004. Total revenues are forecast to fall by 3% from the 2004 level to SI$590 million. Budget support from bilateral agencies will drop to 36% of the 2004 amount because of the cessation of Australian budget assistance, and the remaining New Zealand aid (SI$40 million) will be earmarked for education. However, domestically sourced revenues are estimated to rise by 10.7% on the basis that increased revenues from the goods tax, import duties, and ministerial fees and charges will more than offset falls in company and withholding tax and log export duties. Achievement of this outcome assumes nominal economic growth of 10.5% and effective elimination of the tax exemptions that reduced the 2004 revenues from the goods tax. However, such a growth assumption may be optimistic and the removal

of tax exemptions requires legislative reform in a situation where legal capacity is stretched.

Total recurrent expenditures are projected to rise by 19.9% from the 2004 level, with the public service wage bill and expenditures on goods and services surging by 31.3% and 21.9%, respectively. These figures reflect the Government's commitment to continuing its program of rebuilding public administration and service delivery. In particular, it is making a strategic reallocation of resources toward improving service delivery in the health and education sectors; revitalizing the productive sectors; supporting law and justice and good governance; and promoting the country internationally (as a destination primarily for tourism, but also for FDI). The budget also has an increased provision for debt servicing that includes amounts for payment of arrears, but the provision is still insufficient to cover all debt service obligations. The Government has stated its intention to pursue debt negotiations with bilateral lenders and domestic trade creditors in 2005, to further reduce its debt burden. The 2005 development budget estimates a high, probably unrealistic level of project expenditures of SI$585.6 million; over 97% of this spending is funded externally, mostly through grants, and is allocated to the key strategic areas of the National Economic Recovery, Reform and Development Plan, 2003–2006.

The July 2004 restructuring of the Government's domestic debt reduced stress in the financial sector and increased the capacity of the Central Bank of Solomon Islands (CBSI) to use open-market operations as a policy instrument, though it still had the capacity to use reserve requirements and impose credit limits. The strong foreign reserves position permitted CBSI to remove exchange rate controls on current account transactions; the central bank also continued to address the problems of key nonbank financial institutions under its supervision. In addition, CBSI prepared a report on the financial condition of the National Provident Fund, and took over as provisional manager the bankrupt Development Bank of Solomon Islands, initiating a process of liquidation. Finally, it initiated supervision of the insurance industry. However, while the legal framework for dealing with antimoney laundering was established in 2002, the institutional framework for effective implementation is still to be created, and antiterrorism legislation remains in draft form.

Figure 2.32 Domestic credit, Solomon Islands, March 2002–December 2004



Source: Central Bank of Solomon Islands, *Quarterly Review*, June 2004, available: www.cbsi.com.sb/About_CBSI/eco/monetary_statistics.htm.

Some progress was made in 2004 in implementing the structural reforms needed to promote both good governance and sustained, broad-based private sector-led economic growth. However, much more of the same is needed since few of the elements for successful private sector-led growth are in place yet: a large residual of uncertainty from the civil tensions of 2000 to mid-2003 remains; public service delivery is generally poor; property rights and the legal system are weak; the financial sector is not functioning effectively; physical infrastructure is underdeveloped; the quality and reliability of water, electricity, and communications services are poor; and the costs of establishing, running, and closing a business are high by regional standards.

The cabinet has committed itself to reform, but this commitment must be translated into effective, innovative actions supported by coordinated donor assistance. In 2004, an Economic Reform Unit was established within the Ministry of Finance, National Reform and Planning, in order to facilitate the design and implementation of economic reforms. The process of simplifying the legislation and procedures governing foreign investment began, but this has to be finalized and implemented. A tax and customs reform strategy has been presented by the Pacific Financial

Technical Assistance Center in response to a government request and needs to be acted upon. Improving utilities services requires a medium-term process of public enterprise reform that has barely begun. To round off, the long-delayed new forest legislation needs to be passed and implemented. This will be a litmus test of the Government's real commitment to good governance in this key sector of the economy.

Some sector-specific signs of a restoration of foreign investor confidence appeared in late 2004, with the signing of a memorandum of understanding between the Government and a Papua New Guinea-based palm oil company on the reconstruction of a palm oil operation on Guadalcanal, and a reported increase in foreign interest in minerals exploration. However, the key Gold Ridge gold mine remained closed, and there was no evidence of a general improvement in foreign investor confidence.

Outlook for 2005–2007 and medium-term trends

In the context of a slowdown in global economic and trade growth, economic activity in 2005–2007 will largely be determined by the balance between two opposing factors. On the one hand, short- and medium-term growth will be reduced to the extent that new and entirely appropriate forest legislation—aimed at reducing logging rates to sustainable levels—is introduced and implemented. On the other hand, private investment and economic growth will be stimulated if the following three conditions are met: gains from improved law and order and public finances are consolidated, structural reforms are designed and implemented promptly, and major economic activities disrupted by the ethnic tensions of 2000–2003 are restarted. With regard to the last point, a major boost to the economy can be expected by 2007 if the rehabilitation of the Guadalcanal palm oil operation proceeds as planned. A start to palm oil production on Malaita could add to this stimulus, as could the revitalization of the Gold Ridge gold mine. Aid-funded physical infrastructure projects are expected to drive the construction sector, while manufacturing production is likely to do no more than nudge up until palm oil processing gets under way in 2007. Modest growth in the services sector will be fueled by the Government's increased recurrent spending and by external grant-funded development expenditures.

The official budget forecast is for growth of 4.5% in 2005, but this seems either to discount the impact of declining log production or to assume that the new forest legislation will be ineffective. Aggregate growth rates of about 3% for 2005 and 2006 appear more realistic if logging is curtailed substantially, with a possible acceleration toward 6% in 2007 as palm oil production recommences. In the absence of such an acceleration, income growth will barely keep pace with that of the population, and so living standards will stagnate.

With a reduction in bilateral budget support and the need to spend on the essential revitalization of public administration and service delivery, pressure on the recurrent budget will intensify in 2005 if the official growth forecast indeed turns out to be too high or if efforts to reduce tax exemptions fall short (or both). However, this pressure will be met with a government commitment to aggregate fiscal discipline and to the continued implementation of the public debt management strategy, which will lead to a reduction in the ratio of public debt to GDP.

Inflation is projected to moderate slightly to about 5%, on the assumptions that monetary policy will control any inflationary pressures arising from excess liquidity in the banking system, and that the exchange rate will remain relatively stable.

The current account is expected to weaken in 2005 as log exports drop and imports rise in line with increased development expenditures, but to improve over the medium term as palm oil exports restart. It is anticipated that the level of foreign reserves will provide in excess of the central bank target of 4 months of import cover.

Democratic Republic of Timor-Leste

The economy contracted in 2002–2003 but there are indications of an increase in activity in 2004. A rapid rise in petroleum revenues has helped generate a substantial fiscal surplus that is expected to grow over the medium term and to provide the basis of a large intergenerational investment fund. Prospects for the local economy remain dominated by the public sector, with the private sector continuing to face significant hurdles to achieving international competitiveness.

Macroeconomic assessment of 2004

The country's first multiyear national accounts were finalized in 2004. They show an overall contraction in the economy from 2000 to 2003, attributable to a reduction in the contribution from the UN (excluding military and diplomatic expenditures) and, to a lesser extent, from the oil and gas sector (due to the natural depletion of a small field operational since 1998). Non-oil, non-UN GDP is estimated to have increased by 22% over the period, though most of the growth was in 2001.

The latest official projections are for a decline in GDP over FY2004 (12 months ended 30 June 2004) and again in FY2005, on the basis of the continued winding-down of the operations of the UN and the peacekeeping forces ahead of their scheduled pullout in May 2005, and a decline in expenditures by some bilateral aid programs. These negative factors are projected to outweigh an expected improvement in the agriculture sector underpinned by better weather conditions and ongoing rehabilitation of the sector.

These forecasts may prove pessimistic. The growth projections were prepared before the consequences of an early start-up in a major new petroleum project, the Bayu-Undan field, were fully appreciated. Gas recycling to extract liquids began in February 2004 and the project will provide a substantial boost to GDP during 2004. The available indicators suggest that the local economy improved over 2004.

Deposits with commercial banks have risen strongly since 2000, with a 16% increase in 2004 to $84 million by end-December. The commercial banking sector aggressively pursued new loans, and lending to the private sector grew from $22 million to $70 million in 2004. This is a release of funds equivalent to 16% of non-oil, non-UN GDP. New vehicle registrations rose by almost 50% to 7,000 vehicles in 2004, a contributory factor being the greater availability of credit. With most vehicles limited to Dili district, with its population of 170,000, the large increase in registrations points to considerable spending power in the capital.

Preliminary data indicate an 11% rise in taxable imports during 2004, only a minor share of which was attributable to higher petroleum prices. Domestic revenue collections also went up, assisted by improved enforcement.

Non-oil exports picked up but remained very low. Preliminary data suggest that coffee, which accounts for almost all non-oil exports, increased from $4.0 million in 2003 to $6.6 million in 2004. This compares with a preliminary estimate of imports for the year (excluding for aid or peace-keeping activities) of $113 million. The large trade deficit will be offset by inflows of international assistance and petroleum revenues.

Inflation remained low at 3.2% in the

12 months to December 2004, with the largest price rises recorded in transportation (12%) and food (4%).

The major fiscal development during the year was a substantial upward revision in petroleum revenues to the Government. The combination of higher world oil prices, a change in tax treatment favorable to the Government, and an early start-up of the Bayu-Undan field increased petroleum revenue collections for FY2004. Revenues rose from the budgeted level of $31 million to $41 million, and expected collections for FY2005 have nearly tripled from $44 million to $130 million. Even without these upward revisions, the central government budget was projected to be in surplus in both FY2004 and FY2005. The sound fiscal position has now been entrenched. As of end-December 2004, the Government was holding net deposits of $168 million with the Banking and Payments Authority.

Macroeconomic policy developments

The key macroeconomic issue to be resolved over the medium term is the management of the considerable petroleum revenues now coming in. Receipts from the Bayu-Undan field are projected to peak in FY2011 at $380 million and, over the 20-year life of the project, to total $3.8 billion ($2.2 billion in net present value terms). There are also other petroleum developments in prospect, notably the Greater Sunrise field. In comparison, non-oil, non-UN GDP was estimated at $300 million for 2003.

The Government has adopted a policy of pursuing intergenerational equity by maintaining the real value of petroleum wealth. This is to be achieved by limiting spending to the "sustainable income," i.e., the amount of petroleum revenues that could be spent every year indefinitely. Based on current projections, the sustainable income from the Bayu-Undan field is $70 million. Spending this amount would allow government expenditures to grow from the FY2005 level of $75 million to $113 million by FY2008.

The new savings policy marks a substantial shift in fiscal management. The previous intention was to spend petroleum taxes and save only the "first tranche petroleum" (a de facto royalty payment). The previous policy would have seen annual expenditures increase to the order of $500 million within 10 years and savings accumulate to $1.5 billion by 2030. The new policy will instead lead to lower annual expenditures and is projected to result in approximately $4.5 billion being accumulated in the investment fund by 2030.

Achieving the objective of maintaining the real value of petroleum wealth rests on the overall fiscal surplus being large enough to allow for sufficient savings. This in turn rests on the future financial support of the international donor community.

Grants fund more than $150 million in annual public expenditures. UN expenditures were estimated at $77 million in FY2004, but most financial support is scheduled to cease in FY2005. Current commitments to budget support of $30 million–$35 million made under the Transitional Support Program are also scheduled to end then. Multilateral and bilateral projects are budgeted at $135 million–$155 million for FY2005–FY2007.

The Government has the fiscal capacity to replace much of the existing grants and to self-fund most, if not all, essential activities. This is because revenues and grants to the government are projected to be substantially above the current budget for expenditures and net lending (Figure 2.33). However, self-funding by Timor-Leste of all or much of the essential expenditures currently funded from grants would be at the expense of saving petroleum revenues.

The Government has proposed saving petroleum revenues in a petroleum fund based on the Norwegian model. Funds would be invested abroad in low-risk assets and be subject to accountability and transparency measures. A public discussion paper was released in late 2004 and enabling legislation is to be passed in time for the fund to be operational from FY2006.

Continued progress was made during 2004 in reducing electricity subsidies to the main urban areas. A new management team and the introduction of prepaid meters are projected to reduce subsidies by more than half by FY2008, from their current level of approximately 10% of government expenditures.

Outlook for 2005–2007 and medium-term trends

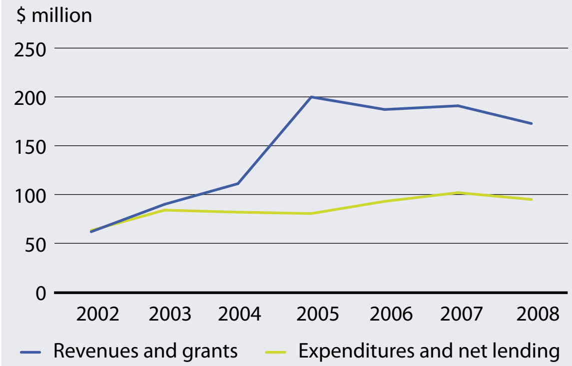
As the ratio of public expenditures to GDP approaches 100% and the formal private sector is still emerging, developments in the local economy will continue to be dominated by the public sector.

The UN presence was to have ceased in May 2004. A further extension beyond May 2005 is unlikely, and the pullout will in itself have a negative effect on economic activity in the short term. But there is a large carryover of public expenditures from FY2004, and the budget provides for a 17% increase in spending under bi- and multilateral programs during FY2005. The greatest short-term risk is that long-standing delays in implementing public programs arising from difficulties in procurement and capital project planning will continue, so damping the potential fiscal stimulus.

The medium-term fiscal projection is for only slightly higher government expenditures by FY2008, though this projection was made before petroleum revenues were revised substantially upward. In late 2004, the Government declared its intent to spend some of these additional revenues and to raise the level of spending beyond those currently budgeted. It also indicated that the rate of increase in expenditures would be constrained by capacity for the funds to be spent well. A 19% rise in expenditures from currently budgeted levels could be funded while still meeting the objective of only spending the sustainable income from petroleum revenues.

The ability of the Government to secure donor funding will play a major role in determining the GDP outcome over the medium term. The FY2005 budget projected that bi- and multilateral aid programs will fall by almost half to $81 million by FY2008, but this projected decline is in part a consequence of the limits of the planning cycle and may be reversed as budget planning proceeds. Sector investment programs are being prepared to help orient expenditures toward implementation of the National Development Plan and achievement of the Millennium Development Goals; the Government is seeking substantial donor support to help implement these programs. In addition, Timor-Leste is expected to become eligible for the US government-financed Millennium Challenge Accounts in 2006 (if not late 2005), a source that could provide as much as $20 million–$30 million a year in grants.

Figure 2.33 Revenues and expenditures, Democratic Republic of Timor-Leste, FY2002–FY2008



Sources: Ministry of Planning and Finance, *The Democratic Republic of Timor-Leste Combined Sources Budget 2004–2005*, Budget Paper No. 1, 1 July 2004; Ministry of Planning and Finance, *Supplementation of the General Budget of the State 2004–05*: Information Document; staff estimates.

The private sector continues to face significant hurdles to achieving international competitiveness. Wages in Timor-Leste are substantially higher than in neighboring countries, and the state of infrastructure is poor in general. Low productivity of key sectors and gaps in the regulatory environment, such as a few unresolved issues with business registration and customs administration, have made it difficult for new private sector activities to emerge. The rapid expansion in commercial bank lending in 2004 suggests that at least some industries are ready to grow despite these obstacles. With local financing provided by domestic deposits now largely committed, the private sector will increasingly need to rely on foreign investment to grow.

Considerable progress has been made in developing the regulatory environment that foreign investors usually require. A Law on Commercial Societies is in place, and draft laws on domestic and foreign investment, insurance, and bankruptcy have been prepared. However, the draft investment legislation carries the downside of a potential loss of substantial revenues through the provision of concessions. Such legislation, if implemented, may reduce the initial economic stimulus from additional investment.

Tonga

Economic activity saw widespread weakening over the year to June 2004, and inflation rose. Nonetheless, progress was made in stabilizing the macroeconomy with the budget moving to surplus and international reserves rising to comfortable levels. The Government is continuing to pursue economic and public sector reform with the aim of achieving sustainable growth.

Macroeconomic assessment of 2004

Tonga experienced widespread weakening in economic activity in FY2004 (year ended 30 June 2004). Difficult trading conditions were reported by businesses across a range of industries, including wholesale and retail trade, manufacturing, transportation, power, and telecommunications. A shift to a budget surplus reduced the demand stimuli provided by the general government sector; the government-owned airline went into liquidation; the fish catch declined; the main agricultural export, squash, suffered a large fall in the international price; and there appears to have been an increase in the direct importing of household items at the expense of local traders. GDP growth is estimated to have slowed from 3.1% in FY2003 to 1.6% in FY2004.

The main areas of the economy to expand over FY2004 were tourism and construction. Tourist arrivals rose by 6% in the first 3 quarters of the year (relative to the corresponding period of the previous year), and over the same period tourism receipts are estimated to have risen by 15%, equivalent to 8% of GDP. The construction sector benefited from the continued reconstruction required by the 2001 cyclone, work on new church and cinema complexes, EU-funded projects, the Tonga High School project, and other residential buildings.

Inflation continued at the double-digit rate of 11.0% in 2004, compared with 11.6% in 2003. This was attributable mainly to a rise in the price of imported items of 15.1% (compared with a 5.3% increase in the price of locally produced goods). Other factors were the substantial depreciation of the pa'anga against the currencies of New Zealand and Australia (the main sources of imports), higher world oil prices, a rise in the electricity price, and an increase in the tariff rates on alcohol and tobacco.

Despite the low growth and high inflation, efforts to stabilize the economy bore fruit. The FY2004 budget had provided for an overall deficit of 1.6% of GDP following a deficit of 3.1% in FY2003. However, tax collection was better than expected, a hiring freeze on nonessential vacant positions contributed to a wage bill 16.5% below budget, a large cut was made in capital expenditures, and other nonessential outlays were controlled. The preliminary outcome is for an overall surplus of 1.2% of GDP in FY2004. A further important change over the year was a shift from large domestic financing to a net repayment of domestic debt made possible by the surplus and substantial drawdowns of external financing.

International reserves had started the year at 2.4 months worth of imports, below the National Reserve Bank of Tonga's comfort level of 3–4 months worth of imports. However, the receipt of loan funds from ADB, an increase in official development assistance, overseas borrowings by commercial banks to fund their domestic lending, and the refinancing of a

large telecommunications project resulted in an increase in international reserves in November 2004 equivalent to 5.6 months worth of imports.

The Reserve Bank maintained a tight monetary policy stance in view of its concerns over the state of the macroeconomy. It kept its minimum lending rate at 12% in FY2004 and left the reserve deposit rate unchanged. Commercial bank lending rates registered a slight increase over the course of the year.

Total credit to the private sector contracted by 4.3% after rising by 12.6% in FY2003. The contraction was related to the refinancing of one major project and a decline in lending to transport and storage, fishing, and hotels and restaurants. The overall asset quality of the banking system weakened, mainly because of the downgrading of some large exposures. Nevertheless, the financial system remained sound. The risk-weighted capital base of the banking system improved and stayed above the Reserve Bank's minimum level.

The Government put Royal Tongan Airlines into liquidation in May 2004 given its inability to continue financial support. One month earlier, financial difficulties had required the airline to return the aircraft used on international routes. The first 14 months of the aircraft's operation had absorbed a government capital injection of $9 million, the equivalent of 20% of FY2004 expenditures and net lending.

As of end-FY2004, external public debt was the equivalent of 39% of GDP and domestic public debt 8%. Government-guaranteed debt was an additional 7% of GDP, most of which is provided to public enterprises.

Macroeconomic policy developments

The FY2005 budget sets a vision of achieving sustainable growth with social equity. It recognizes that low inflation, adequate international reserves, and a sustainable overall budget position will be required to achieve this, which in turn requires a continuation of the economic and public sector reform that began in 2001.

Improved methods of financial management are being introduced under the provisions of a new Finance Management Act. Medium-term initiatives include expanded coverage of a new accounting system, the placement of heads of department on contract, and revised arrangements for the payment of wages. Reforms to the tax system and public enterprises are also being pursued to strengthen the fiscal position and raise the efficiency of the economy.

The main revenue initiative proposed is the introduction, in April 2005, of a 15% VAT, to be called the Consumption Tax. This will replace a 5% sales tax, a fuel sales tax, and a 20% port services tax, and will allow for a reduction in individual and corporate income tax rates. Administration costs are to be kept low by requiring only businesses with a minimum annual turnover of approximately $50,000 to register for the tax, and this is expected to cover 260 or so businesses. Complementary administrative changes are being made to strengthen the revenue performance.

Implementation of public enterprise reform has been delayed until the financial implications of the liquidation of Royal Tongan Airlines are addressed. Once this matter is resolved, government attention will shift toward the privatization of three of the smaller public enterprises and the delayed corporatization of the post office and printing departments. Work is to continue on integrating funding requests from the public enterprises into the budget and on implementing new public enterprise management legislation.

The Government plans to adopt new legislation to strengthen the supervision of financial institutions by the Reserve Bank. It is also considering legislative changes to assist the bank in implementing monetary policy. Key issues to be faced are the bank's recapitalization, its current ability to finance deficits, its independence in managing interest rates, and the method for setting the reserve requirements of the commercial banks. The Reserve Bank is also working with the Ministry of Finance to issue treasury bills that would allow the management of liquidity through open-market operations.

Outlook for 2005–2007 and medium-term trends

The latest official forecast is for growth of 2.8% over FY2005. The construction industry is estimated to have expanded by 5.0% in FY2004

and is expected to remain firm, buttressed by donor-funded projects, notably the rebuilding of the main hospital, and by an increased allocation of the Government's own funds to capital. Continued expansion in tourism is foreseen, despite the loss of services from Royal Tongan Airlines, leading to overall growth in the services sector. Remittances are expected to increase and to underpin private consumption as source economies grow.

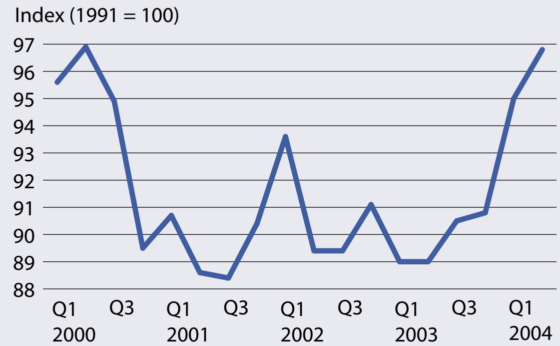
Agriculture and fishing are also expected to strengthen in FY2005. Greater volumes of squash, root crops, and kava are projected in response to better market conditions. Vanilla has the capacity for continued growth, provided that recent high prices are sustained, given that export volumes in FY2004 were half of the level achieved in FY1999. The fishing industry remains hampered by high transportation costs and a lack of capital for investment. Nonetheless, a reversal of the El Niño weather conditions is expected to help raise the catch over the medium term.

The Government's intention was to have inflation under control by the time the Consumption Tax is introduced. This is unlikely as inflation was still high at 10.6% as of November 2004. The introduction of the Consumption Tax is expected to lead to an overall increase in prices, but the impact is intended to be one-off and not have a lasting inflationary effect.

The Reserve Bank's monetary policy objectives have been to maintain an adequate level of official foreign reserves and to promote price stability. Concerns over the sustainability of the foreign reserves position and the continuing high level of inflation are likely to see monetary policy remain tight over the forecast period.

Medium-term prospects for the economy will be influenced by any loss in international competitiveness arising from high inflation. After macroeconomic stability had been eroded in FY2001, the Reserve Bank allowed the pa'anga to depreciate to compensate for rising inflation and to protect official reserves. The real effective exchange rate as measured against its basket of currencies fell by approximately 9% in FY2001, and this depreciation was largely maintained until FY2004. However, the depreciation in the

Figure 2.34 Real effective exchange rates, Tonga, Q1 2000–Q2 2004



Sources: National Reserve Bank of Tonga, 2004, *Annual Report 2003–04*; National Reserve Bank of Tonga, 2004, *Quarterly Bulletin*, vol. 15, no. 1, March.

real effective exchange rate was unwound in FY2004 (Figure 2.34), suggesting a significant loss of competitiveness.

A key risk to be managed over the next few years is the potential for a relaxation of the fiscal position. The FY2005 budget provides for a 23% increase in expenditures and net lending. Most of the additional spending is to be allocated to an 18% increase in wages and a fivefold increase in capital expenditures. Revenues and grants are budgeted to rise by only 8%, leading to a projected budget deficit for the year of 2.2% of GDP. Some 30% of the deficit is to be financed domestically. These estimates exclude the cost of shutting down Royal Tongan Airlines, which was not known at the time of budget preparation.

However, the actual outcome for FY2004 was substantially better than budgeted for the year, and continuing expenditure control can be expected to lead to a better than budgeted outcome in FY2005 as well. Planned improvements to the management of public enterprises offer considerable potential to strengthen the fiscal position. In FY2003, dividends of only $25,000 were received on the Government's equity of $35 million, and half of the government-guaranteed borrowing to public enterprises was nonperforming. Even a small improvement from these levels could have a relatively large impact on government revenues.

Tuvalu

Reflecting the completion of major construction projects, the economy contracted. This coincided with a second year of relatively low offshore revenues for the Government, generating a large budget deficit. Over the medium term, new construction projects are expected to result in increased activity. However, even with an expected pickup in revenues, expenditure control will be required to stabilize the fiscal position.

Macroeconomic assessment of 2004

Economic activity subsided in 2004 following the completion of major construction projects. These included a hospital renovation and extension, and a government office block, both donor funded and on the main island of Funafuti. The total value of these two projects alone almost equaled the value of GDP in 2002. Construction had created substantial casual employment opportunities in 2003 and labor income rose by more than 10% that year. Preliminary estimates suggest that in 2004, labor income fell back to the 2002 level.

Internal revenue collection was boosted in 2003 by the surge in economic activity but fell by 12% in 2004 as activity slowed. Import duties, the main source of internal revenues, were projected to decline by 20% to 2002's level, indicating a large fall in consumption in 2004. Sales tax revenues and income tax collection were projected to decline by 20% and 13%, respectively, over the year. The fall in internal revenues corresponded with the second consecutive year of low offshore revenues. In 2001, the Government sold its investment in the operator of the country's ".tv" Internet domain name and now only receives a small ongoing royalty. Revenues from the foreign fishing fleet operating in Tuvalu's exclusive economic zone were considerably higher than in 2003 but well below trend. An improvement in world equity markets allowed the first distribution since 2001 from the Tuvalu Trust Fund, one of the Government's two offshore investment funds (the other being the Falekaupule Trust Fund). However, distribution was also well below trend (Figure 2.35).

From the mid-1990s to 2002, a strong upward trend in revenues had been seen and, while some of the "windfall" revenues received over the period were placed in the Tuvalu Trust Fund, capital projects and the wage bill also surged. The buildup in expenditures and community expectations has therefore made it difficult to quickly trim back spending as the revenue position has weakened, with the result that large budget deficits emerged in 2003 and 2004—the overall deficit in 2004 was estimated to be approximately 9% of GDP. The deficits have been financed by a rundown of cash reserves, and the tight cash position for much of 2004 necessitated a midyear review of expenditures: cuts fell heaviest on allowances, maintenance, basic supplies, and capital projects, though a 5% wage increase that was provided for at the start of 2004 was preserved, and the number of government employees continued to rise over the year.

The gross net value of government debt is estimated at \$16 million, equivalent to 80% of GDP. As almost all of the debt is concessional, the net present value of the debt is much lower at 40% of GDP. Against this, \$2 million was held as cash

reserves as of September 2004 and $63 million was invested in the two offshore investment funds.

Macroeconomic policy developments

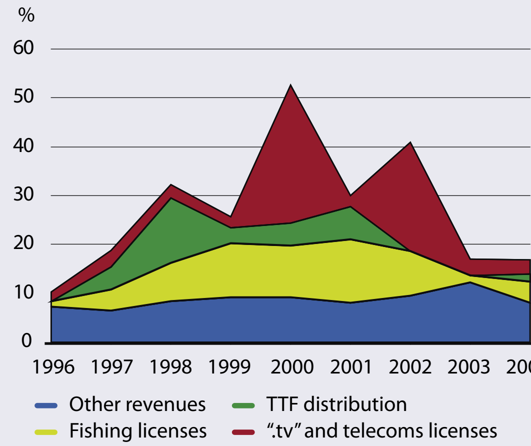
Fiscal management in Tuvalu is greatly complicated by the volatility of the main revenue items. Income from the sale of rights to the ".tv" domain name will remain below trend, but other revenue items have the potential to rebuild. The issue to be faced in framing a budget is whether to cut expenditures to fit the low levels of the last 2 years or whether to be less aggressive in cutting spending in the hope that revenues increase. Budget management also has to deal with the difficulties created by one of the largest revenue items, fishing licenses, coming in over the last month of the financial year. Not only are these revenues received late, but it is difficult to predict changes from year to year. The likely income is only known with confidence well into the second half of the financial year.

Cash reserves had been built up in the Government's buffer fund, the Consolidated Investment Fund, to help manage the volatility and uncertainty in revenues. However, the buffer has declined recently, and once a government overdraft equivalent to 9% of GDP is taken into account, net cash holdings as of end-2004 will only be sufficient to fund the planned 2005 deficit.

One of the main pressures on the budget is the growing wage bill. This has increased by 17% in real terms since 2001, and by 146% since 1996. As of late 2004, 1,100 public servants—some 10% of the population—were on the payroll. If the recent growth in wages continues, personnel costs will inevitably put pressure on the overall budget outcome and displace other expenditures, with an adverse impact on the quality of government services. Budget management faces the additional challenge of providing the funding to maintain and make effective use of recent investments. This includes equipping and staffing the new hospital facility, and maintaining new buildings and newly surfaced roads on Funafuti. These investments create a new, ongoing need in a difficult fiscal environment.

Public debt consists of loans from ADB, the European Investment Bank, and the government-owned (and country's only) National Bank of

Figure 2.35 Revenues and grants, Tuvalu, 1996–2004



TTF = Tuvalu Trust Fund.
Source: Original data from the Ministry of Finance.

Tuvalu. There is some doubt as to whether the two loans secured from the National Bank of Tuvalu will generate any income to cover debt service costs. These loans were used to purchase a share of the only airline operating to Tuvalu and for the National Fishing Corporation of Tuvalu; however, these loans represent less than 10% of gross public debt. The largest single loan, secured to provide funds for the Falekaupule Trust Fund (for the outer islands), is fully invested offshore. The remaining large loans are for economic activities and are at least partly backed by revenue flows, either directly or indirectly. Current debt service costs are 2% of the trend level of revenues and grants, and are projected to rise steadily over the next 10 years. They should remain relatively low at no more than 3% of this trend level, provided that the debt stock remains close to current levels.

Outlook for 2005–2007 and medium-term trends

The economy is dominated by a public sector supported by a high level of foreign grants and offshore income. The main sources of the latter for the Government are returns from the Tuvalu Trust Fund invested in international financial markets, the sale of access to fishing resources, and the country's ".tv" domain name. Households earn offshore income from seafarers who are working for international shipping companies; their remit-

tances amount to some 20% of GDP. Prospects for the economy and the limited private sector will remain dependent on changes in these inflows.

The Government anticipates receipt of a grant from the Japanese Government to rebuild the electricity generation and distribution system on Funafuti in 2005–2006. At an expected cost of approximately 75% of 2002 GDP, construction would provide another temporary, but major, boost to the economy. Grants, excluding those provided for major building projects, are projected to remain steady over the medium term.

Economic activity will also be boosted over the forecast period with the launching of a second major project, the upgrade of the Tuvalu Maritime Training Institute. This is in part motivated by the need to ensure that the institute retains its accreditation from the International Maritime Organisation. Loss of accreditation would put at risk continued growth in seafarers' remittances, which not only represent an important source of aggregate demand for the overall economy, but are particularly important for the outer islands, which offer limited alternative income-earning opportunities.

A distribution from the Tuvalu Trust Fund to the budget is only possible when the market value of the fund exceeds the maintained value, being the real value as measured by the Australian CPI. The market value was below the maintained value in 2002 and 2003, but a 13% gain over the first 9 months of 2004 saw the positions reverse. As long as market returns continue to exceed the low Australian inflation rate, a distribution will be possible.

Fishing revenues have shown signs of recovering from the very poor outcome of 2003. Long-run weather trends are now more favorable to fishing in the exclusive economic zone, and the Government has forecast revenues for the medium term close to the 2004 level. Past experience suggests that there is significant potential for revenues to exceed this forecast.

Current official forecasts are for a deficit rising in 2006 to about 15% of GDP (excluding the effect of the large construction projects which are off budget), mainly because of a poor revenue performance. These forecasts appear too cautious. The likely pickup in economic activity and a more favorable outlook for offshore revenues suggest that the budget position should improve over the next few years, provided that expenditures are controlled. Additionally, a proposal is being considered to introduce a VAT to help generate revenue, and provide for a more efficient tax system. Introduction of such a tax will become increasingly important if the Pacific Island Countries Trade Agreement is ratified as expected, since Tuvalu would forgo duty revenues on imports from the region under the agreement. If large deficits are incurred in the medium term, cash-flow difficulties can be expected to continue. This may require the development of new methods of deficit financing. Options include the sale of government businesses, the main candidate being the National Bank of Tuvalu.

The sharp rise in the Government's overdraft at the National Bank of Tuvalu since 2001 has necessitated a substantial fall in lending to the private sector. Consumer lending for housing has been frozen, assistance to seafarers (to cover traveling costs, etc.) has been curtailed, and the maximum size of other loans has been reduced. This is despite a continuing demand for such loans, particularly to fuel growth of the small private sector. Such crowding-out effects are likely to persist until the Government's overall fiscal position improves.

Vanuatu

Growth in 2004 was modest in a macroeconomic environment of low inflation, improving public finances, and rising foreign reserves. The outlook is for further growth at a rate that barely keeps pace with population expansion.

Macroeconomic assessment of 2004

GDP growth accelerated slightly from 1.6% in 2003 to an estimated 2.2% in 2004, led by the agriculture, forestry, and fishing sector, which expanded by 3.3%. Cocoa production fell because of cyclone Ivy in February and cattle production was sluggish, but copra and kava producers responded strongly to the higher farm-gate prices that resulted from stronger world market prices and from greater competition in commodity marketing following the ending of the Vanuatu Commodities Marketing Board monopoly. Forestry production also picked up from the level seen in 2003. In industry, manufacturing grew because of a substantial rise in coconut oil production, while electricity and commercial construction crept up at less than 2%. After registering zero growth in 2003, the services sector expanded by an estimated 1.9% in 2004 in response to a rise in domestic demand, in turn generated by stronger incomes from agricultural exports, real estate development in Port Vila, and tourism growth. Visitor arrivals in the first 3 quarters of 2004 were 17.5% above the corresponding prior-year period, reflecting the combined impact of an increase in cruise ship visits, an expansion in Air Vanuatu's carrying capacity, and price competition after the entry of the airline Pacific Blue into the market.

Following an overall budget deficit in 2003 of 1.7% of GDP, the 2004 budget targeted a surplus of 0.4%. Although unbudgeted expenditures were made, associated with the snap general election in July, a surplus equivalent to 0.6% of GDP was recorded over the first 3 quarters of 2004, with internal revenue collection exceeding expectations and control exercised over spending. Some reduction in the surplus is to be anticipated as a result of fourth quarter spending, but the aggregate fiscal outcome for the year nonetheless was set to improve significantly on the 2003 result (Figure 2.36). Less progress was made in shifting the allocation of public resources away from meeting the public service wage bill and toward operation, maintenance, and capital expenditures, with the latter at less than 75% of the 2003 level in nominal terms. Spending on wages and salaries was 56.6% of expenditures and net lending in the first 3 quarters of 2004, compared with 38% of actual expenditures and net lending in 2000. In the intervening years, the number of public servants rose in line with population growth and their average real wages grew faster than total real government spending. Public debt declined from 39.2% of GDP in 2003 to 37.6% in 2004 as a result of a reduction in external debt to 27.0% of GDP, while domestic debt remained steady at 10.6% of GDP. In 2004, debt service costs were 13.4% higher than in 2003 and were equivalent to 7.5% of budgeted revenues and grants.

Inflation diminished from 3.0% in 2003 to 1.8% in 2004 as the domestic currency appreciated slightly against the Australian dollar (1.6%) and New Zealand dollar (0.7%), and substantially against the US dollar (13.0%). Food

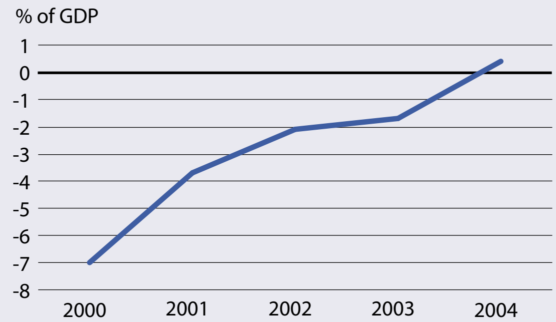
prices registered the largest rise of almost 4% because of cyclone Ivy's impact on domestic food supplies, with all other expenditure groups showing moderate increases. Broad money supply in October 2004 stood at 9.4% above the October 2003 level because of a 12.8% rise in net foreign assets and a 7.4% expansion in domestic credit. The growth in domestic credit consisted of a 10.6% decline in net credit to government and a 9.0% rise in private sector credit that was concentrated in the transport sector. Commercial bank efforts to encourage deposits and then promote lending culminated in a narrowing of the interest rate spread from 9.6% at end-2003 to 9.1% in mid-2004. Increasing liquidity in the banking system was reflected in a rise in excess reserves held at the Reserve Bank and in a declining yield on 91-day Reserve Bank of Vanuatu notes, which fell to 3.75% by October.

The level of official foreign reserves rose to $51.0 million by mid-October 2004, equivalent to 5.2 months of import cover compared with 4.4 months a year earlier. This resulted largely from a 40% rise in merchandise exports in the first 3 quarters of 2004 compared with the same period in 2003, and substantial inflows of official transfers in the wake of the cyclone and earthquake damage. The bulk of the rise in exports was accounted for by copra and coconut oil to European markets, but this was insufficient to prevent a worsening trade balance as postcyclone imports of food and basic manufactures rose, as did imports of machinery, transport equipment, and mineral fuels. Tourism growth contributed to a rise in the services account surplus, and the current account deficit in the first 2 quarters of 2004 was almost 14% below that of the same period in 2003. Direct investment flows made a positive contribution to the balance-of-payments financial account and, with tourism accelerating in the second half of 2004, foreign reserves were projected to rise further by end-December.

Macroeconomic policy developments

Political instability in 2004 hampered policy development and implementation of the Prioritized Action Agenda, which is intended to link the long-term Comprehensive Reform Program with the Government's medium-term investment

Figure 2.36 Budget balance, Vanuatu, 2000–2004



Sources: National Statistical Office, *National Accounts of Vanuatu 1997–2002* and *Quarterly Statistical Bulletin*, September 2004; Government of Vanuatu, *Fiscal Strategy Report*, Budget 2004; staff estimates.

program and annual budget. In particular, the intensification of political instability in the second half of the year constrained the formulation of fiscal policy. The July general election was called to forestall an opposition motion of no confidence, but the incumbent Government lost office to a shaky coalition. This coalition itself was soon subject to a no-confidence motion and another coalition administration took office in December.

The new administration's budget was presented for parliamentary approval in February 2005. An overall budget deficit of 0.2% of GDP is projected, with revenues and grants in 2005 rising by 8.0% from the 2004 budget level and total expenditures and net lending rising by 11.4%. The bulk of the rise in revenues and grants is expected to come from external grants, supplemented by improved collection of tax revenues. All of the projected increase in total expenditures and net lending is attributable to increased recurrent spending, most notably an 8.4% rise in the public service wage bill. There is therefore little prospect in the short term of improving the strategic allocation of public resources.

Tightened liquidity conditions led the Reserve Bank to reduce the liquid assets ratio from 15% to 12% in January 2004. The stance of monetary policy remained unchanged for the rest of the year as liquidity increased and policy targets for inflation (4%) and international reserves (4 months of import cover) were met comfortably. The weights used in the basket of major trading partner currencies, against which the vatu is pegged, were reviewed and adjusted in June 2004,

but remained confidential. The Vanuatu Financial Sector Assessment Group continued its work on ensuring that the regulatory and supervisory framework for offshore and domestic banks met international standards.

The most worrying policy issue is still that of how to deal with the long-term decline in income per head, particularly in rural areas. In 2004, real GDP per head was below the level of 20 years earlier, with the benefits of economic growth largely captured by those in urban employment in the public, tourism, and financial sectors. Real value added in the primary sector has grown at below the rate of aggregate GDP during this period, leaving village populations in a situation of worsening economic hardship. Reversing this trend requires, among other interventions, improving rural producers' access to credit through the development of a secured lending framework, as has been done informally in a rural finance project administered by the National Bank of Vanuatu. In addition, the Government has made a major commitment to the development of a formal secured transactions framework, which will permit a broader distribution of credit via nonbank financial intermediaries.

The private sector remained hampered by the relatively high costs of utility services and of carrying out business activities. The costs of starting a business, the rigidity of employment conditions, and the costs of firing employees are the highest in the region, according to the World Bank's Doing Business Indicators.

Outlook for 2005–2007 and medium-term trends

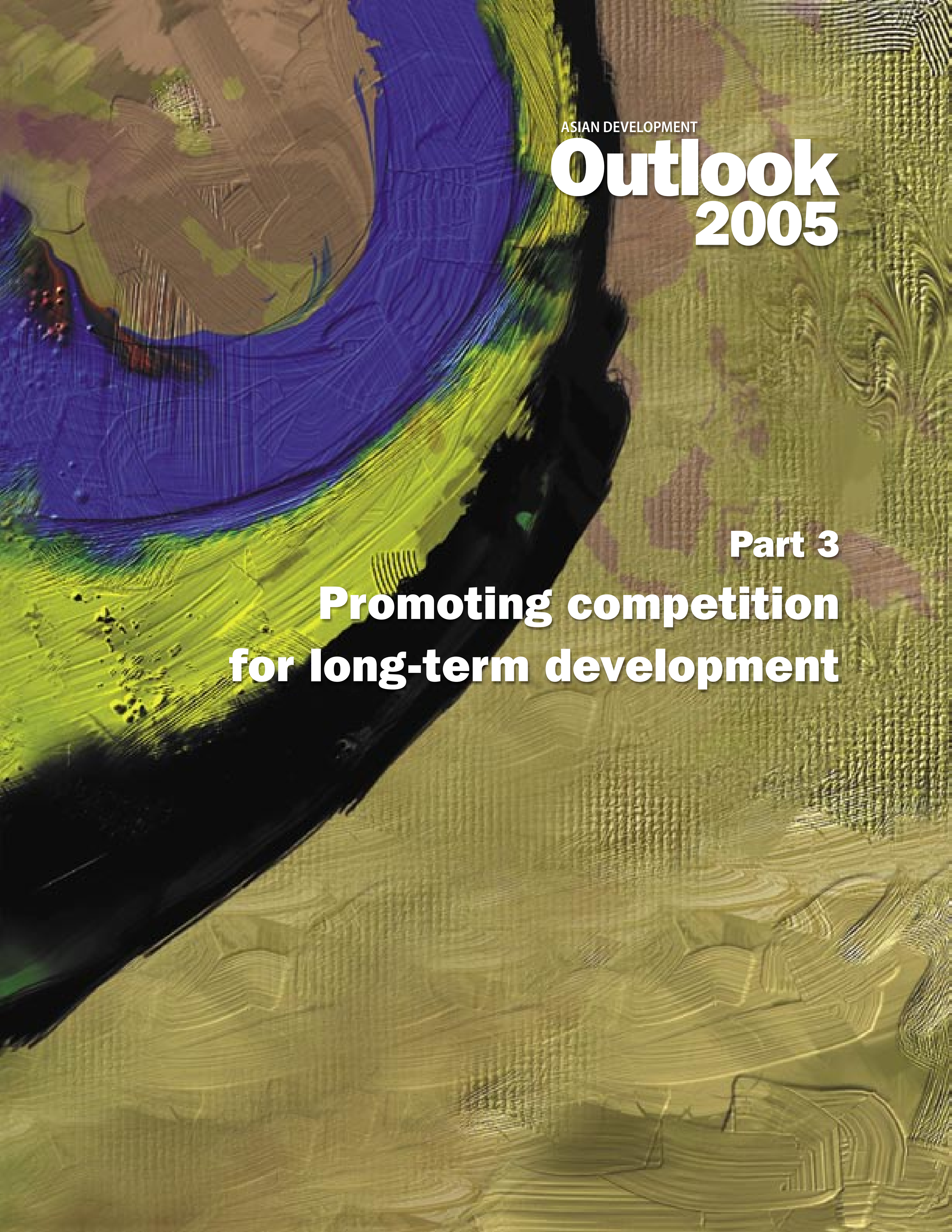
GDP growth in 2005–2007 is forecast to remain in the modest 2–3% range, edging up to 2.5% in 2005 as cocoa and cattle production recover from their 2004 decline and then tapering off to 2.2% in 2006–2007. Agriculture is foreseen as the driving force, while services expand at about 2% annually and industry at 1.5%. The outlook for agriculture assumes favorable weather conditions, some easing in agricultural commodity prices and, crucially, a sustained aggregate supply response to the recent deregulation of export marketing, as opposed to the switching of production between different crops. Growth in services depends on continued tourism expansion, which is expected from the ongoing provision of competitive international air services and more effective marketing, though its pace will be constrained by accommodation capacity. In industry, little improvement is anticipated in manufacturing, while electricity and construction are expected to expand at annual rates of 2.5% and 1.5%, respectively. Given an annual population growth rate of 2.7%, these forecasts imply a further medium-term decline in per capita income, increased under- and unemployment, and little alleviation of hardship in rural areas.

The Government will target budget surpluses of around 0.5% of GDP in 2006 and 2007, on the basis that improved compliance will generate sufficiently stronger tax revenues to cover growth in nominal total expenditures at about the forecast inflation rate of 2.5%. Fiscal prudence may be under threat from political instability, but if maintained will involve a stagnation of aggregate government spending in real terms and a decline in the per capita provision of government services. Limited progress is likely in improving the strategic allocation of public resources because of the relatively heavy weight of the wage bill in total spending and because of the political difficulties of reducing public sector employment and real wages. The achievement of budget surpluses and a policy of no new external borrowing will reduce the stock of public debt from 38% of GDP in 2004 to an estimated 32% in 2007. Continued fiscal discipline and moderate inflation will enable the Reserve Bank to maintain a neutral monetary policy stance in the medium term.

Domestic export volumes are forecast to rise at modest rates in line with agriculture, but—with some weakening in commodity prices—little growth is expected in the value of exports. The value of imports is projected to continue rising faster than that of exports, such that the trade deficit will widen. The net surplus on the services account is expected to increase as a result of tourism growth and, with official transfers, will ensure a virtual balance on the current account. This outcome and the maintenance of a capital and financial account surplus will keep foreign reserve levels above target, at approximately 5 months of import cover. Official external debt is forecast to drop to 22% of GDP in 2007.

ASIAN DEVELOPMENT

Outlook 2005



Part 3

Promoting competition for long-term development

ASIAN DEVELOPMENT

Outlook 2005

Part 3

Promoting competition for long-term development

Promoting competition for long-term development

Liberalization and integration, both with the rest of the region and with the rest of the world, are having strong effects on Asia's firms and their ability to contribute to national development objectives. As competitive forces become stronger, so do some incentives for anticompetitive behavior. Competition policy can both help markets deliver the benefits of competition to consumers and support sustainable economic growth. But there may be tensions between what is good for short-term, allocative efficiency and what is good for long-term, dynamic efficiency. Countries in developing Asia are exploring ways to balance competing concerns, as competition policy moves up the reform agenda in the region.

Introduction

Across developing Asia, countries are striving to achieve or maintain high rates of economic growth and employment. Crucial to reaching these goals is competition in product and factor markets, which leads to greater choice, lower prices, and increased production efficiency, and which ultimately contributes to a country's growth and development. As Ahn (2002, p. 5) notes, "Competition has pervasive and long-lasting effects on firm performance by affecting economic actors' incentive structure by encouraging their innovative activities, and by selecting more efficient ones from less efficient ones over time."[1] Given the importance of firms as the drivers of growth and employment, promoting competition is immediately relevant to the Asia-Pacific region as it adopts open market-oriented policy regimes.

In the past two decades, many countries in the region have adopted market-based reforms and reduced government intervention in their economies in response to heightened competition resulting from regional and global integration. Trade barriers have been lowered, foreign investment encouraged, exchange rate pegs removed, protection of domestic industries withdrawn, and government enterprises privatized. These changes reflect confidence that open-market forces will strengthen firm-level productivity and competitiveness, and will contribute more to growth and development than a closed, centralized orientation would.

As a result, policies to promote competition have climbed up the domestic and trade agenda in Asia, just as they have in the rest of the world. However, Asian countries have been slow to adopt and implement comprehensive competition policies, reflecting a debate between the pros (who point to efficiency gains from greater competition,

lower prices, etc.) and the antis (who are concerned about compromising industrial policy, cost of enforcement, etc).

This part of *Asian Development Outlook 2005* reviews recent developments in competition policy and the interactions among competition, policy, and economic development in Asia, with an eye toward distilling lessons for the future. It reviews the relationship between competition policy and other important policies—such as industrial, trade, and foreign direct investment (FDI) policies. To draw some general principles for developing Asia, this part assesses competition and policy regimes in general and in six developing Asian countries in particular, some with competition laws, some without, in the context of general economic trends, industrial concentration structures, and policy reforms.[2]

One of the major arguments of this part of *Asian Development Outlook 2005* is that competition policy is complementary to other policies. Consequently, liberalization and privatization policies cannot be expected to automatically contribute to economic growth if competition policy and institutional infrastructure are lacking. The domestic benefits of effective competition policy also merit attention, regardless of its consideration in multilateral trade negotiations. And in a dynamic context, finding a balance between promoting short-term competition and preserving long-term incentives for innovation and invention is a critical challenge for sustaining growth and development.

Benefits of competition

Economic theory suggests that prices and quantities in a competitive market will equilibrate to levels that generate efficient outcomes at a given point of time, i.e., attaining static efficiency, if there are no government interventions, asymmetries of information, impediments to the entry and exit of firms, or anticompetitive practices by firms. In this situation, the price that consumers pay for a good will equal the incremental (or marginal) costs of the firm that produced the last unit of the good.[3] Competition is then beneficial because it gives to consumers wider choice and provides sellers with stronger incentives to minimize costs, so eliminating waste. Competition increases the likelihood that cost savings resulting from efficiency gains will be passed on to a firm's customers, who may be either final consumers or other firms (in which case costs of those firms are also lowered). Ample empirical evidence supports these arguments.

Thus, the importance of competition for achieving a higher rate of innovation and adoption of new technologies over time is critical for sustaining Asia's rapid growth. Yet competition is not automatic, and is not the same as *laissez faire*.[4]

> In fact, there are reasons for believing that less mature markets tend to be more, rather than less, vulnerable to anticompetitive practices than the markets of developed countries. The reasons include: (a) high "natural" entry barriers due to inadequate business infrastructure, including distribution channels, and (sometimes) intrusive regulatory regimes; (b) asymmetries of information in both product and credit markets; and (c) a greater proportion of local (non-tradable) markets (Anderson and Jenny 2005).

While perfect competition is a fundamental assumption in any market economy, there is little mention in most economic texts about how perfect competition can be achieved. Early economists such as Adam Smith and Alfred Marshall emphasized the benefits of free entry to, and exit from, industries. This refers to the dynamic form of competition. For the greatest efficiency gains to accrue to the economy, new and efficient firms must be able to enter the market with relative ease, while forcing old and less-efficient firms to upgrade or exit. Competition for profits forces existing firms to seek greater efficiency in resource allocation to boost productivity and lower costs. Inefficient firms are forced out, and their resources reallocated to new or more efficient firms. Firms need to constantly innovate and adapt quickly to the changing environment, thus creating dynamic efficiency (UNCTAD 2004).

Freedom of entry and exit is therefore a crucial condition for maximizing the efficiency benefits of competitive markets. It should be noted that the lower production costs boost the competitiveness of the country's exporters in foreign markets. However, the industrial structure most efficient for static resource allocation is not necessarily the most efficient for dynamic efficiency. Some temporary market power after a new invention or innovation is introduced may be necessary to provide firms with the incentive to undertake such inventions or innovations. This will require consistency and coherence among industrial, trade, investment, competition, and intellectual property regimes.

Economic efficiency is an important, but by no means the only, goal of most countries. Fortunately, competition also serves to diffuse socioeconomic power, broadening participation in economic, social, and political advances while ensuring opportunities for new entrepreneurs. Moreover, it can facilitate realization of the benefits for the domestic economy of integrating into international trade and investment patterns.

In a context of market distortions and restraints to competition

Competitive forces work best in the presence of markets that are free from distortions. However, a perfectly competitive environment rarely exists in all sectors of an economy, so the full benefits of competition do not often materialize. Competition is usually not intense and not equal for reasons of special interests, big government, and citizens' weak economic understanding (Lewis 2004). When markets are not competitive, whether due to policy-induced distortions, technological characteristics, or anticompetitive behavior on the part of market participants, an economy may miss many potential benefits for its citizens. Furthermore, government deregulation efforts that are intended to benefit consumers do not always work as planned.

The most obvious form of noncompetitive behavior is the case of a monopoly, where the price and quantity of production that maximize profit for the monopoly are higher and lower, respectively, than those that would yield the most welfare for society. Similarly, cartelization and collusion by firms, which also raise prices above marginal costs and may limit choices available to consumers or end-user industries, result in market outcomes where the sum of producer and consumer welfare falls below the level attained with static efficiency. Consequently, measures to enforce policies that encourage firms to compete (or discourage or prevent firms from resisting rivalry) can improve the allocation of resources by making market outcomes move toward the statically efficient outcome.[5] Thus, the benefits from competition are not limited to keeping prices at marginal cost for the benefit of consumers, as in static efficiency, but also create a conducive environment for new businesses to enter and grow while at the same time compelling existing firms to continuously improve and perform better.[6] It is important to note that cartels can be local, national, or international.

Given the importance of competition in contributing to economic efficiency in both its static and dynamic aspects, policies to promote competition remain of considerable interest to developing countries in both the domestic and international contexts. The existence of atypical production cost or consumer preference structures in certain economic sectors can also cause tension between promotion of competition and the realization of dynamic efficiency goals. Arguments to limit competition often stress the expected value of letting some firms achieve a large scale of operations. In principle, firm size is said to be important for corporate "competitiveness" under conditions of:

- economies of scale (where larger production runs are associated with lower average costs of production);
- when firms need to attain a certain minimum scale to successfully innovate or imitate, or to raise funds in capital markets; or
- when "learning-by-doing" is faster in larger firms.

When firms have pronounced economies of scale, it is possible that enforcing competition law so as to maximize rivalry between firms is not necessarily a good idea, because there then exists a trade-off between competition policy and efficiency. An example of this is a natural

monopoly—i.e., a situation where, due to overwhelming economies of scale, a market is most efficiently served by a single supplier. This applies often in the case of utilities, usually leading to a regulatory framework to prevent abuse of dominance.

Related to cartelization and monopolization is abuse of dominant position, which consists of both structural dominance of a relevant market as well as harmful conduct (e.g., predatory pricing) within that context. Concepts of what constitutes a dominant position (in terms of both market share and insulation from competitive market forces), a relevant market (on the basis of geography or similarity of products), or harmful conduct are often subject to debate, leading to a "rule of reason" approach in trying to determine wrongdoing.

Excess capacity may also draw attention as it can trigger price wars. Mergers and acquisitions can result in vertical market restraints—contractual arrangements linking firms at different levels of the market, such as exclusive dealing, exclusive territories, tied selling, or resale price maintenance (Box 3.1). Governments could, therefore, be justified in taking an active role in managing investment decisions by firms in high-growth or targeted industries (Singh 2002, p. 19). This argument calls into question whether a maximum degree of competition is optimal and suggests that *increasing economic growth requires a mix of cooperation and competition by firms.*

Another example that has received much attention in recent literature and policy debates relates to industries where network externalities are pervasive.[7] In the presence of such externalities, the maximum amount that consumers are willing to pay for a good or service depends, in part, on the number of other consumers who also purchase the item in question. Much of the discussion of network externalities takes place within the context of markets where firms have advanced technologies (Box 3.2), such as in the market for computer software. However, many communications and infrastructure services that are important for economic development exhibit network externalities. Such services include telephones, railways, and water-supply systems (Laffont and Tirole 2000).

Although the analysis of market outcomes in the presence of these externalities can be complex, one theme that does emerge from much of the literature is that *there are instances where consumers will prefer that a smaller number of goods (and possibly a single good) be available in the marketplace*. If a small number of firms supply a product to a large number of consumers, the positive externalities generated for consumers (resulting from the fact that each product they consume is also consumed by many others) may

Box 3.1 Tied sales: Whiskey and beer

Prior to liberalization of production, all liquor in Thailand was produced under concession by the Government. Each liquor-producing facility was government owned. In 2000, the Government decided to sell its aging factories to the Sura Maharas/Sura Thip group (later known as the Sang Som group), which has monopolized the domestic liquor industry since the late 1990s.

Though the whiskey market was supposed to be fully liberalized, licensing conditions remained stringent, with requirements for minimum capacity, minimum registered capital, land, and distance from natural waterways that effectively closed the industry to potential entrants. Hence, the monopoly continued.

In 1994, the Sura Maharas/Sura Thip group entered the beer market, which at that time was dominated by Singha beer. In an attempt to gain a foothold in this market, the Sura Maharas/Sura Thip group tied the sale of its Chang (Elephant) Brand beer to the sale of its white liquors that were in great demand. Retailers were often obliged to sell the excess supply of beer below cost, while raising liquor prices to make up for lost revenue. This practice brought positive results to the group, as Chang beer's market share rose from zero in 1994 to 75% in 2004.

In trying to expand into the bottled water market, the Sang Som group used the same approach—tied sale and dumping. As a result, many small local manufacturers have had to close down. Although authorized to do so, the competition authority has not yet effectively addressed the situation.

Source: Nikomborirak (2005).

Box 3.2 Korea: The broadband Internet market

In July 1998, Thrunet, Korea's third-largest Internet service provider (ISP) in terms of number of subscribers, first launched broadband Internet services. Hanaro Telecom, the second-largest ISP, followed in April 1999, and Korea Telecom (KT) the largest ISP, in December 1999. Korean ISPs generally provide broadband Internet services through digital subscriber line (DSL) or asymmetric DSL (ADSL) and cable modem. ADSL is brought to users via copper telephone lines or optical fiber, while cable modem uses the hybrid fiber coaxial (HFC) network.

During the industry's early stages, most subscribers were cable modem users since this was the predominant service offered by ISPs. However, after KT's entry into the market, the number of ADSL users surpassed that of cable modem users. As of December 2003, ADSL users accounted for 59.5% of the broadband market, cable modem users 34.8%, and local area network (LAN) users 5.6% (Internet Statistics Information System 2004).

KT provides ADSL services to its Internet users via its existing copper telephone lines and does not own any HFC network. For its part, Hanaro Telecom provides ADSL services through optical fiber networks that it had to build, and cable modem services mainly by leasing the HFC network of Powercomm, a firm spun off from Korea Electric. Most of the other ISPs also lease Powercomm's HFC network. Meanwhile, Powercomm is restricted under its basic telecommunications service license to provide broadband Internet services to end-users. Besides Powercomm, which owns the largest HFC network in Korea, there are more than 100 local cable television companies that can lease out their own HFC networks. The existence of this infrastructure, which was encouraged by the Korean Government through the availability of low-interest loans, contributed to the fast growth of Korea's broadband Internet market.

In placing priority on developing the broadband Internet market, the Government did not favor any ISP. In fact, the Government encouraged competition by relaxing its entry policy for ISPs. By classifying broadband Internet services as value-added telecommunications services, existing basic telecommunications service providers were allowed to provide Internet services without requiring additional permits or licenses. New entrants, meanwhile, only had to file a simple report. As a result, more than 75 ISPs have entered the market, making broadband Internet access available at competitive prices (about W30,000–43,000 per month, equivalent to $25–35). This allowed existing dial-up Internet service users to easily switch to broadband Internet services.

By balancing the technical advantages of network infrastructure with the efficiency advantages of competition, Korea has achieved one of the highest rates of broadband penetration at competitive prices.

Source: Chang and Jung (2005).

outweigh the effect of higher prices that might follow from a high degree of market concentration. Put simply, there may be times when consumers prefer concentrated markets with a small number of firms because of the network externalities that larger output levels can create.

Moreover, firms in such industries may adopt pricing strategies that deliberately take into account the impact of the current number of customers on the future demand for their products. Many potential customers may only be willing to buy a product once the number of existing customers exceeds some critical level that generates sufficient externalities. In that case, firms will have an incentive to keep prices lower at present than they would in the absence of network externalities, in order to raise their customer base to that critical level. Network externalities therefore benefit current consumers both directly and through the effects of stronger than usual disincentives for firms to raise prices. Both theoretical and empirical analyses have shown that firms in industries with network externalities often adopt complex pricing strategies that typically involve substantial price discrimination across customers.

The above arguments can provide an efficiency-based rationale for not taking steps to maximize rivalry between firms in particular (limited) circumstances. Put another way, in certain sectors with observable and identifiable technological characteristics, maximizing rivalry among firms may harm the interests of both consumers and producers. Nonetheless, this does

not imply that there is no role for competition policy in these markets; rather, it means that *competition policy must be applied in ways that take account of the technological characteristics of such markets*—as indeed competition authorities increasingly do. Recent contributions highlight the importance of appropriately tailored competition rules in network industries, due precisely to concerns over the market power that can be created or entrenched through network effects (see, e.g., Church and Ware 1998).

Competition policy regimes

Once one allows for the possibility that private firms can create barriers to entry or foreclose entry to a market by new firms, then improving dynamic economic performance may well require enforcement of policies to promote or ensure competition.

Objectives

Competition policy is concerned both with private anticompetitive practices and with government measures or instruments that affect the state of competition in markets. For example, trade barriers, barriers to FDI, and licensing requirements (among others) can influence the extent of competitive pressures in markets and so are often seen as appropriate concerns of competition policy.

Barriers to trade and FDI, as well as stringent licensing and registration requirements, can influence the extent of competitive pressures in markets and so are seen as legitimate concerns of competition policy. Thus, as Peter Lloyd has put it: "Policies relating to the liberalization of international trade, reduction in restrictions on foreign direct investment, privatization, deregulation and the protection of intellectual property rights are all relevant to the promotion of competition in markets" (Lloyd 2001).

Not all countries are driven by the same objectives when adopting competition policies. Some countries adopt competition policies to protect market processes and grant equal rights for firms to engage in commerce. This generally involves the removal or prevention of restraints on competition to enhance consumers' freedom of choice and to give firms freedom to trade and to access markets. Other countries impose competition laws aimed at securing economic efficiency improvements, both static and dynamic. This implies that the economy's resources are allocated to the activity that provides the highest value; that production is done at minimum possible cost; and that innovation and technological progress allow the expansion of the economy's feasible production set.

Thus, *competition policy is usually aimed at enhancing consumers' freedom of choice and firms' freedom to trade and to access markets, balancing short-term (static) efficiency improvements with long-term, dynamic efficiency and development.* This is illustrated in five of the six countries studied (endnote 2), which already have the relevant legislation in place and explicitly identified the objectives for their competition laws.

The People's Republic of China (PRC), India, Korea, Thailand, and Viet Nam all mentioned free competition, or the protection or promotion of effective competition, as the main objective of their competition laws (Table 3.1).

For the PRC, the objectives of its competition law are to safeguard the healthy development of a socialist market economy, encourage and protect fair competition, stop acts of unfair competition, and defend the lawful rights and interests of producers and consumers.[8] India's Competition Act states in its preamble the objectives of preventing practices that have an adverse effect on competition, promoting and sustaining competition in markets, protecting the interests of consumers, and ensuring freedom of trade carried on by other participants in markets, while keeping in view the economic development of the country.[9]

The stated purpose of Korea's competition act is to promote fair and free competition, encourage creative enterprising activities, protect consumers, and strive for balanced development of the national economy by preventing the abuse of market-dominating positions by enterprises and the excessive concentration of economic

Table 3.1 Competition policy regimes

PRC	India	Korea	Malaysia	Thailand	Viet Nam
Competition policy objectives					
To safeguard the healthy development of the socialist market economy, encourage and protect fair competition, stop acts of unfair competition, and defend the lawful rights and interests of operators and consumers	To prevent practices that have an adverse effect on competition, promote and sustain competition in markets, protect the interests of consumers, and ensure freedom of trade carried on by other participants in markets, while keeping in view the economic development of the country	To promote fair and free competition, encourage creative enterprising activities, protect consumers, and strive for balanced development of the national economy by preventing the abuse of market-dominating positions by enterprises and the excessive concentration of economic power, and by regulating undue collaborative acts and unfair trade practices	Growth with equity (general development objective)	To promote fair and free trade within a competitive environment, and to prevent business structures from creating monopolies and conducting unfair trade practices	To create and promote an equitable and nondiscriminatory competition environment and to foster fair business competition
Competition legislation					
1980 Regulations Concerning Development and Protection of Competition; 1993 Anti-Unfair Competition Law; Other regional/sectoral regulations; 1998 Price Law; Anti-Monopoly Law (draft)	Monopolies and Restrictive Trade Practices Act 1969 (MRTP Act); Competition Act 2002	Monopoly Regulation and Fair Trade Act 1980; Other sectoral regulations; Omnibus Cartel Repeal Act 1999	No national competition law; Sectoral regulations	Price Control and Anti-Monopoly Act 1979; Trade Competition Act 1999; Goods and Services Price Control Act 1999	Price Regulation 1992; Commercial Law 1997; Ordinance on Prices 2002; Competition Law 2004
Competition policy history					
No competition policy until late 1970s	MRTP Act was part of the command-and-control laws, rules, regulations, and executive orders adopted after independence in 1947; with the adoption of free-market principles came the recognition of the need for an effective competition regime, hence the new Competition Act	Series of unsuccessful attempts to introduce competition law since 1964	Since independence, sectoral regulations imposed	Competition law in place since 1979	Initially, only price control measures were put in place

Source: Compiled by Asian Development Bank staff.

power, and by regulating undue collaborative acts and unfair trade practices.[10] Similarly, Thailand's competition act aims to promote fair and free trade with a competitive environment, and to prevent business structures from creating monopolies and conducting unfair trade practices.[11] Viet Nam's competition law was approved by its National Assembly in November 2004. The main objectives of the law are to regulate unhealthy competitive practices and practices in restraint of competition.

To date, Malaysia has not passed any economy-wide competition legislation. Since independence, it has relied on sectoral regulations to enforce competition in markets.

Thus, the objectives of competition law are not confined to include static efficiency considerations and, in many cases, extend to include dynamic economic performance. Moreover, competition law is only a subset of a nation's competition policies and should not be confused with other policies that affect the intensity of competition in a nation's markets. The governments of most of the countries studied have envisaged their competition laws as supportive of their national development objectives. Each one consequently views the prevalence of competition as contributory to the country's economic development.

Is competition policy necessary or appropriate for developing countries? For the full benefits of competition-induced efficiency to be realized, well-functioning input markets (especially those for capital and labor) play a critical role. Unlike industrial countries, many developing economies do not have well-functioning factor markets—such as stock exchanges and bond markets—and have often been unable to create institutions that support the operation of markets, such as bankruptcy codes, efficient contract enforcement, and the like (Laffont 1998). These "missing markets" and "missing institutions" alter the optimal degree of competition in an economy and, therefore, have implications for the vigor and manner with which competition policy should be enforced. These considerations are especially important when efforts to achieve dynamic efficiency drive policy making.

The competition laws of PRC, India, and Viet Nam, for instance, do not have specific provisions against monopolies. However, the PRC's competition act does have a provision preventing monopolies from forcing others to buy their goods. It also has a couple of provisions relating to the protection of intellectual property. In a similar vein, Viet Nam's competition law subjects monopolies, even if they are state owned, to the same prohibitions as private enterprises holding dominant market positions in the same sectors. Prohibitions include selling below cost, fixing prices, restricting production or distribution, and bundling unrelated obligations into a contract, among others. India's Competition Law does not directly ban cartelization, but prohibits collusive behavior among firms that adversely affects competition.

In comparison, the competition law of Thailand expressly forbids the creation of monopolies and devotes a full chapter to specifying antimonopoly and anticompetitive provisions. Korea's competition law is also unambiguous in its intent to promote competition in monopolistic or oligopolistic markets by regulating abusive market-dominating behavior and by controlling mergers.

Instruments

In many countries, the anticompetitive effects of government measures are addressed through the instrument of competition advocacy activities. This involves the conduct of activities by competition authorities related to the promotion of a competitive market environment through nonenforcement mechanisms, such as by establishing close relationships with other government agencies to influence their activities in pro-competitive ways and by increasing public awareness of the benefits of competition (ICN 2002).

The potential contribution of competition advocacy activities to national economic performance has been discussed extensively at the International Competition Network, at the Organisation for Economic Co-operation and Development (OECD), and in the World Trade Organization (WTO) Working Group on the Interaction between Trade and Competition Policy. An overview of the different types of competition advocacy is provided in Box 3.3.

Notwithstanding the importance attached to competition advocacy in both national competition regimes and in the work on competition

Box 3.3 Importance of competition advocacy

The growing importance attached to competition advocacy is described by Anderson and Jenny (2002).

> Apart from the potential benefits for developing countries of appropriate competition law enforcement activities, discussions in the WTO Working Group on the Interaction between Trade and Competition Policy and other fora such as the OECD Global Forum on Competition Policy have called attention to the importance of so-called competition advocacy activities. These may include public education activities, studies and research undertaken to document the need for market-opening measures, formal appearances before legislative committees or other government bodies in public proceedings, or "behind-the-scenes" lobbying within government. These, it has been suggested in the Working Group, may be among the most useful and high payoff activities undertaken by agency staff (p. 7).

Anderson and Jenny go on to discuss the particularly strong link between competition advocacy and regulation:

> The importance of competition advocacy activities arises partly in relation to regulation. Of course, in both developed and developing economies, regulation can and often does serve valid public purposes. For example, it is well-established that regulation can be an efficient response to market failures such as imperfect information, the existence of a natural monopoly (a situation in which a market is most efficiently supplied by a single firm) and other such problems. Nonetheless, it is important to recognize that, notwithstanding its avowed aims, regulation often thwarts rather than promotes efficiency and economic welfare. This is likely to be the case, for example, where it imposes restrictions on entry, exit and/or pricing in non-natural monopoly industries. In fact, experience in both developed and developing countries shows that, in many cases, rather than having regulation imposed on them for the public benefit, incumbent firms have often sought regulation for their own benefit, for the purpose of limiting entry into the industry and helping them to enjoy higher prices for their products. … In the light of this, efforts to remove inefficient regulatory restrictions and related interventions can be central to the establishment of healthy market economies in developing and transition economies (p. 7).

Source: Anderson and Jenny (2002).

policy in international organizations, another instrument—namely competition law and its enforcement—is at the center of competition policy in many countries.

Competition law refers to the set of rules and disciplines maintained by governments relating either to agreements between firms that restrict competition, or to the abuse of a dominant position (including attempts to create a dominant position through mergers) (Hoekman and Holmes 1999). UNCTAD (2002) provides a list of firms' actions that may fall within the purview of competition law, five of which figure prominently in most laws:

- Measures relating to agreements between firms in the same market to restrain competition. These can include provisions banning cartels as well as provisions allowing cartels under certain circumstances.
- Measures relating to attempts by a large incumbent firm to independently exercise market power (sometimes referred to as abuse of dominant position).
- Measures relating to firms that, acting collectively but in the absence of an explicit agreement between them, attempt to exercise market power. These are sometimes referred to as measures against collective dominance.
- Measures relating to attempts by a firm or firms to drive one or more of their rivals out of a market. A law prohibiting predatory pricing is an example of such a measure.
- Measures relating to collaboration between firms for the purposes of research, development, testing, marketing, and distribution of products.

This list of five instruments is not supposed to be exhaustive, nor is it meant to suggest that each element is given the same weight or referred to in the same terms in each country with a functioning competition law.

While it is important to know what issues

competition law covers, it is just as essential to stress that the following government interventions fall outside competition law:

- most consumer protection laws, such as those relating to faulty products, warrantees, and misleading advertising;
- unfair trade laws, such as laws on anti-dumping and countervailing duties, and measures to protect national industries against surges in imports;
- government policies toward the registration of new businesses and taxation and corporate governance oversight of existing businesses; and
- most trade and FDI policies. (Note, however, that policies toward mergers and acquisitions fall within the scope of competition law.)

Despite the distinction between what falls within and beyond the scope of competition law, competition laws (in those jurisdictions that have them) do not cover all economic sectors. Some sectors—often including those involving state-owned firms—are exempted by law from the disciplines of competition. Other firms that engage in anticompetitive practices at the behest of the government are also often exempt from competition law. In addition, many competition laws include provisions that allow the government or an independent agency to grant exemptions to firms or sectors after the competition law has been enacted.

An important point is that competition law and advocacy are not entirely separate spheres—in many countries, advocacy activities are explicitly authorized by relevant national legislation. The Competition Law of India, for example, contains specific provisions relating to competition advocacy activities.

> The Competition Act extends the mandate of the Competition Commission of India beyond merely enforcing the law. Under the advocacy provisions of the act, the commission will be able to participate in the formulation of the country's economic policies and in the review of laws related to competition. The provisions allow the central government to refer existing or proposed laws to the commission for an assessment of their effects on competition. The commission must respond to such a request within 60 days. The commission will therefore be assuming the role of competition advocate, acting proactively to bring about government policies that lower barriers to entry, promote deregulation and trade liberalization, and enhance competition in the marketplace.
>
> The Competition Act seeks to bring about a direct relationship between competition advocacy and competition law enforcement. One of the main objectives of competition advocacy is to foster conditions that will lead to a more competitive market structure and business behavior, thus avoiding the need for intervention and enforcement by the Competition Commission of India (Chakravarthy 2005).

The mix of competition policy instruments used, and the manner in which they are employed, will depend on a country's broader development objectives, its historical and institutional background, and the international context.

Consistency with other development objectives

During economic transition or reforms, the benefits of an open market economy cannot be fully realized unless restrictions on competition are removed. Sectors with characteristics of natural monopolies, such as utilities and telecommunications, need to be subjected to competition law or regulation to prevent abuse of firms' dominant positions. Price liberalization that is not accompanied by competition policy can lead to price increases if monopolistic structures are allowed to remain. Trade and investment liberalization may bring in more market players, but those agents can abuse their dominant positions if no competition policy is in place. Competition authorities can watch out for practices such as market-sharing agreements, predatory pricing, and cartelization, which

allow the benefits of liberalization to accrue to firms instead of to consumers. Without adequate competition, such issues can be difficult to resolve (Box 3.4).

Several objections about the use of competition policies have been raised, e.g., competition policy does not allow state authorities adequate discretion in relation to other development policies, particularly trade or industrial policies; its effective contribution to economic efficiency is relatively small; and it gives too much weight to efficiency relative to other societal goals such as environmental protection, income distribution, etc.

Thus, one argument often proposed that restricting competition can enhance dynamic efficiency is that in the case of young industries, firms may need to finance growth and reducing rivalry will result in higher prices that, in turn, can generate the internal funds to attain this goal.

A variant of this argument was advanced by Amsden and Singh (1994) as practiced in Japan. They observed that:

> In general, whether competition was promoted or restricted [in Japan] depended on the industry and its life cycle: in young industries, during the developmental phase, the government discouraged competition; when the industries became technologically mature, competition was allowed to flourish. Later, when industries are in competitive decline, the government again discourages competition and attempts to bring about an orderly rationalisation of the industry (p. 945).[12]

Restraining competition to bolster investment in a developing country setting is not necessarily more effective and less costly than offering firms an investment subsidy or tax credit, or taking measures that encourage banks to lend to firms. Reducing rivalry has the effect of increasing prices paid by customers. In contrast, an investment subsidy or tax credit that stimulated investment by the same amount as the reduced rivalry would not have the same adverse effect on customers' welfare. The investment subsidy or tax credit would, though, have implications for the government's budget, highlighting the importance of initial country conditions.

A related possible trade-off between competition policy and dynamic efficiency occurs when firms need to attain a certain size to compete effectively in world markets. Some advocates of industrial policy argue that domestic firms "need" profits to finance foreign expansion. If true, this might imply that the enforcement of competition laws related to cartels and merger review should place greater weight on export competitiveness than on domestic customers' welfare.

While monopoly profits could in theory have a beneficial effect by providing a source of funding for the investment necessary for a firm to compete internationally, several criticisms of this argument can be made.

First, capital markets are a more efficient source of funds for investment abroad than monopoly profits derived from domestic consumers. Tapping capital markets through either bonds or equities also increases discipline on the firm's investment decisions by imposing obligations, controls, and incentives on the shareholders and managers of firms. In contrast, when a firm has access to monopoly profits, it has less incentive to invest rationally and efficiently either at home or abroad.

Second, if monopoly profits are necessary to fund a foreign investment, then in effect the investment is only viable because of a cross-subsidy from domestic consumers. The overall effect on the domestic economy would consequently be negative as the investment would in reality be financed by a tax on domestic consumers to subsidize competition in export markets.

Third, a firm may seek to expand externally following a domestic merger and, as a consequence, the merger raises monopoly issues in one product market. If the firm produces more than that one product, rather than blocking the whole merger it would be more appropriate to apply competition remedies to the specific domestic market power abuse (Ireland 2003).

Finally, the assumption that larger domestic firms have greater export competitiveness is questionable, especially when the creation of those larger domestic firms results in a substantial reduction in the degree of rivalry between incumbent firms. Intense competition in the domestic market can build discipline that leads to success abroad. Firms that have to compete

Box 3.4 Competition in the Malaysian services sector

The following cases highlight some competition issues in the Malaysian services sector.

Malaysia Airlines vs AirAsia

Prior to 2002, Malaysia Airlines System Berhad (MAS) was virtually a monopoly operator in Malaysia's domestic airline market. With the entry of AirAsia, the market became more competitive. MAS responded by introducing a new pricing scheme (Super Saver Scheme) which offered a 50% discount for 10 seats in every flight, even though, in July 2001, the Government had allowed MAS to raise fares by 52%. AirAsia in turn countered MAS' pricing strategy in September 2002 by offering lower fares. Despite MAS' plea for intervention by the Ministry of Transport to resolve the price war, the Government maintained that the competition between the two firms is healthy. This case highlights an important impact of market entry on competition in a Malaysian service industry.

The Pangkor-Lumut Ferry Case

Two firms—Pangkor-Lumut Express Feri and Pan Silver Ferry—provide ferry services between Lumut and the island of Pangkor. A price war started between them in January 2003, and the adult round-trip ticket price plunged from RM10 in December 2002 to RM1 in July 2003, stabilizing later at around RM4. On 20 October 2003, the companies increased the ticket price from RM4 to RM10, generating a public outcry. In what seemed an angry response, the ferry operators suspended the sale of monthly passes to frequent users. The public viewed the price increase as an outcome of collusion between the two operators to avert the adverse consequences of a protracted price war. Both firms claimed that they incurred losses amounting to about RM10,000 a month during the price war.

The Government's response to the problem has been limited. Following the public's complaints in October 2003, the Perak state government attempted to negotiate a reduction of the ticket price (RM7 was considered reasonable), though without success. It then referred the problem to the Ministry of Transport. Under the Merchant Shipping Ordinance, however, tariffs for merchant and passenger ships with less than a registered gross weight of 40 tons are not regulated. The Government is currently planning to amend the law to enable them to undertake regulatory oversight in such matters. For the time being, the Ministry of Transport has resorted to direct negotiations with the concerned parties in an attempt to maintain reasonable fare levels.

This case highlights that a government's lack of regulatory oversight could lead to anticompetitive conduct, and raises interesting issues about the potential links between regulation and competition. The price increases in October 2003 were apparently an outcome of an exercise of market power by two colluding firms. A competition law prohibiting collusion would have been able to deal with this problem.

The Haulage Industry Case

The haulage industry was liberalized in 1997 to increase its efficiency. The number of haulage firms increased from five that year to about 60 in 2003. However, by 2003 the Container Hauliers Association of Malaysia (CHAM) had only six firms, including the original five. Slightly more than half of the new entrants (about 30 firms) had formed or joined another association, the Association of Malaysian Haulers (AMH).

Following the continued entry of more new firms into the industry, a price war broke out in the industry around 2000. By 2003, container haulage rates had fallen by between 20% and 40%. In an effort to stem the drop in rates, the two industry associations agreed to stop giving rebates to their customers from 1 January 2004. As of late 2004, the Commercial Vehicle Licensing Board, the industry regulator, had not made any comment on these initiatives even though it sets price ceilings for the industry.

In this case, entry liberalization for the haulage industry clearly precipitated a price war, which industry associations attempted, together, to end (aided by the fact that the market share of the six CHAM members in container haulage is about 55%). It is too early to tell whether the industry associations' efforts will work, especially given the large number of firms involved. Furthermore, the continued practice by some firms of renting out their hauler permits to other companies, and the illegal trucking of empty containers, can continue to undermine the industry's resolve to coordinate prices.

This case illustrates that tariff regulation can compromise competition in an industry. When market conditions change in such a way that an equilibrium price lower than the regulated tariff level prevails, firms may collude to maintain prices at the regulated level by agreeing not to wage price wars. When this occurs, the regulated tariff acts as a benchmark for a collusive price level. Worse, since the regulated tariff level is set by the Government, the industry associations' acts of explicit collusion may escape any legal sanction even if they are clearly anticompetitive. Competition policy could help resolve such cases. Perhaps even more important, regulation may need to be scaled back to allow competition itself to resolve such problems by allowing more entrants into the market.

Source: Lee (2005).

domestically know how to cut costs, operate efficiently, attract customers, and fight for market share. This discipline gives them an advantage when expanding into foreign markets.

Some argue that, for firms to reach the appropriate size, state action is called for, essentially to create or foster "national champions." These state actions may include forced mergers and acquisitions, or state-encouraged mergers and acquisitions by private firms. Even in this case there is an issue as to what should be the appropriate competition law enforcement regime for national champions after they have been formed.

An important feature of policies employed to create national champions is that they can involve discrimination against foreign firms. The discrimination can be de jure, for example, when foreign firms are simply banned from acquiring or merging with domestic firms in certain sectors. Also, a foreign firm's proposal to buy or to merge with a domestic firm may be reviewed under a different and potentially more stringent procedure than when two domestic firms decide to form a single combination. Alternatively, the discrimination could be de facto, for example, when merger review procedures are implemented in such a way that proposed combinations involving domestic firms are treated differently than those involving at least one foreign firm.

Industrial policy, competition, and competition policy

Concepts

A recurring concern in the debate over the efficacy of competition law in developing countries is that its enforcement may compromise important industrial policy goals, creating an inherent tension between the two. However, the characterization of industrial policy in the literature is considerably less precise than that of competition law, and can be a source of considerable confusion in discussions on development policy.

No single accepted definition of industrial policy exists, but a persistent theme is that industrial policy in developing countries is intended to facilitate a structural transformation of their economies. As Ajit Singh (2002) puts it, the crucial importance of industrial policy is to achieve structural changes required for development. Likewise, structural change in favor of industry has been viewed as a prerequisite for developing countries' modernization and growth, and developing countries' industrial policies were aimed to speed up the industrialization process to achieve levels of industrial development that were comparable with those in Europe and North America (Dervis and Page 1984).

The ultimate objectives of industrial policy are generally taken to be faster national economic growth and economic development, while the intermediate objectives are to expand the output of those sectors with high value added or the potential for considerable growth of value added. Not every industry targeted needs to be identified as high value added or having prospects for fast growth. Furthermore, nothing in principle prevents a nonindustrial sector—such as services or agriculture—from being so identified.

> After all, industrial policies are supposed to have been confined to the trashbin of history in modern and modernizing economies, along with other outmoded policies like central planning and trade protection. The reality is that industrial policies have run rampant during the last two decades—and nowhere more so than in those economies that have steadfastly adopted the agenda of orthodox reform. If this fact has escaped attention, it is only because the preferential policies in question have privileged *exports* and *foreign investment*—the two fetishes of the Washington Consensus era—and because their advocates have called them strategies of "outward orientation" and other similar sounding names instead of industrial policies. Anytime a government consciously favors some economic activities over others, it is conducting industrial policy. And by this standard, the recent past has seen more than its share of industrial policies (Rodrik 2004, pp. 28–29).

As with competition policy, there appears to be no accepted set of instruments that are always considered to be part of industrial policy. Several characterizations of industrial policy instruments can be found in the literature. In his analysis of East Asian industrialization, Wade

(1990) differentiates between sectoral and functional industrial policy instruments. He defines sectoral industrial policy instruments as those aimed at directing resources into selected industries so as to give producers in those industries a competitive advantage. In contrast, he defines functional policy instruments as those that affect either economy-wide factors (such as the supply of engineers or the price of energy) or in principle alter in the same manner firms' or investors' incentives, irrespective of the industry or sector in which they operate. An example of a functional instrument of industrial policy would be an economy-wide investment subsidy or tax credit.

Pangestu (2002) presents perhaps the most exhaustive categorization of the instruments of industrial policy—external, product, and factor market interventions. External market interventions, aimed at protecting domestic industries from imports, include import tariffs, quotas, local content requirements, and export promotion measures. Product market interventions, intended to foster competition in domestic markets, include competition policy (to ensure fair competition between domestic and foreign players) and domestic market-entry regulations. Factor market interventions, often designed to influence the operations of foreign affiliates so that the host country realizes a net benefit from FDI, include policies such as performance requirements and restrictions on FDI.

Pangestu's characterization of the instruments of industrial policy is of interest for several reasons. First, her characterization highlights how the enforcement of competition law is *one* of the large number of policy instruments associated with industrial policy. This is important because it implies that the preponderance of industrial policy instruments falls outside the domain of competition law. Second, Pangestu presumes the goal of competition policy here is to promote rivalry and not to restrain it, as Tilton (1996) had suggested. This hints at divergent views as to the contribution to economic development of rivalry between firms. Third, the fact that she feels the need to list so many policy instruments to accurately characterize the term industrial policy suggests that the term is so wide-ranging as to be of little more than descriptive value.

Tilton (1996) identified two types of industrial policy instrument in his analysis of postwar Japanese economic performance. The first instrument, which is similar to Wade's sectoral policy instruments, is described below:

> The principal way industrial policy functions here is by allocating resources to favoured sectors. It can do so through policies that directly provide resources to industries, such as tax breaks, loans, subsidies, and import protection. More important, however, have been policies to reduce competition between firms. … Industrial policy may also support industry by providing or helping to circulate information about market or technological opportunities (pp. 2–3).

He adds:

> A second form of industrial policy, strategic trade policy, seeks to appropriate the benefits of strategic industrial sectors by promoting them at home and helping them gain a larger share of world markets (p. 3).[13]

For the purposes of this chapter, Tilton's characterization of industrial policy is important because it highlights the fact that some competition policy and trade policy instruments are also seen by some as *industrial policy* instruments.

> Overall, then, … government did play a variety of roles in the successful Japanese industries. However, these roles were very different from what is closely associated with Japan, and they were not the Japanese policies that have been the most widely emulated. Not only was there little of the intervention in competition associated with the received government model; in some successful industries, such as automobiles, the industry actually spurned government's efforts to suppress competition (Porter et al. 2000, p. 31).

In light of these findings, it would be misleading to argue that there is an intellectual consensus behind the proposition that limiting rivalry promoted Japanese economic development. Moreover, in a contribution to the WTO Working Group on the Interaction between Trade and

Competition Policy in 2001, *Japan itself argued that intrafirm rivalry has previously played and continues to play an essential role in Japan's development*:

> While it has been commented that Japan's postwar economic development was achieved by subordinating competition policy to industrial policy … much of Japan's economic dynamism has in fact been rooted in the robust market mechanisms created through competition among firms. Industrial policy and competition policy coordinated mutually and developed an environment that allowed companies to engage in free and fair competition. The introduction of competition policy early in Japan's economic reconstruction, as well as the subsequent evolution of this in response to economic development, was a great factor in Japan's rapid economic growth in the past. Even today, it is those sectors where competition has been intensive - the automobile industry, for example - which tend to have the greatest international competitiveness (Japan 2001, p. 2).

The Japanese experience is not unique. In Korea, it also appears that the costs of creating such a cadre of large firms have become increasingly evident over time. It is said that these large firms used their market power at home to frustrate entry by rivals, to raise prices, and to resist the enactment and enforcement of competition laws that could have put a stop to these adverse outcomes. These points have been made with some force in a submission by Korea to the WTO Working Group on the Interaction between Trade and Competition Policy in 2001, noting that:

> Korea's experience demonstrates that it is better to introduce a competition regime at the initial stage of economic growth, when monopolies have not yet gained political and economic power. Despite their merits of achieving economy of scale, large monopolies, if left unchecked, are very likely to engage in excessive facility investments, cause price hikes resulting from their inefficient operations, and hinder opportunities for new entrants. This eventually necessitates the introduction and enforcement of competition policy to remove anti-competitive elements in the market under the political and social pressure stemming from the rising public discontent against the unbalanced distribution of wealth (Korea 2001, p. 3).

In addition,

> With the progressive liberalization of world trade, developing countries can no longer resort to the export-oriented economic growth policy through the protection of domestic industries. Therefore, competition policy should be put into operation from the early stage of economic development to respond proactively and promptly to the rapidly changing economic conditions at home and abroad. Greater competition will ensure that unrestrained interaction of competitive forces will yield the best allocation of economic resources, thereby helping promising small and medium enterprises to grow on market-driven foundations and form a healthy industrial platform (Korea 2001, pp. 3–4).

The widespread use of industrial policies in developing Asia highlights the importance of examining their interaction with competition and competition policy. This is illustrated in Box 3.5.

People's Republic of China

Ever since the start of its open-door policy in the late 1970s, the PRC has persistently pursued industrial policies by, for example, identifying and providing preferential treatment to what have been termed sunrise industries. Industrial policy objectives are embedded in various policies covering the fields of FDI, science and technology, education, land use, and taxation policies, among others. According to Jiang (2002, p. 49), the central Government published more than 80 detailed industrial policies from 1978 to 1997, pertaining to virtually every government department and industry. Jiang divided them into the following three categories: those designed to reform the industrial landscape, those with interventionist measures, and those intended to support or restrict industries and enterprises.

Box 3.5 The colored television cartel in the People's Republic of China

After engaging in several rounds of price wars in the late 1990s, top managers of nine TV manufacturers in the People's Republic of China, which reportedly account for more than 80% of the market, held a summit in June 2000 and agreed to form an alliance. The top TV producer, Changhong, did not join the alliance. The alliance agreement covers: research and development cooperation in digital technology standards and new products; joint efforts in promoting exports; and, most notably, setting minimum prices for TVs sold domestically.

The State Development and Planning Commission (SDPC, now State Development and Reform Commission) publicly announced that the agreement was in breach of the 1998 Price Law, and that the alliance was a monopoly in disguise. However, a high-ranking official from the Ministry of Information Industry, which supervises the TV sector, supported the alliance, stating that it embodied the healthy development of the industry via self-protection, self-discipline, and voluntary cooperation.

After meeting with the nine producers, SDPC and the Ministry of Information Industry jointly declared in August 2000 that while there was nothing wrong with discussing long-term issues via dialogue, setting minimum prices violated the 1998 Price Law. No formal action has been taken by the alliance, but one of its members has been pricing TVs lower than the floor price set by the alliance.

Source: Lin (2005).

He argues that the PRC's industrial policies have undergone three stages of development in relation to their interaction with competition:

- From the late 1970s to the mid-1980s, they promoted competition by encouraging entry of new firms, particularly in nonstate sectors, introducing competition among existing enterprises and relaxing price controls.
- From the mid-1980s to the mid-1990s, they limited competition by restraining establishment of new small and medium enterprises, restricting competition between rural and state-owned enterprises (SOEs), and providing preferential treatment to large SOEs.
- Since the mid-1990s, they have promoted and limited competition in concert, by promoting competition in monopolistic industries, on the one hand, and instituting measures to rescue SOEs that were facing difficulties, on the other.

Until the mid-1990s, policy makers regarded industrial policies as the cure to many economic problems and the key to long-term economic development. Whenever a shortage or surplus occurred in the marketplace, or excessive competition existed (as manifested in, for example, price wars or a large number of loss-making enterprises), the public expected the Government to step in with proper industrial policies.

During the first stage of economic reform (late 1970s to mid-1980s), a primary goal of the Government was to improve firms' performance by introducing competition (relaxing price controls, removing entry barriers, and so on). Such measures were generally successful. From the late 1970s until the mid-1990s, market mechanisms were only regarded as supplementary to central planning. As competition intensified, new small-scale entrants (mostly nonstate owned) began to crowd out large SOEs. Toward the latter part of this period, the Government introduced new industrial policies to protect SOEs from increasing competition. The second stage in Jiang's analysis corresponds to such a correction period. After a period of consolidation, industrial activities consequently slowed down, and a new round of industrial policies was introduced to restimulate industrial production.

In October 1992, the Government decided to replace its traditional central planning approach (supplemented by markets) with one aimed at establishing a "socialist market economy." Gradually, market mechanisms began to be accepted as another, perhaps better, solution to economic problems. The Government still uses industrial policies, but they are no longer regarded as a panacea for the country's economic ills.

Throughout the 1990s, the central Government continued to encourage large-scale enterprises. Taking its cue from Korea, it regarded the establishment of large conglomerates as the most important means of achieving

economies of scale to be able to compete with multinational enterprises both in the domestic and international markets. Merger and acquisition (M&A) activities were regarded as effective vehicles to absorb and transform loss-making SOEs. In 1991 and 1997, a national team of 120 large enterprise groups from industries considered of strategic importance was selected. To enhance competitiveness, the Government granted special treatment to these national champions, including tariff protection, special rights to engage in international trade, requirements for potential foreign investors to transfer technology to these selected firms, and favorable terms on loans from state-owned banks.

In spite of the adverse effects of the 1997–98 Asian financial crisis, particularly on Korea, the PRC Government still considers setting up large-scale domestic enterprises as a top priority. Unsurprisingly, a large number of large-scale mergers or acquisitions that took place in recent years were government managed. For example, in a government-ordered merger in 2002, the Civil Aviation Administration of China pushed nine domestic airlines directly under its supervision to form three super groups: China National Aviation and China Southwest became subsidiaries of Air China; Yunnan Airlines and China Northwest became subsidiaries of China Eastern; and China Northern and Xinjiang Airlines became subsidiaries of China Southern. Under the administrative transfer technique, these three "super groups" secured the assets of the regional carriers for free.

As far as competition in its domestic markets is concerned then, PRC industrial policies have shifted toward encouraging interfirm rivalry. This has been accomplished without compromising another stated government goal: that of building a cadre of large firms able to withstand competition on world markets. Moreover, to the extent that enhancing competition in the domestic markets is a prerequisite to having firms perform well on global markets, PRC industrial policies toward rivalry in domestic markets could well have underpinned the exporting prowess of this select group of firms.

India

Somewhat similar to the PRC, since the early 1950s India has had a planned strategy for its economic development. The Industries (Development and Regulation) Act, 1951 (IDR Act) empowered the state to channel the direction of private investment through the extensive use of industrial licensing. Entry into industries, capacity expansions, and choice of product mix and technology were effectively subject to state control. The intention was to reallocate resources from production of consumer goods and into the production of machine tools and capital goods. Only small-scale industry was exempted from licensing to encourage labor-intensive consumer goods production in rural areas. By the late 1960s, policies to protect the small-scale sector against competition from the large-scale sector were in place.

Additional Indian legislation, particularly the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) and the Foreign Exchange Regulation Act, 1973 put in place more barriers to entry. The Industrial Disputes Act, 1947 controlled firm closures and labor retrenchment, effectively creating barriers to exit. At the same time, the public sector was made responsible for the development of infrastructure and was given control over key sectors such as defense and defense equipment, iron and steel, energy, power, transportation, and telecommunications. Central government departments and public sector enterprises were mandated to accord price and purchase preferences to the public sector.

In 1991, India's industrial policies underwent a substantial change. The Industrial Policy, 1991 liberalized FDI, foreign technology agreements, and compulsory industrial licensing. Licensing in all but 18 industries was abolished, and an additional 12 industries were subsequently delicensed. Only industries relating to strategic or environmental concerns remained subject to licensing. In the same manner, the monopoly of public sector industries was abolished, save for industries dominated by security and strategic concerns, such as defense equipment, railway transport, and atomic energy and nuclear minerals. These measures catalyzed competition in industrial manufacturing and services. However, a number of commodities remained subject to price and quantity controls, such as sugar, fertilizers, pharmaceuticals, and cement. As a result, even in some industries with a private sector presence, market conditions and outcomes are not truly competitive.

Korea

Accounts of Korean economic development show that the Government, differentiating between domestic and foreign competition, undertook steps to promote the development of large firms that could compete on international markets while at the same time encouraging fierce competition between these firms. These measures are thought to have secured the benefits of large firm size without the costs associated with diminished competition. In recent years, however, this argument has fallen out of favor.

Rodrik (1995) summarized Alice Amsden's (1989) thesis on Korea's economic development since World War II as an incentive system based on an effective balance between carrots and sticks. The Government adopted measures such as trade protection, selective credit subsidies, export subsidies, export targets (for individual firms), public ownership of the banking sector, and price controls aimed at acquiring technological capacity and building world-class industries. At the same time, it set stringent performance standards in exchange for the subsidies and protection. Penalties (such as rationalization) were imposed on poorly performing firms, and rewards (such as subsidized credit) were offered to firms fulfilling government targets. This kept the system free of the rent seeking that has proliferated in other regimes. Amsden and Singh (1994), in describing the implications of this apparent mix of policies, contend that the Government encouraged big business through licensing and subsidized credit, but ensured that no collusion existed between big businesses by allocating subsidies only in exchange for adherence to strict performance standards.

High and growing concentration ratios appear to be the result of these policies. Smith (2000) reported a trend of growing *chaebol* market power from 1970 up to the mid-1980s. From 1977 to 1994, the 30 largest *chaebol* accounted for between 32% and 40% of total national output. In 1994, total sales by the top five *chaebol* were 49% of national income. Amsden (1989) showed that in 1982, only about 18% of 2,260 commodities, or 30% of all shipments, were produced under competitive conditions. The result was an industrial structure different from one that a market economy would have produced. Large, diversified business groups, which were less subject to the discipline of the market than to the discipline of managerial hierarchies, dominated the economy (Smith 2000).

Over time, the costs of creating such a cadre of large firms became increasingly evident, as these large firms used their market power at home to frustrate entry by rivals, to raise prices, and to resist the enactment and enforcement of competition policies that could have put a stop to these practices. Early efforts to introduce competition laws in the country were easily thwarted by lobbying from the corporate sector, as the monopolies had already gained political and economic power. Although some were able to achieve economies of scale, the monopolies, if left unchecked, were more likely to over-invest, over-diversify, and over-price due to their inefficient operations. The Government takes the view that the 1997 financial crisis and the problems now besetting the *chaebol* are somehow caused by the lack of a competitive economic environment in the past decades. To correct the situation, the Government is exerting extra effort to establish a more competitive market structure through stricter implementation of competition and related laws. However, it is facing difficulties in the process as vested interests resist change. This experience highlights the importance of having faith in the benefits of competition from an early stage of economic growth and of incorporating competition policy based on the functioning of markets into the basic framework of economic policy (Korea 2001).

For policy makers convinced of the need for industrial policies to groom internationally competitive firms or national champions, one implication of the Korean experience is that mitigating the adverse domestic side effects of such a policy will require measures, such as the enforcement of competition law, that stimulate or ensure rivalry between these firms. The Korean and PRC experiences both suggest that policies to create large national firms ought to be complemented by measures to ensure continued rivalry in domestic markets.

Malaysia

In Malaysia, growth with equity has always been the primary economic objective. Race

riots in 1969 prompted the Government to adopt an interventionist long-term development policy—the National Economic Policy—aimed at reducing poverty and redistributing wealth among the different ethnic groups. Over time, the objective of wealth redistribution received greater attention than poverty reduction. Specific ownership targets were set for commerce and industry. Outright purchases, licensing, quotas, and government procurement regulations were implemented to meet these ownership targets for the *bumiputra* community. Large SOEs and state development corporations were also established to accumulate corporate assets on behalf of that community.

In the agriculture sector, several marketing boards were established under the National Economic Policy to reform distribution networks. The Government believed that persistent poverty in the agriculture and fishery sectors was due to the exploitative behavior of rural traders with monopolist or monopsonist positions. The exclusionary nature of government policies to redistribute wealth reduced, to a certain extent, the degree of competition in some sectors, such as government procurement.

The Government also employed industrial policy to further develop its economic sectors. Policy measures included: (i) trade-related instruments such as import tariffs, import licensing, export promotion or processing zones, and export-related equity or ownership incentives (Box 3.6); (ii) industry promotion instruments such as pioneer status, investment tax allowance, research and development (R&D)-related tax incentives, and local content programs; (iii) national champion-type investments such as Proton (the national automobile project, see Box 3.7); (iv) factor market-related instruments such as foreign labor policy, priority sector lending guidelines, and provision of industrial areas; and (v) regulatory interventions in domestic markets such as licensing, price ceilings, government procurement, moral suasion on mergers, and market liberalization.

In general, export-oriented industrial policies and factor market-related instruments appear to have had a neutral impact on competition in Malaysia's domestic market. In contrast, import substitution strategies have raised issues related to market access, as for instance, in the automotive sector. The national champion-type investments that are supported by these strategies tended to reduce competition.

Eventually the Government realized that the painful trade-offs accompanying redistributive policies could be softened by economic growth propelled by the FDI-driven export sector. This approach resulted in the adoption of pro-growth policies, such as market liberalization in both tradable and nontradable sectors that increased the degree of competition in affected markets. However, in anticipation of greater competition from foreign firms, the Government also took steps to consolidate various industries (most notably banking) via mergers, to partially offset the competitive impact of liberalization.

Thailand

Thailand's industrial policy focuses mainly on promoting companies that employ advanced technology, invest in R&D activities, provide training programs, utilize available domestic resources (including labor), and promote industrial linkages. Firms with such qualifications are likely to receive incentives from the Board of Investment.

However, many state rules and regulations pose barriers to entry to certain industries. Manufacturing industries that display high market concentration usually receive state protection in various forms, including high tariffs and surcharges imposed on competing imported products, stringent licensing conditions making new entry difficult, or a change in the excise tax regime that benefits the incumbent monopoly.

Certain laws or cabinet decisions also grant exclusive rights to SOEs to provide services to the public. For example, until recently the law granted a statutory monopoly in the ownership and operation of all telecommunications services to state enterprises. Private participation was subject to build-transfer-operate agreements, whereby private operators built the networks and then transferred ownership of the networks to the state enterprises in exchange for exclusive rights to operate the networks for a specified period of time. Under such an arrangement, the private concessionaires could not claim any assets and were subject to operating conditions

Box 3.6 Malaysia: The steel industry case

Malaysia focused on steel production as part of its heavy industrialization program in the early 1980s. The two largest steel projects in Malaysia are Perwaja (producing billets) and Megasteel (producing hot- and cold-rolled coils). After investing more than RM10 billion in Perwaja, the Government sold the then loss-making firm to a private company, Maju Group. Megasteel, in contrast, has always been a privately owned plant, with a market capitalization of more than RM2.4 billion.

Both investments are protected from foreign competition via import duties and permits (administered by the Ministry of International Trade and Industry) and price regulation (set by the Ministry of Domestic Trade and Consumer Affairs [MDTCA]). Rising demand for steel scrap (the basic raw material for making steel products) abroad since early 2003 reduced the availability of this input for domestic production.

As a result, steel supply for domestic consumption declined and steel prices increased sharply. Domestic consumers of steel products such as the construction industry were severely affected. Concomitantly, both Perwaja and Megasteel reported significant improvements in their financial performance.

To alleviate the shortage, the Government undertook the following measures: suspending for 6 months import restrictions on steel billets and bars, and exempting raw materials from import duties; restricting steel exports; and directing MDTCA to introduce an automatic pricing mechanism for domestic steel billets and bars to provide incentives for steel production for domestic consumption.

These events illustrate the complex interaction among industrial policy, competition, and trade. In this case, the implementation of industrial policy (in the steel industry) via trade policy (import permits and duties) and regulation (price controls) resulted in adverse impacts on other sectors (such as construction). The temporary solution of liberalizing imports clearly increased competition between local and foreign steel producers. Meanwhile, there is no indication that the Government considers restricting exports as a temporary option, and may aim to keep this restriction in place even after the automatic pricing mechanism comes into effect.

Source: Lee (2005).

set by the state enterprises, some of which restricted competition. With the enactment of the Telecommunications Act in 2002, the statutory monopoly is now void.

Similarly, the state-owned metropolitan and interprovincial bus operators hold exclusive rights to provide services on main routes. But unlike telecommunications, the monopoly is granted by the executive—i.e., through a cabinet decision—rather than through legislation. Again, private operators can only operate under concessions from the state enterprise and therefore must pay a royalty fee that can either be a fixed fee or a profit-sharing scheme.

Viet Nam

Industrialization and modernization have for a long time been strategic development objectives for Viet Nam. Although there has been a significant shift in development priorities at the central level, there is still a strong emphasis on the adoption of government-led industrialization policies, similar to those previously applied in Japan or Korea. This has an important implication for competition policy in Viet Nam, since for many years competition was limited and special preference given to SOEs was quite persistent. The objectives of self-sufficiency and self-reliance remain dominant forces in the Government's choice of policies, particularly in the promotion of certain key industries where the state takes a lead role.

In response to increasing competition from foreigners in domestic and international markets, the Government has adopted a policy of promoting conglomerates. General corporations (GCs) have been established to take control of SOEs with the aim of strengthening accumulation of capital and increasing competitiveness, abolishing the administrative dependence of SOEs on the relevant ministry or local administrative authority, leveling the playing field for central and local SOEs, and strengthening the management of SOEs. In effect, each GC will perform the role of management team for a group of SOEs.

A GC allocates capital from the Government

Box 3.7 Malaysia: The EON and Proton Edar case

Cars produced by the national car company, Proton, which was established in 1983, used to be distributed domestically by EON and Proton Edar. EON was established in 1984 as the sole distributor of the national car (the Proton Saga). The Government was a major shareholder in both Proton and EON. The government strategy was to separate manufacturing from distribution. Proton Edar was established in 1985 and became a wholly owned subsidiary of Proton in 2000, subsequently distributing other Proton models previously distributed by EON. In the same year, the 10-year distribution agreement between Proton and EON ended. This set the stage for the intensification of rivalry between Proton Edar and EON in distributing Proton cars.

Problems arose with the launching of a new Proton car—Gen.2—in February 2003. Proton chose initially to distribute Gen.2 solely through Proton Edar, with EON sourcing its supply of Gen.2 from Proton Edar. (Proton also argued that EON should restrict itself to selling a single brand in a single showroom, referring to EON's practice of selling Audi and Chevrolet cars as well as those of Proton).

Anticompetitive conduct is fairly obvious in this case, as there was severe conflict of interest due to Proton's ownership of Proton Edar. It is in Proton's commercial interest to favor its own subsidiary over EON. This is manifest in Proton's decision to compel EON to source its new product from its rival Proton Edar. Proton's insistence on a single brand in a single showroom distribution policy is also akin to market foreclosure to reduce interbrand competition in the car market.

The Government did not intervene in the initial stages of these controversies. However, as the disagreement became more public and acrimonious, it finally asked each party to present their case in February 2004. This eventually led to their signing a 5-year dealership agreement in March that year.

The dealership agreement signed may contain elements that would normally come under competition policy scrutiny. One such clause is the requirement that EON allocate 70% of its servicing capacity to Proton cars. This may be construed as the use of market power by the supplier firm (Proton) to force a buyer firm (EON) to limit the latter's ancillary services to other competing suppliers. This is an important issue given the importance of ancillary services to the actual sale of the primary product (cars) in this case.

Industrial policy can also restrict competition via the promotion of strong vertically integrated structures. In the Proton case, this took the form of car production and distribution. The absence of a competition law exacerbated these vertical restraint problems. If such a law had existed and if Proton had been found guilty of anticompetitive conduct, it could have been forced to divest its distribution subsidiary. The Government currently regulates these companies via its substantial shareholdings, but without them, these companies would be difficult to regulate without competition law.

Source: Lee (2005).

to its SOE members, who have full autonomy in using these resources for their business activities. GCs, however, can adjust the allocation of funds to ensure the smooth operation of the whole group. GCs also determine how the markets are divided among their members, effectively limiting competition from nonmembers. They impose price ceilings for imports and floor prices for exports. As a result, some GCs, such as Viet Nam Airlines and Viet Nam Post and Telecommunications, act as monopolies, which allows them to earn large profits. As the GCs significantly limit competition in certain sectors, the Government is now considering privatizing them and encouraging competition.

Complementarity with industrial policies

For present purposes, the issue is not whether governments should or should not promote national champions. Nor is the issue whether M&A activity actually attains the efficiencies and cost reductions envisaged, a matter that has been debated extensively in the literature on industrial organization. Rather, the question is whether, in order to promote national champions, governments need, or are well-advised, to relax the enforcement of competition law. In most cases the relevant market is wider than the national market and hence an accurate competition assessment, i.e., one based on the wider market, would not identify a competition problem.

Furthermore, to the extent that creating national champions substantially increases concentration in a domestic market, there may actually be a stronger reason for enforcing competition law than would otherwise be the case. Small economies have all the more reason to apply competition rules more vigorously in the import and distribution sectors. Doing this would ease any adverse domestic implications from national champions.

The purpose here is *not* to undertake an evaluation of industrial policy per se, but rather only to examine the competition implications involved. The experience of these six Asian nations does not show that restricting interfirm rivalry is a common and consistent component of national industrial policies. In fact, some countries' industrial policies have taken no steps to alter interfirm rivalry between domestic firms, though other countries' policies at times have done this. None of this is to say that industrial policy has been ineffective, nor that domestic firms have not been shielded somewhat from rivalry from abroad, although even the latter protection has been diminishing over time.

A (remarkably) broad range of scholarly analysis of East Asian experience—and in particular the Korean experience—suggests that industrial policy measures to create national champions should be complemented with state measures to promote vigorous competition within the country in question.

In the instances where policies to curtail domestic interfirm rivalry were employed in Asia, they were principally directed toward a small number of declining industries or markets with over-capacity—not to infant industries. *The tension between the objectives of competition law (promoting rivalry) and industrial policy (promoting the growth industries of tomorrow) is more apparent than real.*

In an attempt to support other development objectives, sectors with dominant SOEs are often exempted from the disciplines of competition law. The railways in India, for instance, continue to be a state-owned monopoly with administered prices and very limited competition despite the existence of competition law. Similarly, Viet Nam's competition law expressly indicates that the state will continue to control SOEs operating in declared state monopoly sectors and will dictate production and prices for these enterprises. In other countries too, firms engaged in anticompetitive practices at the behest of the government are often exempt from competition law. In addition, many competition laws include provisions that allow the government or an independent agency to grant exemptions to firms or sectors after the competition law has been enacted.

It should be noted that the greater the extent of any sectoral or general exemptions from a national law banning hard core cartels, the smaller the overall benefits of adopting such a provision. Moreover, such exemptions may have a "beggar-thy-neighbor" aspect to them as is likely to be the case in certain international transportation sectors. In particular, government-inspired or government-tolerated cartels are rife in ocean liner shipping conferences, involving cooperative working arrangements as well as agreements to set prices.

The state offers another form of encouragement to private international cartels. Many nations, such as India, appear to have taken the view that their own firms can cartelize markets, provided that those markets are abroad. In fact, numerous jurisdictions have explicitly exempted *export cartels* from their domestic competition laws—essentially providing legal privileges and immunities to their own nation's firms that are members of export cartels.

Initially, such export cartel exemptions were supposedly justified on the grounds that small exporters could join together to share costs of marketing their products abroad. If these cartel exemptions were specifically to aid small firms, then one might have expected the relevant legislation to be confined to these firms. Invariably, it has not been. In recent years some nations have repealed such exemptions—in part, perhaps, because they fear that if their firms adopt the habit of cartelizing foreign markets then there is a greater risk that the same firms will attempt to cartelize the home market too.

Sectoral policies, regulation, and deregulation

Regulation is a type of intervention in sectors with market failure where the existence of competition law is insufficient to correct the market

failure. In such cases, government regulation of firms may increase welfare. To clarify:

> Sometimes, however, Government regulations—and the rules of self-regulatory bodies—block competition. This may be for very good reason. For example, *laissez faire* cannot be guaranteed to deliver food safety, so there is clearly a need for basic food safety regulation. In a sense this stops unsafe food from competing with safe food. But regulation should not block competition and its good incentive properties more than is necessary to achieve public interest goals. Indeed competition is generally helpful in advancing, rather than at odds with, those goals (Vickers 2003, p. 5).

Unfortunately, regulation in practice often differs considerably from the regulation that would be optimal in theory, and sometimes makes market inefficiencies worse. Thus, regulatory policies sometimes conflict with competition objectives (Box 3.8). Restrictions imposed by government agencies on licensing of new firms, for instance, hamper competition and reduce consumer welfare. Imposing uncommon norms and standards, as well as prohibiting foreign ownership in certain industries are other examples of entry restrictions that inhibit competition. Other regulatory barriers to competition may take the form of public subsidies or monopoly rights. The costs of administering regulations may exceed the benefits, even where they are properly applied. Meanwhile, exempting specific industries from competition laws or favoring certain firms in public procurement can also affect the market operation of competing industries or firms.

In view of the potential conflict between regulation and competition, many developing countries have begun to implement regulatory reforms that serve public interests better and support competition more. These reforms have included privatization efforts by governments, as well as removal of market entry restrictions, in order to broaden the scope for markets to allocate resources. Deregulation is aimed at reducing market distortions caused by government intervention. Introducing competition into previously

Box 3.8 The cable television monopoly in Thailand

Cable television service became a monopoly in Thailand in February 1998 as the two incumbent operators merged to form the United Broadcasting Corporation (UBC). The operators argued that they needed to consolidate operations in light of the sharp depreciation of the baht resulting from the financial crisis. Against public sentiment, the Mass Communication Organization of Thailand (MCOT), the government organization authorized to issue broadcasting licenses, approved the merger. According to the terms granted by MCOT, UBC was to offer two packages, silver and gold. The subscription application forms, however, did not offer the option of a silver package.

In May 1999, UBC raised the monthly fee for its gold package, the subscription plan with the most channels, by over 20%, claiming that this was necessary to recover losses incurred from adding new channels. A consumer group filed a complaint with the competition authority, alleging that the cable operator had abused its monopoly by charging excessive prices.

An expert subcommittee, which was assigned to investigate the case, failed to establish whether the price was excessive. But the subcommittee found that UBC had abused its dominance, limiting consumer choice by failing to offer the lower-priced silver package, which had fewer channels. Customers were thus forced to take the gold package, in clear violation of UBC's licensing conditions.

While the Trade Competition Committee concurred that the cable operator was a monopoly, it decided to refer the case to MCOT, which was responsible for monitoring compliance with the licensing agreement and for approving tariffs. Although the tariff was therefore not revised, public pressure prevented further price hikes that were pending at the time. However, a few months later, MCOT approved a price increase. Both gold and silver packages are now available to subscribers, but the package has been altered such that certain licensed channels have been withdrawn from the silver package.

Source: Nikomborirak (2005).

regulated industries has significantly strengthened the efficiency of firms and improved economic performance over time. Interfirm rivalry provides incentives for efficiency-enhancing restructuring. In general in Asia, deregulation and privatization have increased economic efficiency and raised public welfare.

Greater competition between firms resulting from deregulation can encourage managers and capitalists to focus on improving their enterprises' performance so as to maximize profits or at least to stave off threat of bankruptcy, takeover, or other loss of control. Indeed, *more intense competition in product markets tends to intensify the pressure on firms to lower costs.* Competition agencies should thus be involved in governments' regulatory reform efforts, playing the roles of competition advocate, consumer protector, and regulatory police to ensure that complementarities between competition and regulation are maximized. However, competition authorities and regulatory agencies are not substitutes, i.e., one cannot just replace the other. Both should coexist and work together to protect consumer welfare.

Competition policy in the context of regional and global integration

As globalization proceeds, attention has increasingly turned to the cross-border implications of anticompetitive practices. At the international level, contestability of markets in a foreign country requires either freedom of trade or the establishment of an affiliate in a foreign country and national treatment in order to compete on equal terms with domestic producers.

Trade liberalization

Is a liberal trade policy a complete substitute for competition policy? Or must trade reform be complemented by measures to tackle anticompetitive practices? Which types of anticompetitive practices, if any, have followed trade reforms in Asian economies? To what extent have the benefits of trade reform been eroded by lack of attention to competition policy principles? And to what extent has the removal of government impediments to trade (tariffs, quotas, etc.) been replaced by private anticompetitive practices?

Economic theory suggests that trade liberalization will increase national welfare in a competitive domestic market. The liberalization of trade allows producers to venture into world markets, bringing them export opportunities that allow them to increase output and reduce costs through economies of scale. In addition, because there are more players in export markets, competition among them is likely to be stiffer, forcing producers to increase production efficiency, adopt better marketing techniques, and impose stricter quality control measures on their production techniques. As a result, domestic as well as foreign consumers benefit from lower-priced and higher-quality products.

Similarly, import tariffs are perhaps the most common tool that governments of developing countries use to protect domestic industries and limit competition from outside. Reducing import barriers exposes local producers of tradable goods and services to competition from imports, thereby increasing pressure to raise productivity and keep costs down.

These arguments form the basis for assuming that, for small open economies, trade liberalization provides a market structure that encourages competitive industries and prevents monopolistic behavior. However, there is less consensus on whether it will bring about an increase in national welfare when the domestic market is not competitive. Trade liberalization by itself is usually not enough to keep competition at an optimal level in all economic sectors. In addition, while trade barriers have generally been reduced in many countries, they still exist and new forms, such as contingent protection and antidumping regulations, have sometimes been adopted to replace those that have been removed.

That *the intended benefits of trade reform may not be realized without active enforcement of competition law* is a source of complementarity between competition policy and long-term economic performance. The concern here is

that reductions in official trade barriers will be replaced by anticompetitive private practices, the latter counteracting the price-reducing effects of trade reforms. For example, lower import tariffs may merely result in higher profit margins for monopolistic (or oligopolistic) importers, with fewer benefits reaching consumers and the broader economy. To the extent that reductions in the prices of imported machinery and other capital equipment bolster investment and enhance dynamic economic performance, then measures to discipline private anticompetitive practices may be required for reductions in trade barriers on these durable goods to translate into higher growth. *The enforcement of competition law, therefore, reinforces the effectiveness of cuts in trade barriers on growth-enhancing imports.*

In the 1980s and the early to mid-1990s there were a number of trade disputes between the United States (US) and Japan concerning the openness of the latter's markets. Some firms trying to export to Japan claimed that they faced a thicket of private anticompetitive measures. This issue is, therefore, not new in Asia. What is interesting is that non-Japanese Asian economies have begun to see that more open borders do not necessarily result in increased market access opportunities for their exporters or in lower prices for their purchasers.

While an open trade policy would be supportive of competition policy objectives, it is not necessarily a guarantee of competition. Government policies may pose a threat to the attainment of competition objectives, particularly if they give rise to restraints and distortions in trade practices and in the market. All trade policies should therefore comply with an established framework of competition principles. An effective competition policy that ensures that trade policies fall within these contours is in the interests of both consumers and free and fair trade (Government of India 2000).

It can also be the case that instead of engendering competition, trade liberalization results in anticompetitive practices. This can happen either when international cartels simply expand their markets with trade liberalization, or when domestic and foreign firms collude to set prices or market shares. When this occurs, the potential benefits of trade liberalization do not accrue to consumers since government trade barriers are simply replaced with private anticompetitive barriers imposed by suppliers.

It should be stressed that, while international pressure can help, competition from imports is a less robust determinant of beneficial restructuring than competition in domestic markets. This suggests that measures to promote rivalry among domestic firms tend to have a more consistent effect on restructuring—and on dynamic economic performance—than trade liberalization. Therefore, it would be imprudent to rely solely on lowering trade barriers in order to discipline entrenched market power and to provide strong incentives to firms to keep costs under control.

With increasingly open economies, some large producers may undertake steps to protect their markets, including such anticompetitive actions as the establishment of cartels, abuse of dominant position, and abuse of intellectual property rights. Meanwhile, local suppliers could effectively shut out imports in the domestic market through exclusive arrangements with local retailers. The existence of an effective competition policy would ensure that such anticompetitive practices could be challenged and stopped if proven to violate competition principles. An effective competition policy, put in place, can allow trade liberalization to deliver its full potential benefits.

Thus, while bilateral, regional, and multilateral trade agreements have changed the shape of Asia's international trade and competition, competition policy has an important role to play in the domestic market.

India

Until the 1970s, the broad objectives of India's trade policy were across-the-board import substitution and the protection of domestic industry. In addition to the fact that certain key raw materials were produced in the public sector, many commodities were subject to price and quantity controls. Industries providing important commodities (such as edible oils, sugar, fertilizers, pharmaceuticals, aluminum, cement, steel, coal, and petroleum products) were subject to price and quantity controls to varying degrees. This implied that, even in sectors where there was a private sector presence, conditions and outcomes were

not competitive. A complex system of excise and corporate taxes further distorted incentives.

Reforms since 1991 have centered on licensing and tariffs. To meet its WTO commitments, India has abolished its quantitative restriction regime. Tariffs are also being reduced in a phased manner from levels that were among the highest in the world. The Government reduced the average applied tariff rate from 125% in 1990/91 to 35% in 1997/98 and to 20% in 2001/02, with the peak rate declining from 335% in 1990/91 to 40% in 1999/2000 and to 35% in 2001/02. In addition, India bound about 3,300—or nearly 70%—of its 4,700 tariff lines. Of these, 99% were bound at rates of 40% or lower, with the applied rates much lower than the binding rates for most products (Mehta 2003). Nontariff barriers were phased out. These reform measures infused and enhanced competition in the market (Kumar 2003, Mehta 2003).

Korea

As another active participant in successive General Agreement on Tariffs and Trade (GATT)/WTO negotiations on trade, the Korean Government has also made efforts to liberalize trade, especially since the 1980s. In the aftermath of the 1997–98 financial crisis, it redoubled its efforts. The simple average bound tariff rate was reduced from 24.4% in 1997 to 18.5% in 2000, while the applied tariff rate fell from 13.4% to about 8.8%. In the context of its postcrisis agreement with the International Monetary Fund and its Uruguay round commitments, the Government removed quantitative restrictions on the eight remaining items subject to balance-of-payments protection as of 1 January 2001. The import diversification system, implemented in 1978 to restrict imports from Japan (and criticized as constituting an unfair trade practice), was abolished in June 1999. Export subsidies and imprecise import-licensing and certification procedures that allegedly distorted international trade have also been discarded (Lee et al. 2004).

In the case of Korea, where the domestic market is not always large enough to realize economies of scale, and where various trade protection measures have distorted the market and prevented domestic companies from operating in an efficient manner, trade liberalization is likely to have a "rationalization effect" by making inefficient firms exit. The remaining firms would then be more likely to benefit from economies of scale. *The Korean case illustrates that trade liberalization does not automatically lead to a more competitive domestic market, and that the best outcomes are achieved when liberalization is accompanied by measures to increase competition in the domestic market.*

Malaysia

In Malaysia, where competition concerns are addressed through sectoral regulations, some strains between industrial policy, trade liberalization, and competition pressures have become apparent. Box 3.9 gives an example of such strains.

Thailand

Thailand is an open economy, with the value of trade (exports plus imports) representing approximately 108% of GDP in 2001. However, Thailand still maintains high tariffs compared with other ASEAN countries. The country's average applied tariff rate is 38.2% for agricultural products and 13.9% for manufactured goods.

Under the Common Effective Preferential Tariff scheme—the mechanism by which the ASEAN Free Trade Area (AFTA) was established—tariff rates have been significantly lowered. On 1 January 2003, tariffs on all products were reduced to 0–5%, with the exception of those placed on the scheme's temporary exclusion list, sensitive list (mainly agricultural products), and general exceptions list (mainly products relating to national security, culture, and health). Thailand appears to have the smallest number of items on these lists. In addition, AFTA has a very liberal rule-of-origin regime: to be eligible for preferential tariff rates, products need to contain only 40% local content, a threshold that applies to all products. In effect, this means that many Thai industries are now facing increasingly strong competition from neighboring countries.

The contribution of imports to competition is evident in a study of trade practices in 12 manufacturing industries by Nikomborirak et al. (2002). The authors found that two product markets that were subject to low import tariffs—batteries and light bulbs—did not experience any restrictive business practices even when the

Box 3.9 Malaysia: AFTA commitments and the national car industry

The Malaysian national car company, Proton, was established in 1983 as a key component of the country's heavy industrialization program. From the outset, the Government "tilted" the playing field by exempting Proton from import duties on completely knocked-down (CKD) kits.

As a result, Proton could sell its cars at 20–30% less than comparable cars produced by other assemblers in the country. By the 1990s, Proton had become the dominant car producer in the Malaysian market.

About 75% of passenger vehicle sales are controlled by two firms—Proton with 45% and Perodua with 30%. This dominance was, however, threatened by Malaysia's commitment under the ASEAN Free Trade Area agreement to reduce import duties to 20% by 2005 and to 0–5% by 2008.

Implementing these trade liberalization commitments is expected to seriously affect Proton's (and Perodua's) competitiveness. To neutralize the committed reduction in import duties, the Government raised excise duties on passenger cars twice, the first from 1 January 2004, and the second 1 year later. The import duty on CKD passenger cars from ASEAN countries was reduced from 42–80%, to 25% by 2004, then to 0% by 2005; excise duty was increased from 55%, to 60–100%, then to 90–250%.

For completely built-up units from ASEAN countries, the import duty was reduced from 140–300% to 70–190%, then to 20%; excise duty was increased from 0% to 60–100%, then to 90–250%.

The box table presents a hypothetical computation of the effects of these changes for a local car relative to a foreign CKD car. The effect of the countervailing increase in excise tax is to increase the price of the local car, thereby reducing its price competitiveness relative to the base case.

In contrast, the reduction in import duties lowers foreign car prices slightly, as the excise tax increase somewhat neutralizes the downward impact. However, without any increase in excise taxes, consumers would pay substantially less for foreign cars.

This illustrates how the impact of trade liberalization (e.g., via import duty reduction) can be neutralized by a government through the use of domestic policies (e.g., excise tax) to support industrial policy.

In Malaysia's case, this strategy is probably an interim strategy aimed at buying some time for restructuring the national industry. The prime minister has, in fact, stated that local automotive companies will have to depend less on government protection.

Sources: Lee (2005); Asian Development Bank staff.

Box table Impact on prices of passenger cars (with ≤1800cc engines), RM

	Local	ASEAN completely knocked-down
Pre-January 2004		
Base price	40,000	40,000
Excise tax (55%)	22,000	22,000
Excise tax rebate	-11,000	0
Import duty (42%)	0	16,800
On-the-road price	51,000	78,800
Post-January 2004		
Case 1: Increase in excise tax, reduction in import duty		
Base price	40,000	40,000
Excise tax (60%)	24,000	24,000
Excise tax rebate	-12,000	0
Import duty (25%)	0	10,000
On-the-road price	52,000	74,000
Case 2: No increase in excise tax, reduction in import duty		
Base price	40,000	40,000
Excise tax (55%)	22,000	22,000
Excise tax rebate	-11,000	0
Import duty (25%)	0	10,000
On-the-road price	51,000	72,000
Post-January 2005		
Case 1: Increase in excise tax, reduction in import duty		
Base price	40,000	40,000
Excise tax (90%)	36,000	36,000
Excise tax rebate	-18,000	0
Import duty (0%)	0	0
On-the-road price	58,000	76,000
Case 2: No increase in excise tax, reduction in import duty		
Base price	40,000	40,000
Excise tax (55%)	22,000	22,000
Excise tax rebate	-11,000	0
Import duty (0%)	0	0
On-the-road price	51,000	62,000

market was highly concentrated. In contrast, markets that were protected by high tariffs, such as alcoholic beverages (whiskey and beer) and motorcycles, and those in which goods are not easily traded, such as cement and cellular phone services, experienced competition problems.

As well as being a member of AFTA, Thailand is engaged in the negotiation of bilateral free trade agreements (FTAs) with several countries. It has signed trade and investment framework agreements with Bahrain, PRC, and India, as well as with industrial countries such as US, Japan, and Australia. The country is beginning to feel the impact of these FTAs: the first "early harvest" provisions under the agreement with the PRC required tariffs on most fruit and vegetables to be eliminated by 1 October 2003, leading to an instantaneous influx of fresh food products to Thailand from the PRC. Thailand's FTA with Australia was signed on 5 July 2004. It is believed to have exposed the local automobile market to stiff competition from that country—a production base for large cars—since it came into effect in January 2005.

The Thai services sector appears to be eluding trade liberalization at the bilateral level. Except for the bilateral agreement with the US, which is expected to cover services, there is no clear indication that FTAs will lead to a progressive opening up of the services sector to competition. There are concerns, however, that selective trade liberalization, particularly in certain services sectors, will lead to higher market concentration.

Under the proposed FTA with the US, the entry of large US multinationals could lead, in the longer run, to US domination of Thailand's markets in the absence of competition from other, non-US, multinational operators. For example, if Thailand accedes to the US request to open up the express delivery market to US companies only, global operators such as TNT and DHL will not be allowed to compete, and the domestic market could end up being dominated by a few large American operators, such as Federal Express and Courier.

Thailand has not liberalized any of its service markets in the absence of commitments in its bilateral and multilateral agreements to do so, so empirical evidence on the impact of service liberalization is lacking. Nevertheless, a study by Nikomborirak (2004) indicates that the entry of foreign banks such as ABN Amro, United Overseas Bank, United Bank of Singapore, and Standard Chartered Bank since the crisis, enabled through acquisitions of ailing Thai banks, appears to have broken the domestic banking cartel, bringing about a remarkable improvement in service. Customers now enjoy longer banking hours, more diversified financial services as a result of customer segmentation, and credit card services that are free of annual fees (TFRC 2003).

Bilateral FTAs that involve Thailand and a developed country must contain competition policy provisions to satisfy the GATT requirement that such agreements cover "substantially all trade" (Article XXIV). So far, Australia is the only developed country to sign an FTA with Thailand. The competition policy provisions in the agreement are relatively weak in that they focus mainly on voluntary cooperation between the competition authorities of the two countries.

The FTA between Thailand and the US is likely to contain more advanced commitments on the implementation of domestic competition law. Very briefly, the competition policy chapter in the Singapore–US FTA, on which the Thailand–US agreement is likely to be modeled, requires each party to (i) maintain measures to proscribe anticompetitive conduct, (ii) prohibit SOEs from engaging in restrictive trade practices or abusing their monopoly position unless granted an exception on efficiency grounds, and (iii) ensure that SOEs act solely in accordance with commercial considerations in the sale and purchase of goods or services.

Viet Nam

Over the last two decades, Viet Nam has moved toward a more open, transparent, and enabling trade regime. Rights to trade have been expanded and granted in virtually all sectors of the economy, regardless of ownership. However, the trade regime is still characterized by price controls and quantitative restrictions, which were placed even on imports of goods that were not produced domestically, such as refined oil, fertilizer, steel, cement, and paper.

Most of these protectionist measures created barriers to entry and led to high concentration in affected sectors. Domestic prices for these

commodities are often higher than in international markets and neighboring countries. Consequently, firms operating in protected industries reap huge profits but remain inefficient in their operations. While the overall level of protection has been steadily declining as a result of the Government's commitments to its bilateral trading partners, the consequences of protection remain visible.

Import tariffs are also widely used. While the average rate seems to be moderate, the dispersion remains quite high. Manufacturing is still highly protected, even if the effective rate of protection has significantly declined.

At the same time, the Government has adopted export-related measures to counter the effects of its import-substitution and protection policies. These include export promotion schemes, duty drawbacks, tax and duty exemptions, access to preferential credit, and a performance-based rewards system. The dual-policy trade regime makes Viet Nam an interesting case: an economy that has achieved an outstanding export performance despite a highly protected trade regime. The country's trade-to-GDP ratio is about 100%, and export growth has remained at about 20% a year for a decade.

These protective measures discouraged foreign competitors from venturing into the domestic market; the impact on domestic competition is, however, less clear. In some cases, such as for rice, easing export quotas increased the number of small private traders that buy paddy from farmers and sell processed rice to exporting companies. Competition toughened among rice traders, and paddy farmers obtained better prices. However, in most other sectors where quotas were removed in 2000, there has been little noticeable impact on domestic competition, as the number of firms has more or less remained the same.

In Viet Nam, the motivations for protection have not always been clear. Price and quantitative controls were formerly placed even on imported goods and commodities not produced in Viet Nam at the time, such as refined oils, fertilizers, some kinds of steel, cement, and even paper. Quantitative restrictions now apply only to petroleum and sugar, but 5 years ago they were placed on over a dozen commodities. Petroleum is still on the list because the Government considers it a strategic commodity that it needs to supply smoothly and monopolistically (Government of Viet Nam 2002). Sugar is on the list because of a government program initiated in 1994 to build a sugar industry capable of ensuring self-sufficiency in supply. The program failed, owing to the inefficiency of the sugar mills (Dapice 2003). Nevertheless, the Government retained quantitative quotas on sugar imports in order to protect the mills from foreign competition and support farmers who relied on the mills to take their sugarcane. Motorcycles and cement were on the list until recently because the Government wanted to support these infant industries.

The incidence of protection across industries is mixed, but its impact on competition is clear: most protectionist measures have created barriers to entry and led to high concentration in the affected sectors. Domestic prices for commodities in protected sectors are generally higher than those in international markets as well as in neighboring countries. For example, in 1999 1 ton of cement cost $29 in Korea, $39 in Singapore, and $46 in Thailand, but $73 in Viet Nam (CIE 1999). Firms operating in protected industries tend to earn huge profits, but their capacity to meet the challenges of deepening integration and increasing competition is in doubt. Honda, for example, reportedly accrued large profits even during the Asian crisis because of its protected position in the market. Most heavily protected industries, such as cement and motorcycles, appear to be uncompetitive (CIEM 2002). The overall level of protection has been declining gradually but steadily, but the consequences of protection are still visible.

The average tariff rate in Viet Nam seems moderate, but dispersion remains high, suggesting that the distortionary impact of tariffs is significant (Table 3.2). The average import-weighted tariff for all commodities was nearly 21% in 1997, falling slightly to 19.6% in 2003. However dispersion as measured by the coefficient of variation was as high as 130.7% in 2003. Manufacturing remains the most protected sector in the economy even though the effective rate of protection fell significantly from 121% in 1997 to 46% in 2003 (Athukorala 2004).

Aware of the negative effects that import substitution and protection policies may have

Table 3.2 Viet Nam: Nominal and effective rates of protection, 1997 and 2003 (%)

	1997		2003	
	Nominal	Effective	Nominal	Effective
Weighted average				
Agriculture	8.12	7.74	12.74	14.70
Mining	9.42	6.05	3.63	0.03
Manufacturing	30.63	121.47	30.30	46.26
All traded goods sectors	20.95	72.22	19.60	27.07
Simple average	23.32	59.54	20.34	26.35
Coefficient of variation	133.81	156.01	102.51	130.65

Sources: Athukorala (2004); Technical Group (1999).

on other sections of the economy, especially exporters, the Government has often introduced countermeasures or neutralizing measures in the form of export promotion initiatives, duty drawbacks, exemptions from some domestic taxes and fees, preferential credit, and, recently, a performance-based rewards system. In 2001, for example, with exports slowing due to weaker demand in international markets, the Government adopted a series of export promotion measures aimed at encouraging firms to expand their exports and find new partners and markets. A value-added tax (VAT) rebate and exemption scheme for exporters and a program of awards for improved export performance were also implemented. Before the export quota on rice was eased and subsequently abolished in 1997, a special fund was set up to support those who bought and exported rice under government orders. A study of the textile and garment sector shows that, although the official tariffs were quite high (at 31% in 1997 and 28% in 2002 for textiles, and 42% in 1997 and 49% in 2002 for wearing apparel), most companies in the sector are exempt from import duties.[14]

To what extent have these external market interventions affected competition in Viet Nam? One thing is clear: they have reduced foreign competition in the domestic market. What is less clear is their impact on domestic competition. In some cases, the removal of protection has led to significant improvements in competition, evidenced by an increase in new entries and a fall in prices and profits per unit. The abolition of the quota on rice exports and the decision to allow private firms to export the commodity in 1998, for example, led to the emergence of numerous small private rice traders who bought paddy from farmers and sold processed rice to exporting companies. Competition in the rice market may have been very tough for these rice traders, but growers obtained better prices. The difference between the export price of rice in Viet Nam and Thailand narrowed significantly due to these measures (Vu 2001). But in other cases the impact of the removal of protection is not so clear. There is a danger that some monopolies will simply change from being government owned to being privately owned or having mixed ownership. Most quotas were removed in 2000, but competition in some sectors shows little sign of change if one looks at the number of firms or price indicators.

People's Republic of China

Of particular interest in the PRC is the prevalence of *local protectionism*. For historical reasons, local governments have had a strong incentive to protect local enterprises from competition from other regions. This has contributed to the duplication of investments and to excess capacity in some industries, and thus the PRC's low degree of industrial concentration.

Local protectionism has taken such forms as imposing taxes on commodities made in other provinces, banning exports to other regions of locally made raw materials that are of high quality or in short supply,[15] or even preventing law enforcement officers from dealing with local firms that counterfeit the brands of other regions (Lin 2001). With the move toward fiscal decentralization since 1978, local governments have

had a strong incentive to shield local firms and protect their tax base. The desire to guarantee local employment is another economic as well as political incentive for local government officials. Throughout the 1990s, local governments competed to attract FDI, even adopting protective measures that would ensure the profitability of locally based foreign firms (Box 3.10).

Local protectionism leads to market fragmentation and thus to low regional specialization. The eight-firm concentration ratios reported in Table 3.3 are consistent with widespread local protectionism in the PRC. Although the degree of concentration has generally increased since 1995, very few industries have a concentration ratio above 50%, and for most the ratio is below 20%.

The central Government has long been trying to prohibit regional protectionism. This was the intention of Article 6 of the State Council's Provisional Regulations Concerning Development and Protection of the Socialist Competition Mechanism, issued as early as 1980. Enforcement of these regulations has, however, been poor.

Trade-related exemptions

In many countries, export cartels are outside the scope of competition law. In India, for example, an exception to the provisions on anticompetitive agreements protects the right of any person to export goods or services from India. Many countries regard export cartels as competition-restricting, but nevertheless exempt them from competition law because they do not affect competition in the domestic market. A further justification for their exemption is that countries do not wish to shackle their export efforts for fear of disturbing their trade balance or balance of payments.

Between them, Evenett, Levenstein, and Suslow (2001) and OECD (2003a) identified 15 countries whose competition laws explicitly or implicitly exclude export cartels. Meanwhile, the proponents of export cartels argue that they are a lawful way of realizing cost-reducing and output-enhancing efficiencies (OECD 2003b). However, exemption of export cartels goes against the concept of free competition, as the circumstances

Box 3.10 Local protectionism and competition in the People's Republic of China: The car industry

Shanghai and Hubei provinces are two leading car-manufacturing areas in the PRC. In 1984, Germany's Volkswagen set up a joint venture with a consortium led by Shanghai Automotive Industry Corporation to produce Santana passenger cars. In 1992, Automobiles Citroën of France and Dong Feng Motor Corporation entered into a joint-venture agreement to establish the Dong Feng Citroën Automobile Company in Wuhan, the capital of Hubei, to produce and sell Fukang cars in the PRC.

In mid-1998, Shanghai municipal government imposed local regulations to protect its Santana sedans. It also added extra licensing fees and sales taxes on consumers buying non-Shanghai made cars, adding some CNY80,000 (about $9,600) to the already high price of domestic cars. As a result, in the first half of 1999, only 24 Fukang cars were sold in Shanghai, compared with 6,400 Santanas.

Hubei swiftly retaliated, levying taxes on consumers purchasing cars other than the locally made Fukang. Taxes included irrigation construction fees (which had been abolished long ago by the central Government) and a CNY70,000 ($8,400) levy for "helping SOEs overcome their losses." This increased the selling price of the Shanghai-made Santanas to CNY326,000 ($39,000) in Wuhan, nearly double their usual price of CNY172,000 ($20,700).

Regulations imposed by Shanghai and Hubei provinces have prevailed despite a 1990 directive from the State Council banning restrictions on interprovincial trade. With more than 120 carmakers nationwide, nearly every locality that boasts of a car-making plant applies restrictions to outside manufacturers to keep its own champions afloat.

Unable to enforce the ban among competing localities, the central Government decided to take under its protection the country's three leading indigenous carmakers—Shanghai Automotive Industry Corporation, Dong Feng Motor Corporation, and First Automotive Works based in Jilin province. In January 2000, Shanghai scrapped its protective licensing fees and opened its market to outside manufacturers.

This strongly suggests that local protectionism can be just as bad for consumers and efficiency as international protectionism.

Source: Lin (2005).

Table 3.3 PRC: Eight-firm concentration ratios in selected manufacturing industries, 1995 and 2000 (%)

Industry	1995	2000
Food processing	5.3	7.5
Food production	9.9	13.1
Beverage production	8.6	20.4
Tobacco processing	33.0	54.0
Textiles	2.8	6.6
Garments and other fiber products	3.8	9.3
Leather, furs, and related products	2.9	—
Timber and straw products	5.7	—
Furniture manufacturing	5.4	—
Papermaking and paper products	5.3	10.9
Printing and recorded medium products	5.1	—
Educational and sporting products	8.1	—
Petroleum processing and coking	44.9	82.8
Chemical materials and products	11.3	7.9
Pharmaceutical products	11.8	28.8
Chemical fibers	37.6	13.8
Rubber products	18.3	36.4
Plastic products	3.6	6.0
Nonmetal mineral products	2.4	6.1
Ferrous metals	30.2	39.5
Nonferrous metals	13.3	10.3
Metal products	4.6	9.5
Ordinary machinery	6.5	9.9
Equipment for special purposes	6.2	11.7
Transport equipment	20.9	28.9
Electrical equipment and machinery	8.8	30.8
Electronic and telecoms equipment	14.7	23.1

— = not available.

Source: China Statistics Press (1997, 2002).

relating to a soda ash cartel operating in India make clear (Box 3.11).

As mentioned in the box, India's new Competition Act has extraterritorial reach. The jurisdiction of the competition authority extends to restrictive trade practices employed by enterprises outside India that have the effect of preventing, distorting, or restricting competition in India, or that give rise to restrictive trade practices in the country. On the provisions relating to extraterritorial jurisdiction in the MRTP Act, the Supreme Court of India ruled that the MRTP Commission would obtain jurisdiction only after goods had been imported and a restrictive trade practice had been found to have taken place.

In Korea, in 2002 the Korea Fair Trade Commission (KFTC) took the unprecedented step of applying Korean antitrust law extraterritorially to six foreign manufacturers of graphite electrodes and imposed fines on the manufacturers for price fixing. The following year the KFTC concluded a large-scale investigation into an alleged international cartel by six foreign vitamin manufacturers, again levying fines. Later that year, it introduced a system of notification of foreign-to-foreign mergers. This series of moves to regulate behavior that has taken place outside the domestic jurisdiction reflects a growing concern about the economic impact of such behavior on the domestic market.

The KFTC's investigation into the vitamin cartel was greatly aided by the findings of competition authorities in other countries such as Canada, Japan, and US. Bilateral cooperation with these countries to disband the vitamin cartel helped the KFTC gain valuable experience in regulating international cartels. However, not all cases are so straightforward.

As far as anticompetitive practices are concerned, trade liberalization is a double-edged sword. The country studies highlight cases where reforms have led to foreign firms undermining domestic anticompetitive practices, lowering prices toward costs. However, the very lowering of trade barriers also enables foreign firms to more profitably engage in anticompetitive acts in Asian economies. Without the threat of competition law-related sanctions, cross-border traders and their domestic rivals will be tempted to replace lower government barriers to trade with agreements to keep prices high. Competition law and its effective enforcement thus play an important role in maximizing the benefits of trade liberalization.

As markets integrate, international anticompetitive practices—especially those associated with abuses of dominant position and international cartelization—have received more attention in Asian policy circles. Although Asian enforcement experience against foreign anticompetitive practices is mixed, such enforcement would not have been possible without a competition law in the first place. The latter is a prerequisite for enforcement and for nurturing international cooperation to tackle these price-raising acts.

At the international level, in 1980 the United Nations' General Assembly adopted a "Set of Multilaterally Agreed Equitable Principles and

Box 3.11 Export cartels in India: The case of a soda ash cartel

In September 1996, American Natural Soda Ash Corporation (ANSAC), an export trading company comprising six American producers of soda ash, attempted to ship a consignment of soda ash to India. ANSAC is registered under the Webb–Pomerene Act, US legislation that exempts associations of American firms engaged in export trade from the country's antitrust laws so long as they do not restrain any US competitor of the association. The Alkali Manufacturers Association of India (AMAI), whose members included all major Indian producers of soda ash, filed a complaint against ANSAC before the Monopolies and Restrictive Trade Practices (MRTP) Commission alleging cartelization. The commission imposed an interim injunction on ANSAC restraining it from exporting soda ash to India as a cartel, while making it clear that the companies could continue to do so individually. Quoting from the ANSAC membership agreement, the commission held that ANSAC was prima facie a cartel. It found that it was carrying out part of its trade practices in India, giving the commission extraterritorial jurisdiction under Section 14 of the MRTP Act, even though the cartel itself was formed outside India (MRTP Commission 1997).

ANSAC then lodged an appeal with India's Supreme Court, which eventually overturned the commission's orders. The court held that the wording of the MRTP Act did not give the commission extraterritorial powers. It stated that the commission could take action only if it could prove that an anticompetitive agreement involved an Indian party, and even then only after the goods had been imported into India (Supreme Court 2002). Thus the commission could not take action against ANSAC or prevent the import of soda ash into the country.

The verdict of the Supreme Court was announced while the new competition bill was pending in the Indian Parliament. With the court's ruling in mind, the bill was amended to allow the Competition Commission of India to grant a temporary injunction restraining any party from importing goods if it could be established that such imports would contravene the substantive provisions of the law.

Source: Chakravarthy (2005).

Rules for the Control of Restrictive Business Practices" (the "UN Set"). The 1995 Osaka Action Agenda of the Asia-Pacific Economic Cooperation forum (APEC) included competition policy as one of 15 policy areas to be developed by member countries, noting that:

> APEC economies will enhance the competitive environment in the Asia-Pacific region by introducing or maintaining effective and adequate competition policy and/or laws and associated enforcement policies, ensuring the transparency of the above and promoting cooperation among the APEC economies, thereby maximizing, inter alia, the efficient operation of markets, competition among producers and consumer benefits (Asia-Pacific Economic Cooperation 1995).

This was reinforced by a collective action plan and individual action plans in the area of competition policy, and in 1999 by the APEC Principles to Enhance Competition and Regulatory Reform.

In July 2004, the General Council of WTO decided that three of the four Doha round Singapore issues (competition policy, investment, and government procurement, but not trade facilitation) would not be included in the Doha round negotiations, and that developing countries needed more capacity building and institution building in these areas first. However, given the importance of competition in ensuring economic efficiency in both its static and dynamic aspects, competition policy remains of considerable interest to developing countries in both the domestic and international contexts, as evidenced by the number of developing country representatives and their active participation in the discussions.

Indeed, in the context of multilateral negotiations, "developed country protectionism … is bad not only for developing country producers and consumers everywhere but also for developed country credibility in global negotiations to remove trade barriers. What is needed is more globalization, not less" (Vickers 2003, p. 8).

Foreign direct investment

Another related Singapore issue, and another source of complementarity between competition law and dynamic economic performance, is investment. In particular, appropriate enforcement of competition law both enhances the attractiveness of an economy as a location for foreign investment and is important for maximizing the benefits that flow from such investment.[16]

Various questions arise. Would the enactment and enforcement of competition policy also deter some FDI? Is such policy necessary to ensure that foreign direct investors do not engage in anticompetitive acts, including driving out local firms? Do cross-border mergers and acquisitions, which many Asian countries have experienced on a sizable scale for the first time in recent years, pose a particular problem in this regard? Developing countries have long considered cross-border anticompetitive practices a major concern, resulting in the formulation (and updating every 5 years) of the UN Set at UNCTAD.

Overall, FDI inflows can contribute significantly to development, especially if they are of the greenfield type. This is because such investments have a greater potential for knowledge inflow than mergers and acquisitions. In addition, they generally increase the number of players in the market, thereby increasing competition. However, even greenfield FDI can lead to predatory pricing and abuses of dominant positions.

Thus, while most developing countries have already opened their doors to foreign investors, governments are well aware that there is no guarantee that the potential benefits of FDI will automatically accrue to the host economies.[17] This is partly because FDI does not always result in a more competitive market structure. FDI, in the form of cross-border M&A activity in particular, may lead to concentration and market dominance in certain industries. Since such activity often merely results in an increase in the stake of foreign investors in existing domestic firms, it may not increase the number of market players. In such an event, the dominant firm could have price-setting abilities and would likely enjoy higher profit margins.

Alternatively, affiliates of different multinational corporations (MNCs) could set up competing businesses in a developing host country. If the parent MNCs in the home country or countries merge their operations, the affiliates in the host country are likely to eventually merge as well, possibly creating a dominant firm, or worse, a monopoly. It could very well be the case that the merger eliminates competition in the host country but not in the MNCs' home country (or countries).

Competition policy should, therefore, operate in concert with FDI liberalization. A typical relevant provision in competition laws is the ban on any merger, acquisition, or takeover that will allow the newly merged entity a dominant position in the market or prevent competitors from gaining access to a market. To complicate matters, avoiding these consequences entails the adoption of effective competition policy in both the home and host countries.

Generally, MNCs are attracted to locations with competition policies already in place. This is because the *existence of a competition policy indicates some commitment by the government to ensure a level playing field among investors, whether domestic or foreign*. In addition, the presence of an effective competition policy reduces the uncertainty faced by prospective foreign investors in terms of when and how the authorities might implement a new policy.

Thus, government policy on FDI must be consistent with the objectives of competition policy in order for developing countries to gain the full benefits of FDI. Governments generally avoid trying to attract foreign investors by granting anticompetitive concessions, such as monopoly rights to particular markets or industries, because it is likely that the overall impact on the economy will turn out to be negative in the long run.

The following brief review of the six countries highlights the diversity of their experiences with respect to the impact of FDI on competition in their domestic economies.

People's Republic of China

In the PRC, since an open-door policy was adopted in the late 1970s, inward FDI has been a major driving force for increased competition. The emergence of foreign-invested companies greatly changed the landscape of competition in almost all industries. However, entry of foreign investors

is far from free. They are subject to numerous government regulations. Every new project involving foreign investment must be approved either by the concerned provincial and/or regional government or by the Ministry of Commerce (formerly the Ministry of Foreign Trade and Economic Cooperation), depending on the size of the investment.

The Government (or governments) also sets requirements on modes of foreign entry. Prior to the mid-1990s, formation of joint ventures was the main FDI mode of entry, driven by the Government's desire for local partners to learn about and adopt advanced foreign technologies. In addition, the Government used local content requirements in an attempt to foster backward linkages from FDI (via vertical technology transfer to local suppliers). Only with the PRC's WTO accession in January 2002 were wholly foreign-owned enterprises allowed.

FDI in the PRC has generally affected industrial structures through two channels. First, increased competition from foreign companies that are often equipped with superior technology and management drives out inefficient local firms from the market, leading to a higher degree of industrial concentration. Second, foreign firms often merge with or acquire top domestic enterprises in relevant markets. Foreign enterprises have thus become dominant players in such industries as automobiles, cellular phone production, household chemical products (e.g., detergents and skin care products), and soft drinks. These developments have sown concern that foreign enterprises might soon dominate most industries, and domestic firms may be driven out of business (Box 3.12).

As a result of the varying experiences of domestic firms under the control of foreign investors, the Government has issued regulations to monitor FDI-related M&A activity. An M&A notification/evaluation system was set up in March 2003, aimed at promoting and regulating foreign investment and introducing advanced technology and management experience from abroad, improving the utilization of foreign investment, rationalizing the allocation of resources, ensuring employment, and safeguarding fair competition and national economic security. The regulation also stipulates that mergers and acquisitions must not create excessive concentration, eliminate or hinder competition,

Box 3.12 People's Republic of China: Possible motivations for foreign direct investment

Zhonghua, manufactured by the Shanghai Toothpaste Factory (STF), has been the top toothpaste brand in the PRC for decades. In 1993, STF gave Unilever the sole right to manufacture, market, and sell the Zhonghua brand in the PRC. The agreement has an unlimited term, subject to trademark renewal every 10 years, provided that total production volume in the last year of the decade is higher than that of the first year.

In 2002, STF wanted to take the brand back because it felt that Zhonghua was not receiving enough exposure from Unilever. Unilever countered that it had spent a lot on Zhonghua's brand development, with the brand accounting for 53% of its annual advertising and promotion budget in its "oral" category. In addition, Zhonghua's production had reached 40,000 tons in 2003 compared with 35,000 tons in 1993. Unilever had also given Zhonghua new packaging and had launched many promotion campaigns that had boosted sales. However, STF claimed that Unilever managed to increase sales only toward the end of the first decade. STF is thus determined to take back the Zhonghua brand to protect its name and its history, just as in 2000 it had taken back the Maxam brand leased to Unilever.

Another multinational, Procter & Gamble (P&G), had previously been accused of "freezing" a local brand. In 1994, P&G set up a joint venture with the Beijing Second Daily Cosmetic Factory, taking a 35% share of its detergent brand, Panda. At that time, Panda was among the top three selling detergent brands in the PRC. In September 2000, the factory bought back its brand. But by that time, Panda had already lost its position in the market, with production dropping from 60,000 tons to 4,000 tons in 6 years. Meanwhile, P&G's detergent brand, Tide, had become a household name.

Some observers feel that in the above two cases, FDI was driven by the domestic brand-freezing motive so as to promote the multinational's own brands.

Source: Lin (2005).

disturb social and economic order, or harm public interests.[18]

Foreign investments involved in the merger or acquisition of a domestic enterprise are required to notify the Ministry of Commerce and the State Administration of Industry and Commerce if: (i) the turnover of a party to the merger or acquisition in the domestic market in the current year exceeds CNY1.5 billion; (ii) the foreign investors have merged with or acquired 10 domestic enterprises in the relevant industry within 1 year; (iii) the market share of a party to the merger or acquisition in the domestic market is 20%; or (iv) the market share of a party to the merger or acquisition in the domestic market will reach 25% as a result of the transaction. Since the regulations apply only to foreign firms, there is widespread concern among foreign investors that future anti-monopoly legislation may not be applied equally to foreign and domestic firms.

India

In line with its 1991 economic reforms, the Government adopted a liberal policy toward FDI, which involved:

- expanding the list of industries open to FDI and limiting the negative list of industries to those that need to be regulated for security or environmental reasons;
- expanding the list of industries subject to automatic approval of FDI;

Box 3.13 Impact of mergers and acquisitions in India

The following cases highlight the increased concentration resulting from mergers and acquisitions in India.

The consumer goods industry

Since 1913, Unilever has generally opted for mergers and acquisitions as a means of establishing its business presence in India. Initially, Unilever took over several companies engaged in the trade of soaps and consolidated them. A subsidiary of Unilever, Hindustan Lever Limited (HLL) followed the same strategy in efforts to expand its activities and strengthen its market presence. Prior to 1991, HLL acquired a number of small enterprises that had run into financial difficulties. These acquisitions expanded HLL's activities and allowed it to diversify into, among other things, garments and marine products.

Following the Government's 1991 liberalization policies, HLL sought to restructure its diversified product range and strengthen its market presence by engaging in further mergers and acquisitions. Tea, ice cream, frozen foods, coffee, and detergents were among the products it added to its portfolio in the last decade. As a result, the market share of HLL and its associates has steadily increased (Box table).

The soda industry

Consumer goods are generally sensitive to changes in market networks and brand loyalties. As a result, multinational enterprises tend to exploit the established marketing and distribution networks as well as brand loyalties of their acquired enterprises. A case in point is Coca-Cola, which reentered the Indian market (which it had left in 1977) in 1993 by acquiring Parle, at that time the largest player in the Indian soda market. Parle already had several well-established brands and boasted of a nationwide network of bottling and marketing facilities. This gave Coca-Cola an advantage over its rival Pepsi. Pepsi had entered the country in 1988, but was still struggling with a 25% share compared with market leader Parle's 60%. In acquiring Parle, Coca-Cola profitably used Parle's bottling and marketing network, besides taking advantage of Parle's popular brand presence in sodas. Following Coca-Cola's success, Pepsi acquired Duke, a smaller soda manufacturer, in its efforts to build its market share. Today, Coca-Cola and Pepsi dominate the soda market in India, with their respective shares believed to be 50% and 48%.

Source: Chakravarthy (2005).

Box table Market share of HLL or its associates, 1992/93 and 1997/98

Product	1992/93	1997/98
Ice cream	0.0	74.06
Sauces, ketchups, jams	0.0	63.54
Dental hygiene products	11.20	41.56
Soaps	19.66	26.01
Synthetic detergents	33.12	46.72
Vanaspati	0.85	13.90

- removing the 40% limit on foreign ownership except for a short list of sectors subject to caps;
- granting national treatment to companies with more than 40% foreign ownership; and
- gradually dismantling performance requirements.

These reforms significantly promoted competition in the domestic economy, as the reduced restrictions encouraged the entry of FDI. The result has been a steady rise in FDI inflows from only $75 million in 1991 to $4.3 billion in 2003.

In addition, the Government stopped merger surveillance and regulation in 1991, when the MRTP Act was amended to exclude M&A supervision. This caused a significant rise in cross-border M&A activity, with the average annual number of mergers and acquisitions increasing from fewer than five before 1991 to 51 between 1992 and 2003.

Despite the proliferation of M&A activity between April 1999 and January 2004, the concentration indexes of most of the affected industries show little change. In a few specific cases, however, mergers and acquisitions involving MNCs have resulted in some concentration (Box 3.13).

Korea

As did the governments of the PRC and India, the Korean Government gradually liberalized the services sector from the 1980s to the mid-1990s. After the Asian financial crisis, however, the Government undertook more dramatic liberalization measures and aggressive solicitation of foreign investment. Ceilings on foreign equity ownership in the stock market were eliminated, cross-border mergers and acquisitions were allowed, and foreign land ownership was fully liberalized. As a result, FDI increased substantially. However, as in India, M&A activity seems to have had a tightening effect on market concentration, illustrating that FDI does not automatically lead to more competition in the market (Box 3.14).

Box 3.14 The vegetable seed industry in Korea

In 1998, there were 48 major vegetable seed-producing companies in Korea. Hungnong was the top Korean firm in the vegetable seeds market, with a market share of 32%. Choong Ang ranked second with a market share of about 13%. After the Asian financial crisis, three of the top five firms—Hungnong, Choong Ang, and Seoul Seed Co.—were acquired by foreign multinationals.

Seminis Vegetable Seeds Inc., headquartered in California, US, acquired Hungnong and Choong Ang. Hungnong remains a separate entity from Seminis, specializing in particular products for a particular region, and the prior management remains in full control of its operations. Choong Ang has also remained a separate establishment, but since it was Hungnong's strongest competitor, Seminis had difficulty coordinating their operations. Seminis resolved the problem by adopting a market-sharing mechanism, where each firm would specialize in different products. In products where both firms lack competitiveness, Seminis would resort to importing. In August 1999, Seminis invested $10 million to establish Seminis Asia Corporation. This firm would be the research and retailing arm, but would also act as the Asian headquarters, coordinating between Seminis and its subsidiaries in Korea.

Even after the acquisition, Hungnong remains the top firm, with its market share remaining unchanged and still below the benchmark 50% set by the Monopoly Regulation and Fair Trade Act to determine market dominant firms. Taken together, Hungnong and Choong Ang's joint market share comes to 45%. Although the two firms remain separate entities, Seminis has control over both, and their product portfolios have been restructured with the result that they can no longer be considered competitors. In July 1999, the Korea Fair Trade Commission investigated Hungnong, which had prohibited its retail outlets from selling below a consumer price limit it had set for "Hungnong Chilli," under threat of supply disruption. This illustrates that although Seminis and its subsidiaries have not technically breached the 50% market share benchmark, they have established an effective dominance in the vegetable seed market, with price-setting abilities in certain product lines.

Source: Chang and Jung (2005).

The case of the Korean seed industry illustrates that *market share is an inefficient measure of market dominance*. Other indicators such as the ability to restrict prices and supply should be considered as well. While investment policy alone may have a limited role in promoting competition, it can be supplemented by trade liberalization policy (such as reduced import tariffs to encourage more importing, and thus, more competition), together with effective implementation of competition policy (e.g., M&A regulation) to ensure increased competition in the domestic economy.

Malaysia

FDI has also been an important source of capital in Malaysia's development, where it continues to be regarded in a positive light in manufacturing, partly because most manufacturing FDI is related to export activities. It provides capital, imports technology, generates employment, and earns foreign exchange. FDI in the services sector also confers such benefits. However, when FDI in services competes with home-grown small businesses, such investments are perceived to incur social costs as they tend to drive out small businesses (Box 3.15).

Meanwhile, mergers and acquisitions involving foreign interests are encouraged, but are required to secure approval from the Foreign Investment Committee in the Prime Minister's Department if they exceed equity thresholds set by the Government. The limit on foreign equity participation limits the amount of resources that domestic firms can source from foreign investors to compete in the market. FDI that is export oriented, however, used to be exempt from this requirement. In addition, the Government relaxed limits on foreign equity participation in private enterprises after the Asian financial crisis. Although there is a dearth of studies on the impact of mergers and acquisitions in Malaysia, *relaxing foreign equity participation requirements is generally expected to contribute to increased competition in the domestic economy.*

Thailand

In the small, open, economy of Thailand, foreign trade and investment—and thus foreign suppliers and service providers—have played a major role in its development. The most important law governing foreign-controlled businesses in Thailand is the Foreign Business Act of 1999. The act identifies a negative list of sectors where foreign ownership is prohibited or limited. Businesses listed in category 1 are absolutely prohibited to foreigners[19] unless there is an exception contained in a special law or treaty.

Box 3.15 The hypermarket case in Malaysia

Since the establishment of the first hypermarket by Makro in Malaysia in 1993, the sector has grown rapidly. Today, there are some 22 hypermarkets in Klang Valley. Most of the well-established international hypermarkets such as Carrefour (France), Tesco (United Kingdom), Giant (Hong Kong, China), and Makro (Netherlands) are foreign owned. There have been significant concerns on the part of the Government, however, that hypermarkets compete with and can displace small neighborhood retail (sundry) shops.

Thus, more stringent guidelines have been imposed over time on hypermarkets. These include a higher population density precondition, local product display requirements, a stricter definition of hypermarkets (from 8,000 square meters to 5,000 square meters), preliminary "impact on sundry shops" surveys within a 3.5-kilometer radius, and limitation on operating hours (no 24-hour businesses). In addition, a 5-year freeze on the establishment of foreign-owned hypermarkets in Klang Valley, Penang, and Johor Bahru came into effect on 20 April 2004. The Ministry of Domestic Trade and Consumer Affairs provided no reason for this decision.

The ban will clearly reduce the flow of FDI into the hypermarket sector. It could also delay restructuring of the retail trade sector that could have enhanced local upstream-downstream linkages as well as improve productivity levels. The differing treatment for foreign-owned and locally owned hypermarkets also raises market access and competition issues in the sector. The consistency of such policies with the country's commitment under the World Trade Organization's General Agreement on Trade in Services remains unclear.

Source: Lee (2005).

These include the mass media, as well as rice, animal husbandry, and other resource-based businesses. Those in category 2 are businesses that concern national security or safety, or are involved with local art, culture, handicrafts, or natural resources and the environment. Foreigners are not permitted to start new businesses listed in this category unless they obtain special permission from the minister with the approval of the cabinet.

Category 3 contains businesses that the Government believes are not yet competitive and are thus vulnerable to foreign competition. These include mining, salt farming, forestry, fishery, professional services, and all services unless specified in the ministerial regulations. Similar to category 2, foreigners may obtain special permission to operate businesses listed under this category, but from the Director General and the Foreign Business Committee. To obtain a license, applicants must be able to convince the relevant local authorities that local firms cannot competently conduct the particular investment project.

Based on the list of businesses prohibited to foreigners, manufacturing is generally open to foreign investment, bar a few businesses concerned with national security, small and medium enterprises, and the environment. The services sector, however, remains relatively closed as in Malaysia, since category 3 includes "other categories of service business except those prescribed in the ministerial regulations."

In addition, sector-specific legislation may impose even more stringent conditions for foreign participation. For example, the Telecommunications Act 2001 limits the foreign equity share of a facility-based operator to only 25%. The resulting relatively closed services sector contributes to inefficiencies, which, in turn, impose costs on manufacturing.

While the entry of foreign companies generally promotes greater competition that benefits consumers, in a few cases, it has had the opposite effect, such as the case of the cement industry in Thailand (Box 3.16).

Viet Nam

Viet Nam's policy toward FDI has become more liberal and open in recent years, but restrictions still exist that effectively limit competition. On the surface, these measures appear to limit only foreign competition. In reality, they serve to protect all incumbents from both foreign and domestic competitors. The restrictions take the following forms.

Restricted sectors and forms of operation. Currently, FDI is not allowed to operate in certain sectors. In telecommunications and media, for example, only business cooperation contracts are permitted. In other sectors like oil and gas, air transportation and airport construction, forestation and tourism, foreign firms can only operate in joint ventures with at least one local partner. Until 2004, foreign firms were not allowed to be part of listed companies.

Performance-based requirements. FDI in Viet Nam is also subject to local content, export share, and legal capital requirements. Foreign partners are required to contribute at least 30% of total capital in any joint-venture arrangement. Meanwhile, local content requirements are perhaps the most complicated regulation on FDI. Motorbike manufacturers, for instance, are required to achieve a local content ratio of 5–10% by the second year of operation, which should eventually reach 60% in 5–6 years. Tax rates imposed are also based on these performance indicators. Export performance requirements, on the other hand, are now limited to only 14 items and enforcement is questionable.

Regulations in the financial and land markets. Foreign firms have traditionally had limited or no rights to possess land in Viet Nam. Recently, the Government extended land use rights to overseas Vietnamese (many of whom are foreign investors) and it is currently considering legislation enabling land use rights to be mortgaged with offshore banks. Small and medium enterprises and the private sector still have limited access to credit compared with big SOEs and foreign firms, due to complicated collateral requirements.

Foreign direct investment and competition policy

We have seen that, *in recent years all of the six countries studied have generally been open to FDI. However, this has not always resulted in increased competition in their domestic markets.* This is because other government regulations and policies have created barriers to the development

Box 3.16 Impact of FDI on competition in cement and retailing in Thailand

Cement was one of the industries worst hit by the 1997–98 Asian financial crisis as the local construction industry came to a halt with the collapse of the finance and real estate markets. A few firms were taken over by foreign companies. In 2001, the second-largest market player, which was already majority owned by a foreign cement supplier, made a bid for the third-largest and locally owned cement company, which was then in the middle of a debt-restructuring process. Analysts of many securities houses predicted that the merger would lead to collusion and, hence, an increase in cement prices.

Retail is another sector that was attractive to foreign investors after the crisis. Multinational corporations such as Tesco (United Kingdom), Carrefour and Casino (France), and Royal Ahold (Netherlands) now own most discount stores in Thailand. This is because the Foreign Business Act of 1997 allows wholly foreign-owned retail stores that meet a total minimum capital requirement of B100 million.

While these foreign retail companies compete vigorously among themselves and with local retail and department stores to offer consumers lower prices, their extremely aggressive business culture has caused tremendous friction with local suppliers. A 2001 study by Thailand Development Research Institute confirmed that positive benefits accrued to consumers from competition in the retail industry, but acknowledged concerns over unfair trade practices.

Because of their size, these companies can heavily squeeze local suppliers' margins by imposing conditions such as mandatory enrollment in price promotion schemes and preferential treatment for house brand products, as well as collection of various service fees. Although these practices do not necessarily reflect anticompetitive practices, they can be seen as unfair trade practices. The Thai Trade Competition Commission has published a Retail Industry Code of Ethics in response to suppliers' complaints, but the code does not seem to provide small suppliers with effective protection against unfair trade practices.

Sources: Nikomborirak (2005); Poapongsakorn et al. (2001).

of free competition. In the PRC and Viet Nam, for example, local content requirements are used to encourage backward linkages. This provides a constraint for FDI firms trying to obtain their inputs from the best possible source, and compels them to use local suppliers instead. Thus, even with FDI liberalization, increased competition is not guaranteed, as in some cases other regulations effectively limit the inflow of FDI.

In India, Korea, Malaysia, and Thailand, protection of small-scale firms prevents entry by large firms in certain sectors and industries. As a result, some service industries such as retailing have remained uncompetitive in spite of FDI liberalization. In Korea, retail stores larger than 1,000 square meters need approval by the local government advisory board, but these boards generally have strong connections with existing retailers, who lobby against the big retailers. In Malaysia, as noted above, more stringent conditions were initially imposed on foreign-owned hypermarkets in efforts to protect small local retail stores. Eventually a 5-year ban on the establishment of new foreign-owned hypermarkets was enforced. This contributed to continued inefficiencies in the domestic retail industry.

Just as in trade reform, FDI in Asia has both undermined and created anticompetitive practices. Gross generalizations about FDI's effects are not warranted in this regard. Often, foreign investors come with better technologies and management practices, so assessing the advantages and disadvantages of cross-border mergers and acquisitions requires a careful evaluation of the efficiency effects as well as any potential price-increasing effects.

Effectively enforced competition law discourages the wrong sort of FDI without placing inordinate burdens on efficiency-enhancing foreign investments. However, poorly or arbitrarily enforced competition law can deter overseas investors. Moreover, there is a role for competition advocacy to ensure that the inducements offered and requirements placed on foreign investors do not seriously distort competition in Asian markets. In a competitive environment without distortions, FDI can contribute substantially to growth and development.

Issues for implementation

Recent empirical research has confirmed that barriers to entry are substantially higher in developing economies than in industrial nations (Djankov et al. 2002, De Soto 2000). If reforms cannot be introduced to effectively lower these barriers—perhaps because in some situations poor governance practices cannot be eliminated in any realistic time frame—then dynamic efficiency may actually be best served by competition policy measures that prevent incumbent firms from setting higher prices for customers over the longer term.

In many developing countries, the benefits of competition policy have yet to emerge visibly, because enforcement has been hampered by lack of resources, reliable data, or sufficient information about production costs, market shares, and consumer behavior. In Thailand for example, the Trade Competition Commission has not yet determined the criteria for threshold market share that will both define a "dominant" business and determine a postmerger level of market concentration that would trigger mandatory premerger notification. As a result, all practices that should be classified as abuse of dominance and all mergers that may foreclose future competition are currently exempt.

Even so, in many areas of Asia competition authorities have played an important role in the formulation of liberalization, privatization, and deregulation policies, ensuring that the objectives of those policies induce growth.

The manner in which competition policy is implemented and enforced has important implications for its effects on macroeconomic performance and on the poor. Competition issues may be handled through sectoral regulations, as in Malaysia, or through economy-wide legislation, as in the other five countries discussed. The agency delegated to enforce competition policy may be independent or may answer to a particular ministry. It may be centralized or decentralized. Development of a culture of competition may be left to the competition authority or it may be undertaken through other means, such as via the educational system. Enforcement of competition law may depend primarily on administrative decisions or on recourse to the judicial system.

As economies open up, governments have to make the transition from a protectionist, regulatory regime to a new emphasis on efficiency and innovation. This may require a focus on microeconomic, or second generation, reforms. Governments need to ensure more effective R&D and other support schemes, better physical infrastructure, legal reform, improved education, and administrative reform.

Initial conditions

The diversity of the six countries studied has influenced their implementation and enforcement experiences. Table 3.4 highlights their diversity while Table 3.5 illustrates some of the key aspects of their implementation experiences.

The PRC's human capital base is comparatively strong, with near universal literacy, segments of technical excellence, and R&D strengths for innovation. Its foreign trade and investment have expanded rapidly. In contrast, its commercial institutions have historically been weak, and the country scores poorly in international comparisons of corruption and protection of property rights. But institutional quality is improving quickly, and physical infrastructure is being upgraded rapidly, facilitating the entry of firms.

India's human capital base has pockets of international excellence alongside quite high levels of illiteracy. Until recently, its inward-looking strategy meant that it was unable to exploit its human capital strengths in the global economy. Its commercial environment is broadly predictable, and the legal system cumbersome but independent. It also has the highest level of decentralized economic policy making among the six countries. The 1991 reforms and their aftermath have begun to transform the commercial environment, but the unfinished reform agenda is long and complex.

Korea's development strategy has been underpinned by exceptional strength in certain areas. It reached OECD levels of educational achievement and R&D expenditures at comparatively low levels of per capita income. Its infrastructure and institutional quality are good. External factors—

Table 3.4 Comparative statistics

	PRC	India	Korea	Malaysia	Thailand	Viet Nam
General economic indicators						
GDP, 2003 ($ billion)	1,410	599	605	103	143	39
GDP per capita, PPP, 2003 ($)	4,995	2,909	17,908	9,696	7,580	2,490
GDP per capita, average annual growth (2000–2003) (%)	7.4	3.8	4.8	2.3	4.0	5.7
Openness						
(Exports+Imports)/GDP, 2003 (%)[a]	65.0	31.8	73.8	204.8	122.3	115.0
Export growth, 1990–2003, (%)[b]	18.0	11.2	9.3	11.3	10.3	13.2
Average tariff rate, 2002[c]	12.4	28.0	4.9	5.2	10.5	15.0
Index of Economic Freedom, 2005[d]	3.5	3.5	2.6	3.0	3.0	3.8
Trade Policy Index, 2005[e]	4.0	5.0	3.0	3.0	3.0	5.0
Human capital						
Years of education, 2000[f]	5.7	4.8	10.5	7.9	6.1	3.8
Tertiary enrollment as % of age group, 2002[g]	13.0	11.0	82.0	27.0	37.0	10.0
Number of Internet users as % of total population, 2002	4.6	1.6	55.2	32.0	7.8	1.8
Public spending on education as % of GDP, 2001[h]	2.2	4.1	3.6	7.9	5.0	2.8
Physical infrastructure[i]	46	55	29	31	34	77
Institutional quality and risk						
Corruption (Corruption Perceptions Index, 2004)[j]	3.4 (71)	2.8 (90)	4.5 (47)	5.0 (39)	3.6 (64)	2.6 (102)
Property rights index, 2005[e]	4.0	3.0	2.0	3.0	3.0	5.0
Bureaucratic quality (Public Institutions Index, 2004)[k]	4.39 (55)	4.45 (53)	4.81 (41)	5.06 (38)	4.71 (45)	3.66 (82)

PPP = purchasing power parity.

Notes: [a] Data for Viet Nam are for 2002. [b] Data for Viet Nam are for 1997–2002. [c] Average import tariff (MFN) for manufactured goods, ores, and metals. Data for PRC, India, and Thailand refer to 2001. [d] Index of Economic Freedom ranges from 0 (mostly free) to 5 (highly restricted). [e] This is a composite from the Index of Economic Freedom. The index ranges from 0 (very good) to 5 (very poor). [f] Average years of schooling of population aged 25 and over. Data for Viet Nam refer to 1990. [g] Tertiary enrollments (regardless of age) as a percentage of the 20–22 age group. Data for PRC and India refer to 2001. [h] Data for the PRC are for 1998, India for 2000, and Viet Nam for 1997. [i] Growth Competitive Index, 2004, ranking of 104 countries, 1 is the best. [j] The index ranges from 10 (highly clean) to 0 (highly corrupt) for 146 countries. The highest is 9.7 and the lowest 1.5. Numbers in parentheses are the country rankings. [k] The public institutions index is based on survey data and ranges from 2.47 to 6.59 across 104 countries. The higher the index, the higher the quality. Numbers in parentheses are the country rankings.

Sources: Barro and Lee (2000); Miles et al. (2005); Porter et al. (2004); Transparency International (2005); UNCTAD (2005); World Bank (2005).

aspiring to membership of international organizations and the Asian crisis—have been important factors in its policy reforms.

Malaysia emerges as a country with comparatively high institutional quality, excellent physical infrastructure, and large public investments in education, much of it designed to redress past ethnic imbalances. It has had the most consistent commercial policy environment of the six. Nevertheless, there are concerns that the independence of its legal system may have weakened over the past two decades, there has been a persistent loss of high-level non-*bumiputra* human capital, and it faces competition from below (especially the PRC) and from above (the Asian newly industrializing economies).

Thailand scores well on most indicators, with the principal exception of human capital. In consequence, during the 1990s, as real wages began to rise quickly in the wake of rapid economic growth, it experienced difficulty in managing the transition out of labor-intensive activities. It has become progressively more open in its trade and FDI policies. Historically, its legal

and commercial institutions were not strong, but physical infrastructure is generally good.

The principal challenges in Viet Nam still relate to establishing the infrastructure that underpins a market-based economy since property rights, the legal system, financial intermediation, and physical infrastructure are all poorly developed. Illiteracy levels are low, but so too is the pool of internationally experienced entrepreneurs. Many small and household enterprises operate in an insecure commercial environment, while SOE reform lags. The quality of the physical and commercial infrastructure shows pronounced regional differences.

In their competition regimes, it is useful to divide the six countries into three groups. The first comprises those with historically very restrictive regimes, which have opened up during the past quarter century, namely PRC, India, and Viet Nam. The second covers those that have traditionally been reasonably open, and become progressively more so—Malaysia and Thailand. Finally is the special case of Korea, which was initially highly selective in its opening up, and which has become progressively more open to competition over time. None of the sample countries has become less open toward competition.

In some cases, it is possible to date the promotion of greater competition as part of a package of major general reforms. In Korea, there was gradual liberalization from the late 1980s, with major reforms in the late 1990s in the wake of the economic crisis. In the PRC, the reform process began in 1978, strengthened in the late 1980s, and further consolidated in 2002 on accession to WTO. In India, 1991 is regarded as the key reform year. In Viet Nam, it was the late 1980s *doi moi* reforms, with further liberalization around 2000. In contrast, Thailand, and particularly Malaysia, have always been quite open to competition, and over time have become progressively more so. In neither of these have there been major swings in the policy pendulum.

A range of internal and external factors was operational. These factors include a recognition that outward-oriented economies grow more quickly, and that it is possible to achieve national objectives in an open economy context. Competitive liberalizations—keeping up with one's neighbors—have been another factor. Foreign pressures, including a desire to join international agencies, have often contributed. Conversely, the demise of an international benefactor (the former Soviet Union) was a major trigger in Viet Nam's reforms.

Competition policy enforcement may differ between regions. Three of the six countries (PRC, India, Malaysia) feature quite high levels of decentralized economic policy making. (Local protectionism in the PRC was highlighted above.) Thailand has been pursuing a policy of industrial decentralization for some time, with implications for competition at local levels. In all but Malaysia, economic authority is being progressively devolved away from the center at varying degrees and speeds. In addition, there are large interindustry differences in protection, and thus competition, in all six countries. SOEs frequently receive preferential treatment, especially in PRC, India, and Viet Nam.

In some cases, such as Viet Nam, many of the broader problems associated with the business environment were barely addressed in the first round of reforms: red tape, corruption, insecure property rights, an ill-defined legal environment, poor physical infrastructure, limited financial development, and the huge, inefficient, and privileged SOE sector. The reforms have been a "positive-sum game," since growth has accelerated. But there have been losers too, notably among the bureaucrats who dispensed power and patronage, the SOEs sheltered from competition, and the labor unions in cosseted (especially state-owned) industries.

In Korea, too, there seems to have been ambivalence about recent reforms in sections of the bureaucracy that are reluctant to relinquish control. To overcome this attitude, reformers have proposed the establishment of "free economic zones," where liberalization (particularly of labor markets) can proceed more quickly than elsewhere, highlighting the importance of competition in factor markets. It is unlikely that Korea could achieve its current objective of becoming an economic hub for Northeast Asia unless these reforms are introduced and implemented successfully.

Korea undertook its major liberalizations after it had become democratic, but in any case it

appears that external factors were a major trigger for reform. Two factors in particular stand out. One was the Government's desire to join international organizations (GATT then OECD), membership of which required reform. The second was the Asian financial crisis when, in spite of intense nationalist sentiment, the Government felt it had no choice but to open up the economy.

Promotion of competition can also play an important role during the recovery of crisis-hit economies. With weak consumer demand, tight government budgets, and investment that has been reduced by lowered confidence, exports are critical in the immediate recovery period. Crucial to the competitiveness of exports is the efficiency gains from competition. The 1997–98 Asian crisis also served as a reminder that restrictions on competition may appear compatible with an open trade and FDI regime, while mounting tensions may remain hidden.

Competition is central to the process of globalization. Competition benefits the economy since domestic factors of production are able to maximize their returns, subject to the institutional constraints they face. Competition is also presumed to constitute a spur to better economic policy, to the extent that the option of "exit" for investors exerts a policy discipline on governments. In most cases, potential tension between industrial policy and promotion of competition is handled by ensuring competition in the domestic market, but not necessarily with equal treatment for foreign rivals.

Openness to the international economy varies significantly among the six countries (Table 3.4 above). All have become more open to trade since 1990, as indicated by both trade reforms and rising export-to-GDP ratios. This ratio has increased by more than 50% in three of the countries (PRC, India, and Thailand) and substantially in the others. Malaysia and Thailand were among a very small group of developing economies classified by Sachs and Warner (1995) as "always open." Both exhibit very high trade orientation, quite low average tariffs, modest interindustry tariff dispersion, and limited incidence of nontariff barriers. Qualitative indicators support this conclusion. Korea now has fairly low average tariff rates. Notwithstanding recent reforms, PRC, India, and Viet Nam still have relatively high tariffs, and a higher incidence of nontariff barriers than the other three countries. The more protected an economy is, the more limited competition is, reducing allocative efficiency.

Among the six, Korea's trade and investment regime has arguably been the most unusual. From the early 1960s, it achieved very rapid export-led growth in the context of (until recently) very restrictive policies toward imports (except those required by export-oriented firms) and FDI. Its industrial policy resulted in tremendous achievements but also high costs. In addition to tariff reform and a reduced incidence of nontariff barriers, Korea's reforms in the 1990s included a reduction in the number of subsidy programs, as well as customs simplification. A desire to join both GATT/WTO and OECD, and the imperative to reform in the wake of the 1997–98 crisis, drove much of the liberalization.

Viet Nam's reengagement with the international economy is of fairly recent origin. Typical of a late reformer, its official trade regime remains opaque and poorly documented. Only quite recently was a formal tariff schedule released. It still retains very high levels of protection (several hundred percent) for its automotive, sugar, and garment industries. Much protection is firm-specific in nature, tailored to the needs of inefficient SOEs. Viet Nam aspires to WTO membership soon, which constitutes a powerful incentive to continue and broaden the reform process.

Political commitment to promoting competition and to ensuring the independence of the competition authority plays a large role in effective implementation. In the case of Thailand, intense lobbying has caused delays in the adoption of a threshold market share to define a dominant position. The country's Trade Competition Commission also suffers from human resource and capacity constraints, funding limitations, lack of protection of confidentiality, and limited public awareness and support.

When enforcement is handled through administrative decisions in a decentralized manner, the potential exists for inconsistent enforcement across locations. In the PRC, local State Development and Reform Commission branches have had some success in breaking price agreements among suppliers, such as among nine travel

agencies collectively setting minimum package prices for trips to Southeast Asia. However, stronger coordination of the network of local implementation/enforcement agencies may be necessary to deal with (or stave off) instances of local protectionism.

Several key points emerge from this survey of approaches to, and experiences with, implementing competition policy. Notwithstanding their diversity, almost all developing Asian economies have adopted progressively more open policies toward competition during the past decade or two, and this trend seems set to continue. This more open posture has been accompanied by the adoption of more liberal trade and FDI regimes, a process that has had profound implications for the promotion of competition. These changes have been so rapid in some cases that the policy and institutional framework has been unable to keep pace.

A major challenge for policy makers is keeping up with a rapidly changing international commercial environment. As with FDI, for an economy to reap the full benefits of competition, the quality of incentives, institutions, and infrastructure matters more than before. In transitional economies, the first round of reforms typically focuses on macroeconomic stabilization and partial trade liberalization, while other, microeconomic, components essential for competition typically lag.

Effects on government finances

The effect on a government's budget of implementing and enforcing competition policy is, in principle, ambiguous. On the one hand, outlays are necessary to create and sustain a competition enforcement agency. On the other, greater competition brings benefits. For example, the vigorous enforcement of a bid-rigging law (a form of cartel law) can result in savings for government purchasers who otherwise might find themselves the target of suppliers' conspiracies. In many developing countries, the size of government purchases is now so large that only small reductions in the amount of bid rigging on state contracts would more than cover the likely costs of cartel enforcement. This is particularly noteworthy since as much as a quarter of documented competition law-enforcement actions in developing economies involve bid rigging against state purchasers (Clarke and Evenett 2003). The PRC, for one, has reported several enforcement actions of this type in recent years.

Table 3.6 provides some evidence of the magnitudes involved. The table reports data for seven developing economies that have competition enforcement agencies. It gives the savings to each respective national government if stronger cartel enforcement deterred bid rigging *in just 1%* of the value of state contracts. Those savings (reported in the second and third columns of the table) are compared to the current outlays on the national competition enforcement agency (in the last two columns of the table).

For countries with large government expenditures, such as India, a 1% reduction in bid rigging on state contracts would save the national treasury a sum equivalent to over 16,900% of the cost of its competition enforcement agency! This means that India could increase the expenditures on this agency 100-fold and still come out ahead—so long as the additional expenditures ensured that bid rigging on state contracts fell by at least 1%. In short, government expenditures in most developing countries are large enough that *the savings on government purchases that result from less bid rigging are likely to easily offset any additional outlays needed to rigorously enforce national cartel laws.*[20]

More generally, data on the magnitude of national imports and government consumption expenditures can be employed to gauge the likelihood that investing in cartel enforcement will be beneficial for developing countries. Table 3.7 includes data on 26 developing countries for which there is no record in OECD documentation of active cartel enforcement in the 1990s. The purpose of Table 3.7 is to estimate the minimum percentage reduction in cartelization on different purchases that would have to follow from a $10 million investment in cartel enforcement for this outlay to at least pay for itself.[21]

In the case of a nation's imports, assuming

Table 3.5 Implementation arrangements: Competition laws

PRC	India	Korea	Malaysia	Thailand	Viet Nam
Regulatory agencies					
State Administration of Industry and Commerce (SAIC)	Monopolies and Restrictive Trade Practices (MRTP) Commission	Korea Fair Trade Commission (KFTC)	Various regulatory agencies	Trade Competition Commission (TCC)	Local governments and their departments of prices and finance for price regulation
Quality of competition institutions					
Uneven	Generally good for MRTP Act, but unproven for Competition Act	Generally good; more improvement after Asian financial crisis	Generally high	Generally good but vulnerable to political influence	Weak for the price laws
Implementation problems					
Heavy reliance on administrative channels, rather than on judicial system	No explicit definitions nor mention of certain offending trade practices in MRTP Act	Overly expansive power granted to KFTC, sometimes leading to conflict with its antitrust mandate	Uneven applicability of laws across sectors; some sectors regulated, others not	Failure to pass implementing rules and regulations, so too many exemptions and exceptions	Commercial Law 1997 too broad, with no assigned enforcement agency
Lack of public awareness about laws; some producers think collective price-setting behavior is lawful	MRTP Act did not cover extraterritorial jurisdiction and merger control	KFTC has discretion over imposition of administrative surcharges, and is sometimes criticized for lack of prior resort to the judiciary	Laws vague, needing publication of supplemental clarifying documents	Law broad and vague, leaving much discretion in administration; lack of transparency in implementation	Laws vague, needing publication of supplemental clarifying documents
Anti-Unfair Competition Law of 1993 neither outlaws price cartels nor defines predatory pricing				Composition of TCC vulnerable to political influence and lobbying	
Implementation successes					
Campaign against anticompetitive practices by public utilities yielded a large number of bid-rigging cases	Extraterritorial jurisdiction and merger control subsequently incorporated in Competition Act	Law amended to inhibit concentration of economic power among *chaebol* and their affiliates		Increased awareness by small enterprises as regards unfair trade practices	Administrative fines and remedies imposed for confirmed violations of price laws
Campaign against sector monopoly and regional blockades implemented		Promoted deregulation and privatization of SOEs			
To ensure uniform enforcement, administrative explanations issued for local SAIC branches		Antimonopoly policy has reduced industrial concentration ratio and prices			

Source: Compiled by Asian Development Bank staff.

Table 3.6 Estimated savings to governments through a 1% reduction in bid rigging of government contracts

Country	Conservative estimate of reduction in government spending in 2000, ($ million)		Budget of competition authority in 2000, ($ million)	Ratio of estimated savings to cost of competition agency	
	15% price reduction	20% price reduction		15% price reduction	20% price reduction
India	122.0	162.6	0.7	169.4	225.9
Kenya	4.9	6.5	0.2	20.2	26.9
Pakistan	20.3	27.1	0.3	61.6	82.9
South Africa	34.9	46.5	7.7	4.5	6.0
Sri Lanka	5.1	6.8	0.1	50.9	67.9
Tanzania	1.5	2.0	0.2	9.5	12.6
Zambia	0.5	0.7	0.2	2.7	3.6

Source: Data on central government spending and on the budget of the competition enforcement agency taken from Consumer Unity & Trust Society (2003).

very conservatively that cartels raise prices by 15%, this amounts to calculating what reduction in the percentage of cartelized imports is needed to generate savings of $10 million. For these 26 countries, the mean reduction in cartelization on imports necessary to justify an investment of this magnitude was 1.25%. For 12 of these countries, the reduction of cartelization needed on imports was less than 1%.

The reduction in bid rigging and overcharges necessary to justify increased outlays on competition law enforcement is small. This finding alone suggests that the net impact on a national treasury of adopting a competition law is likely to be positive, in stark contrast to the fears about the implementation costs of adopting multilateral rules on the "behind-the-border issues" in the world trading system. These direct benefits for the government budget and for customers more widely are in addition to the positive impact on macroeconomic performance (and consequently on tax revenues) of greater rivalry between firms.

Toward a competitive future

The discussions above have highlighted the importance of promoting competition. They have also indicated that many other issues are involved in consideration of competition.

> The rich countries have … learned the hard way about monopolistic and oligopolistic behavior, predatory pricing, price fixing, insider trading, accounting conflicts of interest, perverse incentives from stock options, import tariffs, producer subsidies, government ownership of business, property rights, land use policies, and many other matters affecting the intensity and fairness of competition. These are the ways special interests gain favoritism. The so-called Washington Consensus about good economic policy in developing countries is hopelessly superficial about the importance and complexity of achieving intense and fair competition. To become rich, poor countries have to deal with these issues (Lewis 2004, p. 296).

To the extent that the enforcement of competition policy prevents or discourages incumbent firms from taking steps to foreclose entry by potential rivals, then such enforcement will strengthen the incentives of the potential rivals to invest in innovation. This is because these potential competitors will expect it to be easier to enter the market and so will have greater confidence that their investments in innovation will pay off.

Competition, innovation, and intellectual property

Innovation itself is a result of market interactions and the fact that even firms that are not currently

Table 3.7 Reduction in imports or government spending needed to justify $10 million for enforcement of competition law

Developing country[a]	Reduction in cartelization required, 2001 (%)[b]		
	Imports	Government consumption expenditures	Imports plus government consumption expenditures
Algeria	0.58	0.95	0.36
Cameroon	3.06	7.98	2.21
Costa Rica	1.06	3.28	0.80
Côte d'Ivoire	2.28	8.12	1.78
Ecuador	1.25	4.27	0.97
Egypt, Arab Rep.	0.35	0.77	0.24
Ghana	2.05	9.30	1.68
Guatemala	1.34	7.16	1.13
India	0.10	0.15	0.06
Indonesia	0.16	0.71	0.13
Iran, Islamic Rep.	0.23	0.42	0.15
Jordan	1.24	3.61	0.92
Kenya	2.05	6.92	1.58
Lebanon	1.09	2.50	0.76
Malaysia	0.09	0.72	0.08
Mauritius	2.71	13.09	2.25
Morocco	0.63	1.25	0.42
Pakistan	0.61	1.13	0.40
Philippines	0.20	0.76	0.16
Senegal	4.41	16.50	3.48
Syrian Arab Rep.	1.38	3.32	0.98
Thailand	0.11	0.71	0.09
Tunisia	0.80	2.80	0.62
Turkey	0.16	0.39	0.12
Venezuela	0.35	0.77	0.24
Zimbabwe	4.09	4.40	2.12
Mean	1.25	3.92	0.91
Minimum	0.09	0.15	0.06
Maximum	4.41	16.50	3.48

[a] Where there is no record to date of active cartel enforcement. [b] To justify spending $10 million on the enforcement of competition law, given a 15% price increase on cartelized products.

Notes: The assumptions underlying these calculations are very conservative. For instance, a 15% price increase due to cartelization is at the lower end of estimates of the price impact of cartels (see, for example, the case studies in Levenstein and Suslow 2001). Moreover, the $10 million price tag for the enforcement of national competition law is in excess of what the South African Government spends each year on the enforcement of all of its competition laws, not just cartel law. The South African experience is pertinent as South Africa is widely regarded as having an effectively enforced set of competition laws.

Source: World Bank 2004 (for underlying data on imports and government consumption expenditures).

competing with each other in existing product markets may be competitors in markets for future innovations. Competition in such markets (and hence the incentive for innovation) can be undermined by mergers or other (potentially) anticompetitive practices. Antitrust law promotes innovation and economic growth by combating restraints on competitive activity. Firms are more likely to innovate if they face strong competition. By deterring anticompetitive practices, antitrust law ensures that consumers have access to a wide variety of goods and services at competitive prices. More generally, *preserving the ability of innovative firms to enter a market may well be contingent on the appropriate enforcement of various competition laws.*

On the whole, innovation and productivity improvement are likely to be promoted rather than impeded by interfirm rivalry. Nonetheless, identifiable situations can arise in which—given the technologies available to firms in an industry—the maximization of the number of competitors in a market may lead to inefficient outcomes. According to the thinking of leading scholars in the field of industrial organization (see, e.g., Carlton and Perloff 2000), such situations by no means call for the wholesale rejection of competition policy as a tool of economic governance; rather, they call for appropriate tailoring of the application of such policy to take account of relevant technological and other considerations.

Competition policy promotes innovation and economic growth by limiting, if not removing, constraints on open markets and free competition. As noted earlier, firms are less likely to develop new and better products if other firms do not pose any threat of encroachment to their share of the market or if they are constrained from entering new markets. This means that the more stringent competition is among firms, the stronger the incentive to innovate. By preventing restrictive business practices, competition policy guarantees the availability of a large selection of goods, services, and processes at competitive prices.

Similarly, the protection of intellectual property is a spur to innovation in today's economy. Firms and individuals normally invest resources and effort to fashion a unique or better product, process, or service with the expectation of earning a reasonable return on their

investment. If there is no possibility of this, then no profit-maximizing agent will make the investment. Intellectual property rights (IPRs) are vital for fostering innovation and growth in an economy. These rights provide the motivation for research and development leading to new products, services, and production processes.

Firms have an incentive to develop new and better products when the prospect of free riding by other firms is minimized. In general, the objective of IPRs is to compensate the innovator for his or her creative efforts, not to put the interests of the individual innovator over and above the interests of consumers. IPRs are usually granted to ensure that appropriate protection is provided to the innovator. Unlike physical property rights however, IPRs are often limited in scope and coverage. At the outset, consumers will be faced with higher prices as the initial innovator reaps the profits of the innovation. However, by justly rewarding the initial innovator, development of similar and related products will be encouraged, ultimately resulting in lower prices for consumers. This is the rationale for granting protection to intellectual property owners—so that the process of innovation becomes sustained over time. This helps drive the growth and development of an economy. By promoting innovation, IPRs also serve to benefit the public and increase consumer welfare.

Intellectual property law preserves the incentives for innovation. Firms are more likely to innovate if they are protected against free riding. Innovation benefits consumers through the development of new and improved goods and services, and spurs economic growth. The aim is not to promote the individual innovator's welfare, but to ensure a sufficient reward for the innovator to elicit his or her creative or inventive effort while not delaying follow-on innovation and not leading to unnecessarily long periods of high prices for consumers. In order to strike a balance between under- and overprotecting innovators' efforts, IPRs differ from, and are usually less absolute than, "normal" property rights.

Protection granted to intellectual property owners include patents, trademarks and service marks, and copyrights. A patent usually covers new inventions or improvements on an existing product. It is a form of recognition by the government that the inventor has the exclusive use and benefit of the invention. A patent may grant the inventor the right to exclude others from making, using, offering for sale, or selling the invention.

A trademark or service mark is a distinctive symbol, device, word, or name attached to a product to indicate that it is sourced from a particular firm or individual. It is a mark used to distinguish the product from the products of other firms or individuals. A trademark is an identifier for a good, while a service mark is for a service. Trademark and service mark rights are granted to prevent other firms or individuals from using substantially similar marks to take advantage of the reputation of the owner of the trademark or service mark and confuse consumers into buying similar products. They do not, however, preclude other firms and individuals from producing or selling similar goods or services provided that the trademark or service mark is different.

A copyright is a form of protection granted by governments to authors of original works, including literary, musical, dramatic or artistic works, films, sound recordings, broadcasts, and other matters, whether published or unpublished. It gives the copyright owner the exclusive right to prepare derivative works, to reproduce the copyrighted work or portions of it, to display or perform the copyrighted work in public, and to distribute copies or recordings of the copyrighted work. These rights may be sold or transferred to other parties. The copyright protects the work in the specific form it was created, but not the idea, subject matter, theme, or concept expressed in the work.

Thus, IPRs are often limited in duration (patents, copyright), strictly limited in scope (copyright, trademark), not protected against parallel creation by others (copyright, know-how), or lose their value once they become public (know-how).

As discussed above, competition policy instruments include competition advocacy and all measures available to governments that affect competition in markets. In the application of intellectual property policy, competition policy may play a positive role. Among intellectual property instruments available to governments

are patent scope, which establishes the extent to which an innovator has property rights over related innovations, and patent duration, which establishes the length of time the innovator has exclusive rights over his or her own innovation. Governments thus have the ability to ensure that competition concerns are incorporated into the implementation of intellectual property policy.

For example, in the PRC's 1993 Anti-Unfair Competition Law, Article 5 offers protection against trademark infringement. It prohibits not only the forgery of trademarks and certificates of quality and origin, but also the use of similar brand identification—brand names, packaging, or designs—that would be likely to confuse the consumer. A fine of 100–300% of the value of the illegal gains may be imposed for breaches of the law. Criminal sanctions may also be imposed. Article 10 protects trade secrets, which are defined as technical and operational information that is not known to the public; that is capable of bringing economic benefits to the owners of the rights; that has practical applicability; and that the owners of the rights have taken measures to keep secret. The law imposes a fine of CNY10,000–200,000 on those who obtain such secrets illegally, or who know or should know that a trade secret was obtained illegally but nevertheless agree to distribute such knowledge to a third party.

Intellectual property rights and competition policy

Intellectual property rights and competition policy are complementary since both seek to promote innovation and enhance consumer welfare. They are also complementary ways of attaining allocative efficiency in a market economy. Like IPRs, competition can inspire innovation. Competition drives firms to introduce new or improved products, services, or processes in order to survive in the marketplace, capture a larger share of the market, or simply increase profits.

The desire to gain control of a particular market segment can also encourage firms to develop new products to satisfy consumers' unmet needs. Thus, free enterprise and open markets serve to benefit the public and increase consumer welfare through innovation, as well as through keeping prices low.

Several intellectual property practices clearly have a competition dimension. Some of the more common ones are described below: [22]

- Pooling and cross-licensing arrangements—owners of IPRs license their rights to one another and split royalty fees. This may result in cartel-like behavior on the part of the pool members.
- Exclusive territories—the licensor agrees not to license any other licensee in a particular area. This grants licensees monopolies to serve particular territories, but restricts them from expanding into other localities.
- Grantbacks—the licensee is required to license back to the licensor improvements made by the licensee on the licensor's intellectual property. To some extent, this is tantamount to exclusivity between the licensor and licensee, and excludes others from profiting from the intellectual property.
- Acquisitions of IPRs—outright purchases of IPRs or of firms owning IPRs. Similar to other asset acquisitions, this could allow a firm to have monopoly power over a market or to obtain a dominant market position.
- Exclusive dealing—an auxiliary agreement is attached to the granting of a license, which prohibits the licensee from selling, distributing, using, or licensing a competing technology. This denies rivals the opportunity to use the licensee as an outlet for their products or processes.
- Reach-through royalties—the licensor requires that royalties be based on the product's total sales, irrespective of whether the licensor's technology was used in each stage of the production process. This effectively presents an all-or-nothing choice to the licensee, and provides a disincentive to use other or similar technology in some stages of the production process.
- Tying arrangements—the licensed technology has a variable input related to usage that can only be sourced from the licensor. This allows the licensor to earn a profit both on the licensed technology and on the licensed complementary input. An illustration is home

printers sold at low prices, but for which the consumable input, the toner, is sold at high prices.

- Compulsory licensing—legal intervention to restrict the monopoly rights of existing patent holders. This grants certain firms the license to use, sell, or distribute a patented technology to make it more available to a larger number of users. Compulsory licenses are often granted in cases of national emergency, such as during the anthrax attacks after the events of 11 September 2001 in the US, when many manufacturers were granted compulsory licenses in order to make the anthrax vaccine more readily available.
- Vertical price restrictions—the licensor determines the price at which the licensee must sell the licensed products. This effectively limits competition among licensees, as the licensor restricts the price at which the product can be sold.

From a short-run perspective, there appears to be some tension between the goals of IPRs and competition policy. The apparent conflict arises because intellectual property laws give the innovator the right to exclude others from exploiting the innovation. This may lead to market power, and even monopoly as defined under existing competition legislation. Thus, intellectual property law, in seeking to protect property rights, limits competition to a certain extent. Meanwhile, competition policy is generally driven by the assumption that the removal of barriers to free competition is the best way to maximize consumer welfare.

However, competition and IPRs are not essentially in conflict. IPRs, while providing some form of statutory monopoly, generally do not provide market power of such a significant degree as to cause concern to competition authorities. This is because the scope of a particular IPR is often smaller than the relevant market, so that the opportunity to create similar products to compete with the protected one still exists.

The apparent short-run tension between competition and IPRs also contrasts with a longer-term view. *IPRs generally strengthen competition in the economy over the long run, by providing incentives for the development of new products and production processes.* In recognizing that technological progress contributes to social welfare, the apparent conflict between IPRs and competition policy is resolved. Since the long-run goals of competition policy and IPRs are mutually reinforcing, governments are increasingly willing to restrict competition temporarily at present, so that competition in new products and processes can be attained in the future.

The above issues illustrate how competition policy can be associated with the implementation of IPRs. While there is some complementarity in the goals of intellectual property policy and competition policy, the interface between them may be difficult to manage. This is because IPRs can limit competition in the short run, resulting in a trade-off between the immediate benefits from increased competition and the future benefits from subsequent innovations. Therefore, governments need to balance policies on intellectual property and competition to ensure that consumer welfare is maximized and that policies support economic growth. Policy makers face the challenge of coordinating the instruments of intellectual property policy and competition policy to efficiently allocate resources toward the development of new and better goods, services, and processes.

Policy makers have striven to maintain the balance between intellectual property policy and competition policy by using various pre- and post-patent grant mechanisms. Pregrant measures typically include limiting the scope and duration of patents. This is because overly broad patent grants, interpretations, or applications of IPRs may unduly limit competition. Many agree that some form of protection for the innovator's investment is justified to encourage future innovation. Too much protection, however, may unintentionally result in just the opposite. This is because procedures that are too complicated or too stringent would actually serve to discourage prospective pioneers from innovating similar products and follow-on innovators from developing the next generation of products.

It is therefore imperative for governments to ensure that protection granted to intellectual property holders will still allow current and future innovators to build new and improved products or processes from the existing patented products

or processes. By contrast, postgrant measures typically include allowing compulsory licenses and exemptions on specific uses of the patent, especially for patents related to health issues.

Apparent conflict arises because IPRs give an innovator the right to exclude others from exploiting the innovation, which may lead to market power and even monopoly as defined under competition law. Intellectual property law seeks to protect property rights, and in so doing, limits competition. Competition policy may therefore play a positive role in forming intellectual property law, especially through competition advocacy with the policy makers formulating intellectual property law. Competition policy expertise should prove useful in helping decide on issues like the correct scope and duration to be awarded under intellectual property law.

Competition law, meanwhile, has generally reflected the premise that consumer welfare is best served by removing impediments to competition. However, this short-run view of some competition authorities has been replaced by a longer-run view, which acknowledges that *technological progress contributes at least as much to social welfare as does the elimination of allocative inefficiencies from noncompetitive prices. There is now growing willingness to restrict competition today in order to promote competition in new products and processes tomorrow.*

Patent and competition policy are complementary instruments for rewarding the innovator most efficiently: patent scope by preventing imitation and antitrust by affecting price through constraints on contracts for transferring technology. Patent scope and competition policy are distinct instruments for affecting the incentives to research and to transfer technologies: one sets the "threat points" or the opportunity cost of entering into the licensing agreement (e.g., whether or not a rival can introduce an imitation) and the other establishes the feasible set of legal licensing contracts. Consequently, intellectual property law and antitrust law are complementary since both seek to promote innovation and enhance consumer welfare, and are complementary ways of achieving efficiency in a market economy.

Despite sharing important goals, IPR and competition policies are not purely complementary and managing the interface between them is difficult. A completely legitimate use of IPR can restrict competition, at least in the short run, thereby producing a trade-off between the benefits of increased competition and the gains from further innovation. A typical challenge facing policy makers is to coordinate patent instruments (patent scope and duration) and competition instruments (contractual restrictions) so as to achieve an efficient allocation of resources directed toward the development and use of new products and processes. Thus:

> A country's optimal patent policy is found by equating the sum of the extra deadweight loss that results from strengthening the IPR protection granted to domestic firms and the extra consumer surplus loss that results from expanding the fraction of goods that are subject to monopoly pricing with the benefits that flow from providing greater incentives for innovation to firms worldwide. A country's optimal IPR protection depends on the policies set by its trading partner, because the strength of foreign patent rights affects the responsiveness of global innovation to a change in a country's own patent policies (Grossman and Lai 2004).

Summary and conclusions

From reviewing the experiences of six diverse Asian countries in regard to competition policy, lessons emerge that may benefit other developing countries. Countries with different initial conditions of competition and at different stages of reforms or integration with global trade and investment flows may follow different paths to reaping the gains from competition. However, the globalizing economic environment imposes a form of discipline on domestic economic activity, creating pressure for promoting the sort of efficiency improvements that competition can bring.

Greater competition in product markets can lead to lower prices, greater choice, and increased production efficiency, ultimately contributing to

a country's growth and development. Restrictions to competition must generally therefore be removed to enable markets to deliver the benefits of competition to consumers and to support sustainable economic growth. At the same time, the greatest degree of competition possible may not be optimal, and increasing economic growth requires a policy mix promoting both cooperation and competition, balancing short-term (static) efficiency improvements with long-term, dynamic efficiency and development.

We have seen that competition policy is concerned with both private anticompetitive practices and government measures or instruments that affect the state of competition in markets. Competition policy is usually aimed at enhancing consumers' freedom of choice and firms' freedom to trade and access markets. There are some instances where consumers will prefer that a smaller number of goods (and possibly a single good) be available in the marketplace. There are also some instances where production may be most efficiently pursued by a small number of producers (possibly just one). Competition policy must be applied in ways that take account of the technological characteristics of such markets.

Most of the countries studied have envisaged their competition laws as supportive of their national development objectives. The prevalence of competition is consequently viewed as contributory to the countries' economic development. Tension between the objectives of competition policy and industrial policy is more apparent than real. To the extent that creating national champions substantially increases concentration in a domestic market, there may actually be a stronger case for implementing competition policy than otherwise. Japan itself has argued that intrafirm rivalry has previously played and continues to play an essential role in its development.

Most measures to protect domestic industries or firms create barriers to entry and can lead to high concentration in affected sectors. At the subnational level, local protectionism leads to market fragmentation and thus to low regional specialization. Competition law can reinforce the effectiveness of cuts in trade barriers on growth-enhancing imports. The trend toward greater openness and globalization is likely to continue, with competition playing a key role in enhancing the international competitiveness of a country's firms. In turn, growing firms will contribute to the country's growth and employment. Thus, participating in international organizations such as WTO or OECD is an effective way to bring the pressures of international competition to bear on promoting competition in domestic markets.

During economic transition or reforms, the benefits of an open market economy cannot be fully realized unless restrictions on competition are removed. This has been reflected recently in India (where competition policy has been revised and expanded), Viet Nam (where a new competition policy was adopted in late 2004), and the PRC (which has firm plans to develop and implement a new competition policy). Opening markets is not enough by itself for countries to begin reaping the benefits of competition. Firms will still find incentives to engage in anticompetitive practices. Thus, the intended benefits of trade reform may not be realized without active enforcement of competition law. The Korean case illustrates that trade liberalization does not automatically lead to a more competitive domestic market, and that the best outcomes are achieved when liberalization is accompanied by measures to increase competition in the domestic market. This experience highlights the importance of having faith in the benefits of competition from an early stage of economic growth and of incorporating competition policy into the broader economic policy framework.

In recent years all of the six countries studied have generally been open to FDI. This has been true longer in Malaysia and Thailand in particular. It has not always resulted in increased competition in their domestic markets. However, for foreign investors the existence of a competition policy indicates some commitment by the government to ensure a level playing field among domestic and foreign investors. And relaxing foreign participation requirements can be generally expected to contribute to increasing competition in the domestic economy.

Competition policy is affordable. In most countries it will more than pay for itself. The saving on government purchases, which results from less bid rigging alone, is likely to easily

offset any additional outlays needed to rigorously enforce national cartel laws. Even greater may be the increase in tax revenues resulting from greater competition-induced growth. At the same time, implementation of competition policy serves to reinforce consumer rights and the competition culture that help ensure that the benefits of competition are realized.

Development of a "competition culture" can, in turn, ensure that competition is strengthened. In most developing countries, the interests of consumers are poorly represented and are much weaker than those of producers. Organizing and promoting consumers' rights create a potent force for ensuring the promotion of competition. In this regard, it can be crucial that the authority charged with promoting and enforcing competition has independence from ministries or other agencies representing producers or producer groups.

Competition can help create a prosperous future. Preserving the ability of innovative firms to enter a market may well be contingent on the appropriate enforcement of competition laws. IPRs generally strengthen competition in an economy over the long run by providing incentives for the development of new products and production processes. Such technological progress will likely contribute at least as much to social welfare in the long run as the elimination of allocative inefficiencies resulting from noncompetitive prices will in the short run.

With regional and global integration accelerating, the pressures of international competition and their context have become increasingly palpable. However, as we have seen, competition policy is important in its own right for domestic reasons, and does not have to be considered jointly with the rest of the Doha round's Singapore issues. Regardless of whether multilateral rules on competition policy are negotiated under WTO, each country should strive to develop and implement its own competition policy.

Drawing on lessons from the experience of Japan and Korea, developing countries in the Asia-Pacific region should start early and take a long-term view in implementing competition policy. Most have completed their first round (macroeconomic) reforms, which play a key role in setting a framework for greater competition. Late reformers, such as Viet Nam, still face challenges from the first round of reforms but are acting to ensure that restraints to competition will pose minimal hindrance to future development. The benefits of competition will flow more freely from the strengthening of property rights, development of a credible legal and judicial system, trade and FDI liberalization (informed by competition policy), and infrastructure expansion.

The complementarity of competition and competition policy with industrial, trade, and FDI policies highlights the need for active competition advocacy. Too often, the advocacy functions of competition authorities are neglected at the expense of enforcement of competition law, only to create the need for even greater enforcement as other legislation is enacted without consideration of the implications for competition.

The general conclusion is that competition confers net benefits on an economy. Productivity rises, choice expands, and some (generally the bulk) of the increased benefits are appropriated by domestic consumers and factors of production. These benefits appear to be especially important in connecting the country to the global economy and ensuring the international competitiveness of its firms as the country develops. At the same time, the discipline of participating in a globalizing economy reinforces the importance of competition. Of particular relevance is the fact that, while many countries are moving to implement or strengthen their competition policies, none appears to be moving toward repealing them.

Endnotes

[1] For a review of his evidence in support of this claim, see Table 1.1 and Section IV.1 of Ahn (2002).

[2] The countries were selected for the variety of their conditions and experiences with competition and competition policy. Country studies were prepared by Ping Lin (Lingnan University); S. Chakravarthy; Seung-Wha Chang (Seoul National University) and Youngjin Jung (Woo, Yoon, Kang, Jeong & Han); Cassey Lee (University of Malaya); Deunden Nikomborirak (Thailand Development Research Institute); and Vu Quoc Huy (Institute of Economics). They were studied in greater detail as part of an Asian Development Bank regional technical assistance study (Brooks and Evenett 2005, forthcoming).

[3] The concept of efficiency has both static and dynamic aspects. *Static* efficiency refers to maximization of the benefits of voluntary exchange at a *given point in time*; that is, maximizing the sum of producer and consumer surpluses in a given market at a point in time. *Dynamic* efficiency refers to the maximization of the sum of such surpluses *over time*. The latter takes account, in particular, of the impact of technical progress, innovation, and investments of various types.

[4] As Vickers (2003) notes, "questions about the *desirability* of competition – whether it directs incentives positively – should not be confused with questions about its *inevitability*. There is no inconsistency in regarding competition as beneficial but vulnerable to being undermined – for example by cartel activity … in short, being pro-competition is by no means the same as being pro-*laissez faire*. … Hence the importance of public policies to safeguard and promote competitive incentives. In a sense, the competition policy is judicious regulation to bring out the best in *laissez faire*. A competitive market is generally a far better regulator than any regulator can hope to be" (p. 3).

[5] This rather theoretical discussion is based on some rather strong assumptions. In the context of a developing country, these assumptions may well not hold and the same actions which increase efficiency and welfare in an optimal situation may be inferior to "second-best" solutions. However, since second-best solutions require a level of detailed analysis beyond the capabilities of many developing countries (and possibly many industrial countries as well), promoting competition will generally be preferable to alternatives.

[6] Cartels figure prominently in relation to bid rigging in government procurement processes, and thus their deterrence can also improve the efficiency of government.

[7] See White (2000), for an accessible economic analysis of such externalities and the implications for regulatory and competition policy.

[8] Article 1, 1993 Anti-Unfair Competition Law, available: http://www.globalcompetitionforum.org/regions/asia/China/ch_unf1.pdf.

[9] The Competition Act, 2002 (No. 12 of 2003), available: http://dca.nic.in/competition_act2002.pdf.

[10] Article 1, Monopoly Regulation and Fair Trade Act, available: http://ftc.go.kr/data/hwp/monopoly.doc.

[11] Competition Act 1999, available: http://www.globalcompetitionforum.org/regions/asia/Bangkok/Bankok%20Act.pdf.

[12] Amsden and Singh (1994) cite Okimoto (1990) in support of this claim.

[13] Strategic trade policy involves setting up national trade policies—such as tariffs—to enable a domestic sector to reap greater economies of scale from the protected home market or to enable the sector to expand output and lower costs through learning-by-doing effects. Both of these result in lower production costs enabling a nation's exports to, in theory, expand export sales. In addition to expanding the output of the domestic industry, proponents of strategic trade policy note that it can result in profits being effectively "shifted" from foreign firms to domestic firms.

[14] A survey of 150 textile and garment enterprises conducted by the Institute of Economics shows that, although the sector relies heavily on imported inputs, its import tax commitments are very low (Institute of Economics 2000). In 1999, imported materials accounted for 66% of total materials purchased. By 2000 this share had increased to 77%. However, 58% of these imports were totally exempt from tax in 1999, and the rest were subject to low tax commitments. As a whole, the tax rate for the sample was barely 1%.

[15] Watson et al. (1989) cite the "wool war" and the "silk war" of the mid-1980s as examples of local governments trying to keep raw materials within their locality to favor local manufacturers.

[16] These arguments are developed, for example, in UNCTAD 1997 and in other references cited therein.

[17] For a more complete discussion of FDI in developing Asia, see ADB (2004), Part 3 "Foreign Direct Investment in Developing Asia" or Brooks and Hill (2004).

[18] Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, available: http://www.helplinelaw.com/law/china/merger-acquisition/index.php.

[19] A "foreigner" refers to a natural person who is not of Thai nationality or a juristic entity, (i) which is established under foreign law, (ii) in which half or more of its capital is owned by foreigners even if the company is incorporated under Thai law, or (iii) in which half or more of the value of the total capital is being invested by foreigners even if more than half the capital is owned by Thai nationals. (The third requirement is effectively a bar on the use of Thai nationals as nominees.)

[20] See Clarke and Evenett (2003) and Evenett (2003, part III) for a more general discussion of the costs and benefits of enforcing national anticartel laws. The available empirical estimates suggest that the reduction in overcharges incurred in jurisdictions with active cartel enforcement regimes from *only one* major international cartel in the 1990s would have gone a long way to pay for the entire state outlays of Brazil, Mexico, and several European Union member states on their respective competition law enforcement regimes.

[21] The $10 million figure is almost certainly larger than the outlays necessary to implement a cartel law in a small or middle-sized developing economy.

[22] This subsection draws heavily on Tom (1998).

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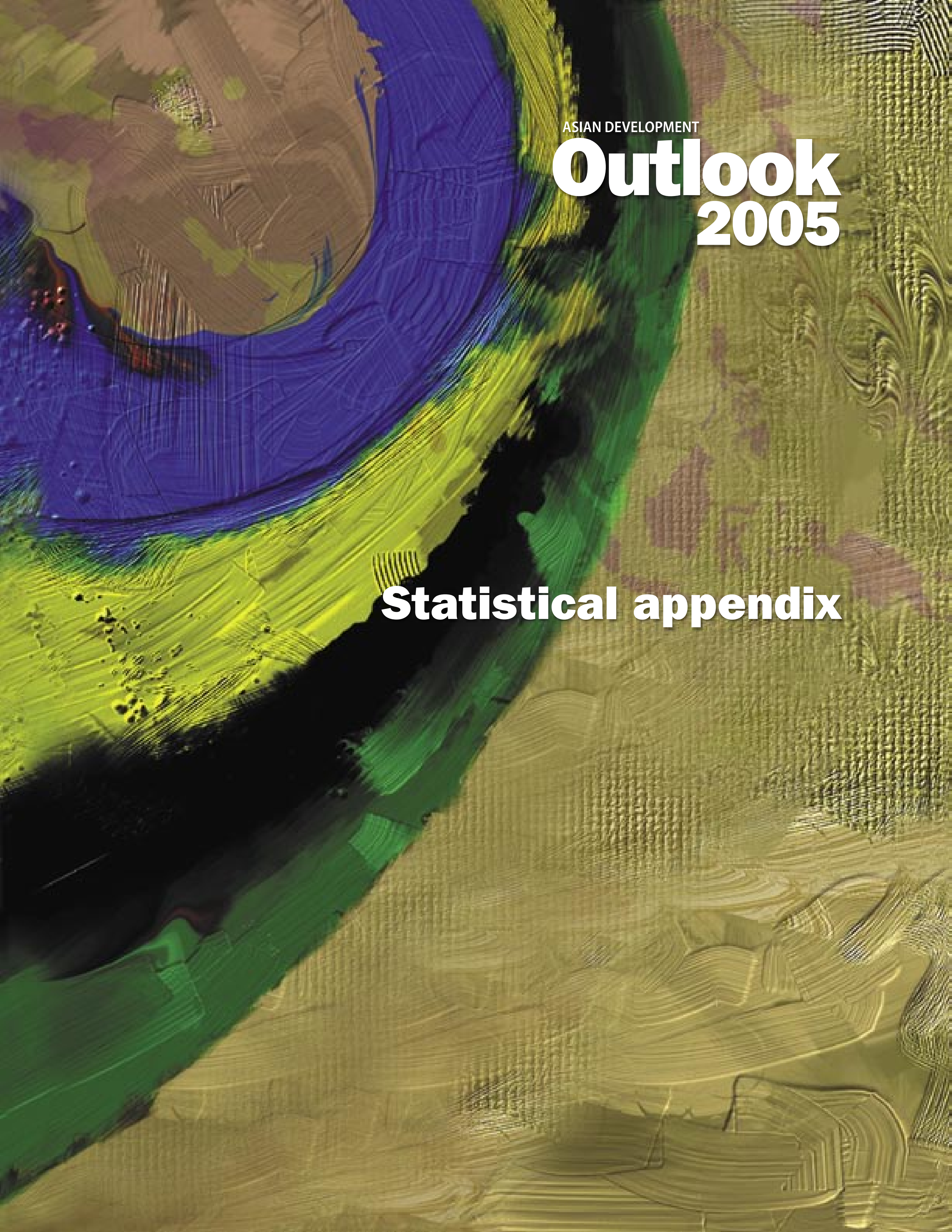

ASIAN DEVELOPMENT

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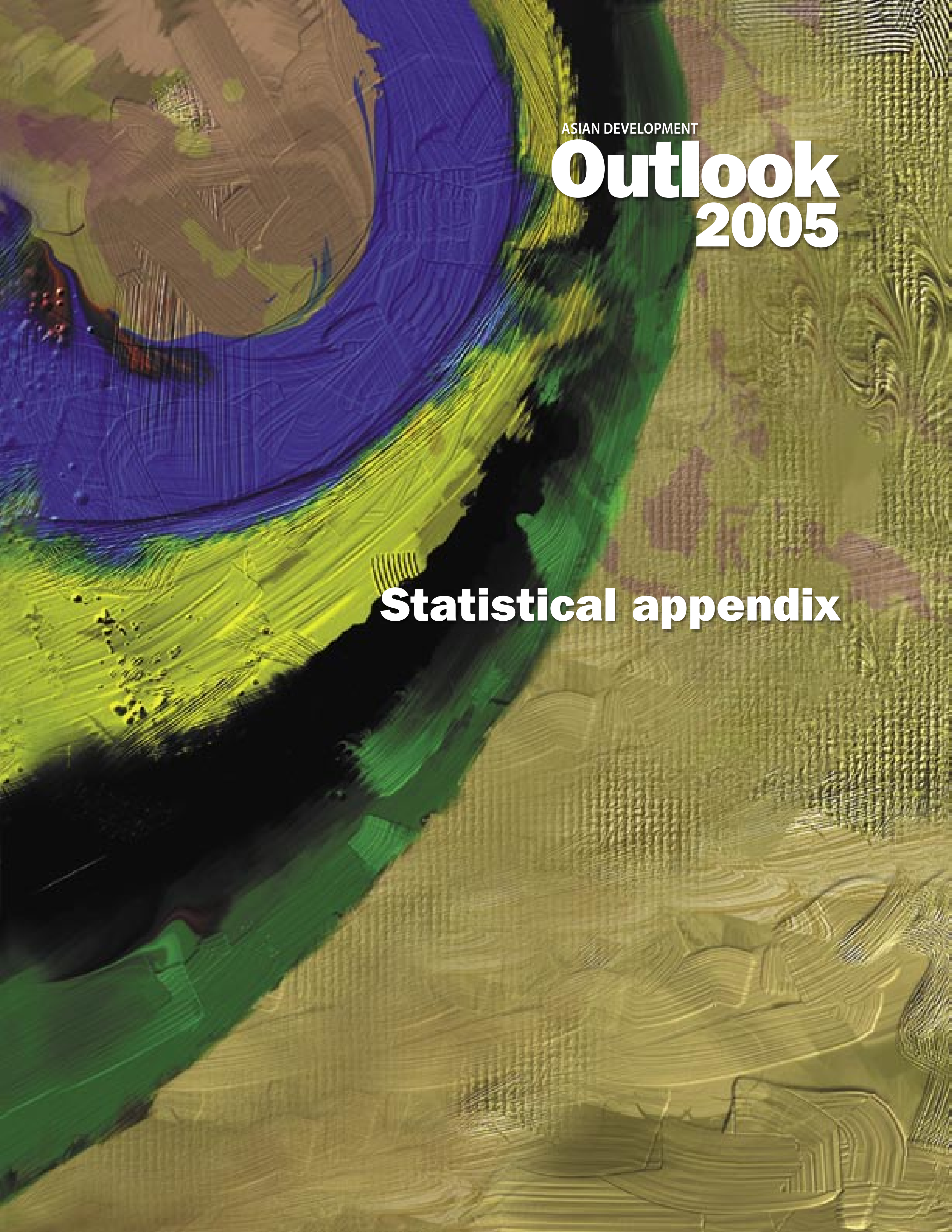
Statistical appendix



ASIAN DEVELOPMENT
Outlook 2005

Statistical appendix

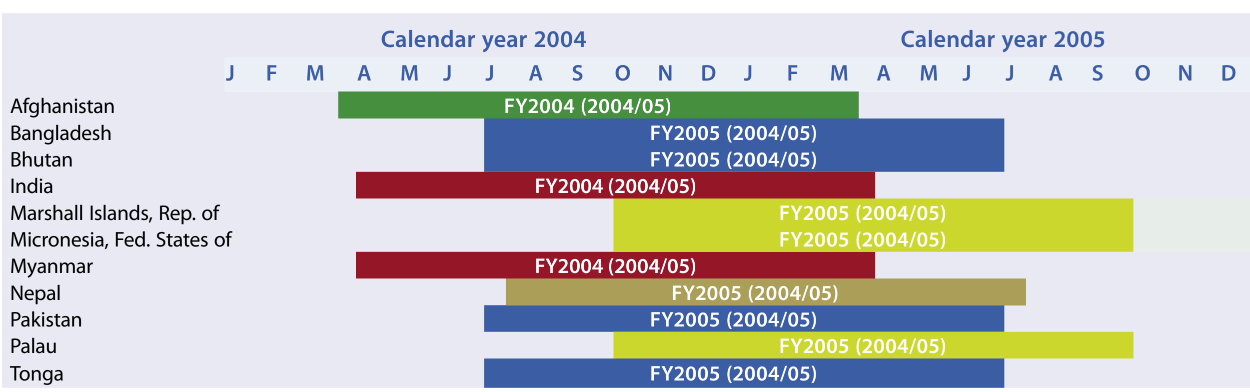
Statistical notes and tables

The statistical appendix presents selected economic indicators for 42 developing member countries (DMCs) of the Asian Development Bank (ADB) in a total of 23 tables. These tables can generally be classified into the following accounts, namely: national accounts, both production and demand sides; labor (unemployment); prices; money supply; components of the balance of payments; external debt and debt service; exchange rates; international liquidity (gross international reserves); and government finance. The DMCs are grouped into five subregions: East Asia, Southeast Asia, South Asia, Central Asia, and the Pacific.

These tables contain historical data from 2000 to 2004. Forecasts for 2005 to 2007 are also provided in the following tables: growth rate of GDP (A1), growth rate of per capita GDP (A2), growth rate of value added in agriculture (A3), growth rate of value added in industry (A4), growth rate of value added in services (A5), gross domestic investment (A7), inflation (A8), changes in money supply (A9), growth rate of merchandise exports (A10), growth rate of merchandise imports (A12), trade balance (A13), current account balance (A14), current account balance as percent of GDP (A15), debt service ratio (A18), central government expenditures (A21), central government revenues (A22), and fiscal balance of central government (A23).

As much as possible, efforts were undertaken to standardize the data to allow comparability over time and across DMCs. However, limitations exist because of differences in statistical methodology, definitions, coverage, and practices. A discussion of the sources, definitions, scope, and nature of data in the 23 tables, as well as the methodology for the computation of regional and subregional averages or totals, follows.

Historical data are obtained from official sources, statistical publications, secondary publications, other working papers, and internal documents of the Asian Development Bank (ADB), International Monetary Fund (IMF), and World Bank. Data for 2004 for Afghanistan, Bhutan, and India are staff estimates. Projections for 2005 to 2007 are staff estimates except Papua New Guinea which used official government projections. Data in the tables are reported either on a calendar year or on a fiscal year basis. The DMCs that record most of their accounts on a calendar year basis (except government finance data, which are reported on a fiscal year basis) are: Cook Islands, Hong Kong, China; Lao People's Democratic Republic (Lao PDR); Samoa; Thailand; and Democratic Republic of Timor-Leste. Palau reports government finance and balance-of-payments data on a fiscal year basis. Some countries record the majority of their accounts on a fiscal year basis (see figure), with



some of their accounts recorded on a calendar year basis, e.g., GDP data for Bhutan.

Regional and subregional averages/totals for DMCs are provided for nine economic indicator tables. Data for Afghanistan, Myanmar, and Nauru are excluded in the computation of subregional averages/totals due to measurement problems. Out of the nine economic indicator tables, six have regional and subregional averages (A1, A2, A8, A10, A12, and A15). Where there are missing data for a given year, regional and subregional averages are computed on the basis of the available information only. Meanwhile, regional and subregional totals are incorporated in three tables (A11, A13, and A14), except that in Table A11 subregional totals are represented in terms of percentage shares of the subregions' exports to DMCs (excluding the PRC), PRC, Japan, United States (US), and the rest of the world relative to the subregions' total exports to the world.

For four tables, (A1, A2, A8, and A15), levels of gross national income (GNI) in current US$ using the World Bank Atlas method are used as weights to calculate the subregional and regional averages. Tables on growth rates of merchandise exports and imports (A10 and A12) do not incorporate weights in the computation of averages; regional and subregional averages in these two tables are computed on the basis of a consistent sum, which means that if there are missing country data for a given year, the sum of the prior year used for computing the growth rate excludes the corresponding country data.

The GNI data, in current US$, for DMCs from 2000 to 2003 were obtained from the World Bank Group WDI Data Query (http://devdata.worldbank.org/data-query/). The most recent data, 2003, are also used to derive the weights for the computation of regional and subregional averages for 2004–2007. The GNI data, in current US$, for three of the DMCs are unavailable, namely Cook Islands; Taipei,China; and Tuvalu. For these economies, GNI data are estimated.

Six tables (A1, A2, A3, A4, A5, and A7) refer to the national income accounts. They show output and sector growth rates, as well as gross domestic investment (GDI) as a percentage of GDP. Definitions relating to output growth, production, and demand, are generally based on the United Nations System of National Accounts.

Sector shares of agriculture, industry, and services for 2003 are, respectively, presented in Tables A3 to A5. For Hong Kong, China, import duties and taxes net of imputed bank service charges are added to the services sector only for the computation of the sector shares to obtain a 100% sum for all sectors. In the case of Korea, the computation of sector shares is based on the share of each sector to the sum of gross value added. To compute the sector shares for Bhutan, Maldives, and Nepal, imputed bank service charges are added to total GDP to obtain a 100% sum for all sectors. In the case of Azerbaijan and Kazakhstan, sums of sector shares do not add up to 100% because of statistical discrepancies and differences in definitions (see below). However, for Azerbaijan and Kazakhstan, where the sum is not equal to 100%, import duties and taxes less imputed bank service charges are excluded in the sector data but are not netted out in the total value of output or GDP.

For Cook Islands, Fiji Islands, Tonga, and Vanuatu, the calculation of sector shares is based on the share of each sector to the sum of gross value added. Data on the sector breakdown of total value of output or GDP in constant prices are not available for Timor-Leste. For Samoa, imputed bank service charges are added to the services sector. For Papua New Guinea, import duties and taxes are excluded in the sector data but are also netted out in the total GDP level so that the sector shares still add up to 100%. For Kiribati, sector breakdown and sector shares are computed based on monetary factor costs, while for Solomon Islands and Tuvalu, sector shares are based on GDP at constant factor costs.

Sector shares are computed based on constant prices except Marshall Islands and Palau where shares are based on current prices. GDP sector breakdown is not available for the Federated States of Micronesia (FSM).

Gross domestic investment (GDI) from the expenditure side of the national income accounts is also presented in Table A7. This represents final expenditures on investment at purchasers' prices. It is presented as a percentage of GDP, valued at current prices.

The following paragraphs examine the tables in more detail.

Table A1: Growth rate of GDP (% per year). This shows annual growth rates of GDP valued

at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most DMCs use constant market price valuation. South Asian countries predominantly use constant factor costs, including Bhutan, India, Nepal, Pakistan, and Sri Lanka, while the Maldives' GDP valuation is at basic prices. Among the Pacific countries, Fiji Islands, Solomon Islands, and Tuvalu employ constant factor cost valuation. For Hong Kong, China, the computations of real GDP and sector growth rates are based on volume indexes.

Table A2: Growth rate of per capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. Data on per capita gross national product in US$ terms for 2003, sourced from the World Bank, are also shown.

Table A3: Growth rate of value added in agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2003. The agriculture sector includes agricultural crops, livestock, poultry, fisheries, and forestry.

Table A4: Growth rate of value added in industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2003. This sector includes the manufacturing and nonmanufacturing subsectors. Mining and quarrying, construction, and utilities fall under the latter subsector.

Table A5: Growth rate of value added in services (% per year). The table gives the growth rates of value added in services and its corresponding share in 2003. Subsectors include trade, banking, finance, real estate, public administration, and other services. For Uzbekistan, construction is included in services.

Table A6: Unemployment rate (%). The unemployment rate is the percentage of the labor force that actively seeks work but is unable to find work at a given time. The unemployment rates of the PRC and Viet Nam refer to unemployment in urban areas only. For Mongolia, the 2003 unemployment rate was sourced from the latest labor force survey which adopts, for the first time, international practices and standards for unemployment computation. For Sri Lanka, data for 2004 refer to the third quarter only. For the Pacific countries, data are primarily obtained from various national censuses, national poverty assessment reports undertaken by the ADB for the period 2002–2003, and the Secretariat of the Pacific Community's Pacific Regional Information System database.

Table A7: Gross domestic investment (% of GDP). This table provides the ratio of GDI to GDP. GDI is the sum of gross fixed capital formation plus changes in inventories. Gross fixed capital formation is measured by the total value of a producer's acquisitions, less disposals, of fixed assets in a given accounting period. Additions to the value of nonproduced assets, e.g., land, form part of gross fixed capital formation. Inventories are stocks of goods held by institutional units to meet temporary or unexpected fluctuations in production and sales. For the Lao PDR, investment approvals based on staff estimates are used as the GDI figure.

Table A8: Inflation (% per year). Except India, which reports the wholesale price index; Kiribati and Solomon Islands, which use the retail price index; and FSM, which uses the implicit GDP deflator, annual inflation rates presented are based on a consumer price index (CPI). For most DMCs, the reported inflation rates represent period averages except Bhutan and the Cook Islands, which use end-of-period data. The data for Singapore are on a calendar year basis, yet the base year used for the computation of inflation rates is November 1997–October 1998. For Palau, the figure for 2004 is as of March only, while the figure for Marshall Islands is as of September only. For Sri Lanka, inflation is calculated using the Sri Lanka CPI (replacing the Colombo CPI), which measures all-island price movements and uses an updated basket of goods with 1995–1997 as the base period. The CPIs of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul, Cambodia is for Phnom

Penh, Kiribati is for Tarawa, Palau is for Koror state, Marshall Islands is for Majuro, Solomon Islands is for Honiara, and Nepal and Papua New Guinea are for urban consumers.

Table A9: Growth in money supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 (for most DMCs). M2 is defined as the sum of M1 and quasi-money where M1 denotes currency in circulation plus demand deposits and quasi-money consists of time and savings deposits including foreign currency deposits. For Korea, M2 includes transferable savings deposits. For Sri Lanka, money supply (M2b) includes time and savings deposits held by commercial banks' foreign currency banking units. For FSM, broad money consists only of deposits, while for India, Kazakhstan, and Philippines, broad money is represented by M3, defined as M2 plus other assets that are less liquid than what would be classified under M2 and M1. For India, 2004 data refer to April 2004–January 2005 only. For Vanuatu, money supply growth for 2004 is as of end-October 2004. For Timor-Leste, M2 excludes currency holdings by the public, for which data are not available.

Tables A10, A12, A13, A14, A15, A16: Balance of payments. This set of tables primarily contains items from the balance of payments (BOP). These items cover the annual flows recorded in the BOP account. Data for Nepal have been revised based on the new BOP format. The revisions are consistent with the fifth edition of IMF's *Balance of Payments Manual*. Substantial changes and additions in almost all BOP items have been implemented in the new format. The new format was implemented for FY2003 data, with the data for FY2001 and FY2002 also being converted to the new format.

Tables A10 and A12: Growth rates of merchandise exports and imports (% per year). The annual growth rates of exports and imports, in terms of merchandise goods only, are shown in these tables. Data are in million US$, primarily obtained from the BOP account of each DMC. Exports in general are reported on a free-on-board (f.o.b.) basis. In this case, exports are valued at the customs frontier of the exporting country plus export duties and the costs of loading the goods onto the carrier unless the latter is borne by the carrier. It excludes the cost of freight and insurance beyond the customs frontier. For Cambodia, exports refer to domestic exports. Import data are reported either on an f.o.b. or c.i.f. (cost, insurance, freight) basis. On a c.i.f. basis, the value of imports includes the cost of international freight and insurance up to the customs frontier of the importing country. It excludes the cost of unloading the goods from the carrier unless it is borne by the carrier.

For East Asia, all economies report imports on an f.o.b. basis except Mongolia which records them on a c.i.f. basis. Imports are valued on an f.o.b. basis for Indonesia, Malaysia, and Viet Nam while the rest of the Southeast Asian countries' imports are valued on a c.i.f. basis. For the Philippines, import data from 2003 were adjusted to correct an understatement of consigned raw materials for electronics exports. Bhutan records imports on c.i.f. basis while Bangladesh, and India, Maldives, Nepal, Pakistan, and Sri Lanka value them on an f.o.b. basis. For 2004, export and import growth rates for India refer to April–September only. For most of the Central Asian republics, all imports are costs on an f.o.b. basis. Most of the Pacific countries report imports on an f.o.b. basis while imports of Cook Islands, Papua New Guinea, and Samoa are recorded on a c.i.f. basis. For Samoa, exports and imports growth for 2004 are computed based on the levels for the first 3 quarters of 2004 only vis-à-vis the levels for the same period in 2003.

Table A11: Direction of exports (% of total). Data for this table are sourced from IMF, *Direction of Trade and Statistics*, CD-ROM (March 2005), with the exception of Taipei,China for which data on exports are sourced from CEIC Data Company Ltd. This table shows the percentage share of exports of each DMC to developing Asia excluding the PRC; PRC only; US; Japan; European Union (EU); and others (or rest of the world). The rest of the world is derived as total exports of DMCs to the world minus their exports among themselves and to US, Japan, and EU.

Table A13: Trade balance (US$ million). The trade balance is the difference between merchandise exports and merchandise imports. Figures on this table are based on the export and import levels used to generate Tables A10

and A12. For the Philippines, the calculation of the trade balance from 2003 includes the understatement adjustment. For Samoa, data for 2004 are as of September only.

Table A14: Current account balance (US$ million). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. In the case of Bangladesh, Cambodia, Lao PDR, Mongolia, and Viet Nam, official transfers are excluded from the current account balance. For the Philippines, the calculation of the current account balance from 2003 includes the consigned raw materials understatement adjustment; inclusion of overseas workers' remittances through informal channels; and revision of trade credits. For Samoa, 2004 data on current account balance include the first 3 quarters only.

Table A15: Current account balance (% of GDP). The values reported in Table 14 are divided by GDP at current prices in US$. In the case of Bhutan, GDP for the previous calendar year is used as the denominator.

Table A16: Foreign direct investment (US$ million). Foreign direct investment refers to equity capital, reinvested earnings, and other capital associated with the transactions of the enterprises, net of repatriations and intercompany loan repayments. For the PRC, foreign direct investment refers to investments of foreign enterprises, economic organizations, and individuals through joint ventures and cooperation; reinvested earnings; and enterprises' borrowings from abroad under approved investment projects. Data on foreign direct investment for Korea comprise equity purchases and long-term, intercompany loans. In the case of Cambodia and the Lao PDR, gross capital flows, instead of net capital flows, are presented. For Bangladesh, only those capital investments passing through banking channels are reported. Data for the Maldives are derived from the United Nations Conference on Trade and Development (UNCTAD) *World Investment Report 2004* and refer to gross inflows.

Table A17: External debt outstanding (US$ million). For most DMCs, external debt outstanding—public and private—includes long-term debt, short-term debt, and IMF credit. The external debt reported by Cambodia and the Lao PDR also excludes that owed to the Russian Federation and the US. For 2004, the external debt figures for the Philippines and Taipei,China are as of end-September only. Data for the Maldives are for the public sector only. Total external debt outstanding for the Fiji Islands includes external debt of the Government, statutory bodies, and the private sector. The FSM's data on external debt are unadjusted for offsetting assets. For Samoa, the figure for 2004 is as of end-September 2004 only.

Table A18: Debt service ratio (% of exports of goods and services). This table presents the total debt service payments of each DMC as a percentage of exports of goods and services. Total debt service payments comprise principal repayments (excluding on short-term debt) and interest payments on outstanding external debt. For Taipei,China, the debt service refers to external public debt only and its 2004 figure is as of end-September only. Exports of goods are used as the denominator in the calculation of the ratio for PRC, Mongolia, Pakistan, Papua New Guinea, and Viet Nam. For the Philippines, exports of goods and services, income receipts, and workers' remittances under current transfers are used as the denominator in the calculation of the ratio. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and workers' remittances. For Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A19: Exchange rates to the US dollar (annual average). The annual average exchange rates of the DMCs are quoted in local currencies per US dollar. For India, the average is based on data from April 2004–February 2005 only. The data for the Cook Islands are in calendar years during 2000–2004. Data for the Fiji Islands are end-period rates. For Samoa, the exchange rate in 2004 was computed using monthly averages from January to September and end-month rates from October to December.

Table A20: Gross international reserves (US$ million). Gross international reserves (GIR) are defined as the US$ value of holdings of special drawing rights (SDR), reserve position in IMF, foreign exchange, and gold at the end of a given period. Most DMCs report GIR without

gold. However, for Southeast Asian countries, gold is included in the computation of gross international reserves. For a few countries, GIR data are reported as of the end of the fiscal year as indicated in the figure at the start of these notes. For Taipei,China, GIR refers to foreign exchange reserves only. For India, GIR refers to foreign currency assets, and data for the fiscal year are until 11 March 2005 only. For the Maldives, GIR comprises foreign assets of the Maldives Monetary Authority. For Pakistan, GIR consists of net foreign reserves with the State Bank of Pakistan. For Azerbaijan, GIR includes Oil Fund assets. GIR data for Fiji Islands, Samoa, Solomon Islands, Timor-Leste, Tonga, and Vanuatu refer to gross official foreign exchange reserves. For Kiribati, GIR refers to total official external assets. For Vanuatu, data reported for 2004 cover the period until September 2004 only. In the case of Papua New Guinea, GIR includes the Bank of Papua New Guinea's holdings of gold.

Tables A21, A22, and A23: Government finance. This set of tables refers to the revenue and expenditure transactions as well as the fiscal balance of the central government. For Azerbaijan, PRC, India, Mongolia, Kazakhstan, and Tajikistan, transactions are those reported by the general government. The shares of these major fiscal items as against GDP are calculated for this group of tables. For Bhutan, ratios are calculated relative to the previous calendar year's GDP.

Table A21: Central government expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a percentage of GDP at current prices. For Singapore, expenditures refer to outlays made from the Consolidated Revenue Account, Development Fund Account and Sinking Fund Account plus net lending minus repayments. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditure and corresponding borrowing. For Bangladesh, expenditures include a residual. One-time expenditures are excluded but a statistical discrepancy is included for Pakistan. For Tuvalu, Tuvalu Trust Fund transfers are excluded.

Table A22: Central government revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For Singapore, revenue refers to receipts credited to Consolidated Revenue Account, Development Fund Account and Sinking Fund Account, including investment income, capital receipts, and investment adjustments. In some countries, other revenue items are included or excluded in the reported revenue figures: social security contributions are excluded for Korea; grants are excluded for Cambodia, Lao PDR, Malaysia, Singapore, Thailand, and Viet Nam; capital receipts are excluded but revenues from disinvestment are included for India; only current revenues are included for Bangladesh and Pakistan; privatization proceeds are excluded for Sri Lanka; sales from assets are excluded for the Fiji Islands; the Revenue Equalization Reserve Fund income is included for Kiribati; the Compact Trust Fund is included for the Marshall Islands; and Consolidated Investment Fund drawdowns are included for Tuvalu. The series for Sri Lanka has been revised to include grants.

Table A23: Fiscal balance of central government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures presented in nominal local currency. The difference is also computed as a share of GDP. Data variations may arise due to statistical discrepancies, e.g., balancing items for both central and local governments, and differences in the concept used in the individual computations of revenue and expenditures as compared with the calculation of the fiscal balance. For Hong Kong, China, the fiscal balance excludes the proceeds from bond issuances. For Singapore, the net investment income contribution is included in the computation of the fiscal balance in 2002 and 2003. For Thailand, the fiscal balance is a cash balance composed of the budgetary balance and nonbudgetary balance. The series for Sri Lanka has been revised to include grants. For Kazakhstan, privatization proceeds are treated as financing items rather than revenues in 2002. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan. For the Fiji Islands, the computation of the fiscal balance does not include the proceeds from the sale of assets.

Table A1 Growth rate of GDP (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	8.0	4.7	6.9	6.7	7.8	6.7	7.0	7.2
China, People's Rep. of	8.0	7.5	8.3	9.3	9.5	8.5	8.7	8.9
Hong Kong, China	10.2	0.5	1.9	3.2	8.1	5.7	4.1	5.6
Korea, Rep. of	8.5	3.8	7.0	3.1	4.6	4.1	5.1	4.9
Mongolia	1.1	1.0	4.0	5.6	10.6	7.0	6.3	7.5
Taipei,China	5.8	-2.2	3.9	3.3	5.7	4.2	4.5	4.6
Southeast Asia	6.7	1.8	4.5	5.0	6.3	5.4	5.6	5.9
Cambodia	7.0	5.6	5.5	5.2	6.0	2.3	4.1	4.7
Indonesia	-	3.8	4.3	5.0	5.1	5.5	6.0	6.5
Lao People's Dem. Rep.	5.8	5.8	5.9	5.9	6.5	7.0	6.5	5.8
Malaysia	8.9	0.3	4.1	5.3	7.1	5.7	5.3	5.8
Myanmar	13.7	11.3	12.0	13.8	12.6	-	-	-
Philippines	4.4	1.8	4.3	4.7	6.1	5.0	5.0	5.0
Singapore	9.7	-1.8	3.2	1.4	8.4	4.1	4.5	4.4
Thailand	4.8	2.2	5.3	6.9	6.1	5.6	5.8	6.0
Viet Nam	6.1	5.8	6.4	7.1	7.5	7.6	7.6	7.5
South Asia	4.5	5.2	3.9	7.8	6.4	6.7	6.2	6.9
Afghanistan	-	-	28.6	15.7	7.5	11.3	10.0	9.6
Bangladesh	5.9	5.3	4.4	5.3	5.5	5.3	6.0	6.0
Bhutan	5.5	7.1	6.7	6.5	7.0	8.0	8.0	8.0
India	4.4	5.8	4.0	8.5	6.5	6.9	6.1	7.0
Maldives	4.8	3.5	6.5	8.4	8.8	1.0	9.0	8.0
Nepal	6.0	4.8	-0.4	2.9	3.3	3.0	3.7	4.3
Pakistan	3.9	1.8	3.1	5.1	6.4	7.0	7.0	7.5
Sri Lanka	6.0	-1.5	4.0	5.9	5.5	5.2	5.8	5.9
Central Asia	8.4	10.8	9.3	10.0	10.4	8.7	8.8	9.2
Azerbaijan	11.1	9.9	10.6	11.1	10.2	14.5	19.0	22.0
Kazakhstan	9.8	13.5	9.8	9.2	9.4	8.5	8.0	8.0
Kyrgyz Republic	5.4	5.3	0.0	7.0	7.1	5.0	5.5	5.5
Tajikistan	8.3	10.2	9.5	10.2	10.6	8.0	6.8	5.9
Turkmenistan	18.6	20.4	19.8	23.0	21.0	10.0	7.0	6.3
Uzbekistan	3.9	4.1	4.0	4.1	7.7	5.0	6.0	6.5
The Pacific	-0.2	2.4	-4.4	2.6	2.6	2.3	1.4	2.1
Cook Islands	13.9	4.9	3.9	3.1	3.4	3.2	3.0	3.0
Fiji Islands	-2.8	2.7	4.3	3.0	3.8	1.5	0.7	1.0
Kiribati	-3.0	-1.9	12.3	2.5	1.8	1.5	1.5	1.5
Marshall Islands, Rep. of	0.0	-3.5	4.0	2.0	-1.5	-	-	-
Micronesia, Fed. States of	8.9	0.1	0.8	3.2	-3.3	2.3	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-	3.8	-4.7	-0.1	2.0	2.0	2.0	2.0
Papua New Guinea	0.0	2.7	-13.2	2.8	2.6	2.9	1.7	2.6
Samoa	6.1	6.8	1.2	3.5	2.3	2.5	3.0	3.0
Solomon Islands	-10.6	-4.4	-0.5	5.3	4.6	2.9	2.6	5.6
Timor-Leste, Dem. Rep. of	-	6.4	-6.5	-4.4	1.5	0.5	3.0	4.5
Tonga	5.6	2.5	2.6	3.1	1.6	2.8	-	-
Tuvalu	13.4	5.9	1.2	3.0	-4.0	-	-	-
Vanuatu	2.6	-2.1	-2.8	1.6	2.2	2.5	2.2	2.2
Average	7.1	4.4	6.0	6.7	7.3	6.5	6.6	6.9

- = not available.

Table A2 Growth rate of per capita GDP (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007	Per Capita GNP, $, 2003
East Asia	7.2	4.0	6.4	6.1	7.2	6.0	6.4	6.7	
China, People's Rep. of	7.2	6.8	7.7	8.7	8.9	7.8	8.1	8.3	1,100
Hong Kong, China	9.3	-0.4	1.0	2.9	7.0	5.6	2.9	5.9	25,430
Korea, Rep. of	7.6	3.1	6.3	2.6	4.2	3.5	4.7	4.5	12,020
Mongolia	-0.2	-0.2	3.2	4.8	9.8	7.4	-	-	480
Taipei,China	5.0	-3.0	3.9	2.9	5.3	3.1	4.1	4.6	13,139
Southeast Asia	5.0	0.1	2.9	3.6	4.9	3.8	4.0	4.3	
Cambodia	5.1	3.7	3.6	3.5	4.2	0.5	2.2	2.8	310
Indonesia	-	2.4	2.8	3.4	3.7	4.0	4.5	5.0	810
Lao People's Dem. Rep.	3.9	3.8	3.8	3.8	3.8	3.8	3.7	3.0	320
Malaysia	5.2	-1.8	2.0	3.1	4.8	3.5	3.1	3.6	3,780
Myanmar	11.5	9.1	9.8	11.6	-	-	-	-	-
Philippines	2.0	0.9	2.0	2.3	3.7	2.6	2.6	2.6	1,080
Singapore	7.9	-4.5	1.8	1.4	7.0	2.6	3.0	2.9	21,230
Thailand	4.6	0.5	4.5	5.9	5.7	4.7	5.0	5.2	2,190
Viet Nam	4.6	4.2	5.3	5.6	5.8	6.3	5.3	6.2	480
South Asia	2.7	3.4	2.1	6.0	4.6	4.7	3.9	4.8	
Afghanistan	-	-	-	13.6	2.9	-	-	-	-
Bangladesh	4.5	3.8	3.0	3.9	4.1	-	-	-	400
Bhutan	2.5	3.5	4.1	3.9	4.0	-	-	-	660
India	2.5	3.9	2.2	6.7	4.7	-	-	-	530
Maldives	2.7	1.7	4.8	6.7	7.1	-	-	-	2,300
Nepal	3.5	3.4	-2.4	0.6	0.8	1.0	1.3	-	240
Pakistan	1.6	-0.2	1.1	3.1	4.4	5.1	-	-	470
Sri Lanka	4.5	-2.9	2.5	4.6	4.4	4.7	4.7	4.8	930
Central Asia	7.8	12.9	9.3	8.9	8.9	9.4	9.8	10.4	
Azerbaijan	10.2	9.1	9.7	10.2	9.1	13.6	18.1	21.1	810
Kazakhstan	10.2	13.8	9.6	8.6	8.5	8.4	7.8	7.9	1,780
Kyrgyz Republic	4.6	4.5	-0.8	5.3	5.9	-	-	-	330
Tajikistan	12.0	13.0	14.0	15.0	16.2	-	-	-	190
Turkmenistan	13.9	16.9	-	-	-	-	-	-	1,120
Uzbekistan	2.7	2.9	2.8	2.9	-	-	-	-	420
The Pacific	-2.5	0.3	-6.5	1.0	-0.6	0.0	-1.1	0.0	
Cook Islands	20.9	2.2	5.3	9.8	4.8	3.2	-	-	-
Fiji Islands	-3.3	2.1	2.9	2.3	3.3	-	-	-	2,360
Kiribati	-4.7	-4.2	9.6	0.0	-0.6	-	-	-	880
Marshall Islands, Rep. of	-3.5	-6.9	0.2	-1.9	-5.3	-	-	-	2,710
Micronesia, Fed. States of	8.6	-0.1	0.5	2.9	-3.5	2.0	-	-	2,090
Nauru	-	-	-	-	-	-	-	-	-
Palau, Rep. of	-	1.9	-6.3	-1.7	0.5	0.6	0.8	0.9	7,500
Papua New Guinea	-3.8	-0.3	-15.7	0.6	-0.4	-0.1	-1.3	-0.4	510
Samoa	5.0	6.6	0.1	2.4	-	-	-	-	1,600
Solomon Islands	-12.7	-6.7	-2.8	2.8	1.5	-0.1	-0.4	2.5	600
Timor-Leste, Dem. Rep. of	-	2.2	-10.2	-8.1	-2.6	-2.4	0.0	1.5	430
Tonga	5.2	2.2	2.3	2.7	1.2	2.4	-	-	1,490
Tuvalu	13.4	7.9	3.8	-	-	-	-	-	-
Vanuatu	-0.1	-4.6	-5.4	-1.0	-0.4	-0.2	-0.5	-	1,180
Average	6.0	3.4	5.0	5.7	6.3	5.4	5.6	6.0	

- = not available.

Table A3 Growth rate of value added in agriculture (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007	Sector Share 2003, %
East Asia									
China, People's Rep. of	2.4	2.8	2.9	2.5	6.3	4.6	4.1	4.1	10.2
Hong Kong, China	-	4.1	-0.7	-5.6	0.7	-	-	-	0.1
Korea, Rep. of	1.2	1.1	-3.5	-5.3	7.4	-7.3	5.9	2.0	3.9
Mongolia	-14.9	-18.5	-10.5	5.6	18.9	-	-	-	23.6
Taipei,China	1.0	-1.9	4.5	0.2	-7.1	-1.4	-1.0	-1.8	1.9
Southeast Asia									
Cambodia	-1.5	2.3	-3.2	9.6	-2.4	3.2	3.5	3.7	36.6
Indonesia	-	4.1	2.8	4.8	4.0	4.0	4.0	4.0	15.4
Lao People's Dem. Rep.	4.9	3.8	4.0	2.2	3.5	4.1	3.0	3.0	48.6
Malaysia	6.1	-0.6	2.6	5.7	5.0	2.1	1.6	1.5	8.1
Myanmar	11.0	8.7	6.0	11.7	-	-	-	-	51.9
Philippines	3.4	3.7	3.8	3.8	4.9	4.0	4.0	4.0	19.9
Singapore	-4.9	-5.9	-5.6	-0.7	11.4	-1.5	-1.5	-1.5	0.1
Thailand	7.2	3.2	1.0	8.7	-4.4	1.0	4.0	3.0	10.2
Viet Nam	4.0	2.3	3.0	3.1	2.8	2.6	2.7	2.7	21.1
South Asia									
Afghanistan	-	-	-	13.3	-16.8	4.0	4.8	4.8	49.2
Bangladesh	7.4	3.1	0.0	3.1	2.7	0.4	3.5	3.0	23.5
Bhutan	4.5	3.2	2.6	4.0	3.5	-	-	-	31.0
India	-0.1	6.3	-7.0	9.6	0.6	4.4	3.9	3.4	21.7
Maldives	-0.7	5.1	15.9	1.9	2.9	-	-	-	9.4
Nepal	4.9	5.5	2.2	2.5	3.9	3.0	3.5	3.5	38.8
Pakistan	6.1	-2.2	0.1	4.1	2.6	5.0	-	-	24.2
Sri Lanka	1.8	-3.4	2.5	1.5	-1.8	0.5	2.0	2.0	19.0
Central Asia									
Azerbaijan	12.6	11.1	6.4	5.6	4.6	4.5	4.0	4.0	14.1
Kazakhstan	-3.2	17.1	3.4	1.4	0.1	2.1	3.0	2.5	7.3
Kyrgyz Republic	2.6	7.3	3.1	3.2	4.1	-	-	-	50.9
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	3.2	4.1	6.0	6.8	10.1	-	-	-	28.6
The Pacific									
Cook Islands	0.1	-2.9	9.4	4.0	-	-	-	-	13.1
Fiji Islands	-1.2	-5.8	4.3	-3.9	3.7	2.1	6.7	1.0	14.7
Kiribati	-44.5	-21.8	105.1	-	-	-	-	-	-
Marshall Islands, Rep. of	8.3	9.7	10.3	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Palau, Rep. of	3.1	2.7	-2.4	0.3	-	-	-	-	4.1
Papua New Guinea	2.1	-4.7	-4.1	3.5	3.0	3.0	3.2	3.3	38.0
Samoa	0.1	-3.9	-6.3	-0.6	-	-	-	-	14.1
Solomon Islands	-14.0	-1.5	4.6	13.0	5.8	1.9	2.7	8.2	50.3
Timor-Leste, Dem. Rep. of	-	8.7	6.0	-0.4	-	-	-	-	25.0
Tonga	5.6	1.0	3.6	3.8	-	-	-	-	26.4
Tuvalu	-2.0	-2.7	-9.4	-	-	-	-	-	-
Vanuatu	7.3	0.5	1.7	8.7	3.3	3.5	2.5	2.5	19.9

- = not available.

Table A4 Growth rate of value added in industry (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007	Sector Share 2003, %
East Asia									
China, People's Rep. of	9.4	8.4	9.8	12.7	11.1	9.3	9.8	10.1	68.0
Hong Kong, China	-	-3.7	-3.7	-4.8	-1.6	-	-	-	11.3
Korea, Rep. of	11.7	3.1	6.4	6.1	9.0	3.7	0.4	1.3	41.5
Mongolia	7.4	11.9	4.7	1.9	15.4	-	-	-	27.1
Taipei,China	5.9	-6.6	6.0	4.5	8.3	4.2	4.1	4.5	32.1
Southeast Asia									
Cambodia	30.8	13.3	17.7	6.6	16.9	-2.0	2.9	4.0	28.1
Indonesia	-	2.7	4.4	3.8	3.9	4.2	4.8	5.4	45.0
Lao People's Dem. Rep.	8.5	10.1	10.1	11.5	11.4	11.9	11.5	9.8	25.9
Malaysia	13.6	-3.8	4.1	7.2	7.9	6.2	6.1	6.4	42.2
Myanmar	21.3	21.8	35.0	20.7	-	-	-	-	13.6
Philippines	4.9	-2.5	3.6	3.8	5.3	4.0	4.0	4.0	33.5
Singapore	11.1	-8.9	3.2	0.5	9.9	4.9	5.1	5.0	31.1
Thailand	5.3	1.7	6.9	9.4	8.2	8.0	7.0	7.5	45.8
Viet Nam	9.6	9.7	8.9	9.6	10.2	10.1	9.9	9.7	38.7
South Asia									
Afghanistan	-	-	-	11.9	29.6	16.7	13.7	15.3	19.6
Bangladesh	6.2	7.4	6.5	7.3	7.7	7.8	8.0	8.0	27.2
Bhutan	3.9	13.7	17.9	7.3	9.6	-	-	-	35.1
India	6.5	3.6	6.6	6.6	8.0	6.7	5.2	6.7	26.9
Maldives	1.6	8.1	10.4	7.5	9.9	-	-	-	14.9
Nepal	8.7	3.2	-2.9	3.0	1.0	2.4	3.5	4.0	22.9
Pakistan	1.3	3.6	2.6	5.8	13.1	10.0	-	-	23.1
Sri Lanka	7.5	-2.1	1.0	5.5	5.4	6.1	6.3	6.8	26.5
Central Asia									
Azerbaijan	5.7	7.3	17.7	15.0	12.2	18.0	25.5	30.5	53.7
Kazakhstan	15.5	13.5	10.4	9.1	10.1	8.8	8.7	8.5	35.1
Kyrgyz Republic	6.0	5.4	-10.7	15.6	3.5	-	-	-	17.2
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	1.3	2.7	3.4	2.8	5.8	-	-	-	15.8
The Pacific									
Cook Islands	18.2	13.3	5.0	2.7	-	-	-	-	9.0
Fiji Islands	-7.9	9.1	2.9	5.1	7.5	2.6	-2.8	-0.7	25.4
Kiribati	-18.5	26.5	37.8	-	-	-	-	-	-
Marshall Islands, Rep. of	16.4	18.6	19.5	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Palau, Rep. of	5.0	5.6	-5.0	1.9	-	-	-	-	12.7
Papua New Guinea	-0.5	8.3	-25.1	18.5	2.1	3.4	-0.9	1.8	33.5
Samoa	13.0	12.2	0.1	5.0	-	-	-	-	26.5
Solomon Islands	-17.0	-15.3	2.4	5.5	9.0	3.4	2.9	9.5	6.6
Timor-Leste, Dem. Rep. of	-	-18.6	-8.1	-4.0	-	-	-	-	26.0
Tonga	1.5	1.5	5.0	4.4	-	-	-	-	16.2
Tuvalu	13.3	10.3	6.5	-	-	-	-	-	-
Vanuatu	2.1	-4.7	-5.9	-1.1	1.8	1.5	1.5	1.6	8.5

- = not available.

Table A5 Growth rate of value added in services (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007	Sector Share 2003, %
East Asia									
China, People's Rep. of	8.1	8.4	8.7	7.3	8.3	8.5	8.3	8.2	24.3
Hong Kong, China	-	1.6	3.1	4.3	8.9	-	-	-	88.6
Korea, Rep. of	6.1	4.8	7.8	1.6	1.3	5.9	5.2	6.8	54.6
Mongolia	17.0	10.0	12.0	7.0	4.0	-	-	-	49.3
Taipei,China	5.9	-0.1	3.0	2.9	4.8	4.4	4.8	4.8	66.0
Southeast Asia									
Cambodia	5.6	4.2	4.3	2.1	7.3	5.0	5.5	6.0	35.3
Indonesia	-	5.0	4.7	6.5	6.9	7.5	8.0	8.5	39.6
Lao People's Dem. Rep.	4.9	5.7	5.7	7.5	7.3	7.3	7.0	6.0	25.5
Malaysia	6.0	6.2	6.4	4.3	6.6	5.7	5.5	5.7	49.8
Myanmar	13.4	12.9	14.8	14.5	-	-	-	-	34.5
Philippines	4.4	4.3	5.1	5.8	7.3	7.0	7.0	7.0	46.7
Singapore	7.9	2.7	3.0	1.4	7.2	3.8	4.3	4.1	68.8
Thailand	3.7	2.4	4.8	4.0	6.2	4.0	5.0	5.0	44.0
Viet Nam	4.5	4.4	6.0	6.8	7.4	7.6	7.6	7.5	40.2
South Asia									
Afghanistan	-	-	-	19.3	27.6	14.9	11.7	9.9	31.3
Bangladesh	5.5	5.5	5.4	5.4	5.7	6.0	5.8	6.0	49.3
Bhutan	8.7	7.6	-2.3	7.8	8.0	-	-	-	33.9
India	5.5	6.8	7.9	9.1	8.2	7.7	7.3	8.4	51.4
Maldives	6.0	2.4	4.7	9.6	9.4	-	-	-	75.7
Nepal	5.7	5.3	-1.4	3.3	4.3	3.2	4.3	5.0	38.3
Pakistan	4.2	3.1	4.8	5.3	5.2	6.5	-	-	52.8
Sri Lanka	7.0	-0.5	6.0	7.8	8.1	6.3	6.6	6.5	54.5
Central Asia									
Azerbaijan	9.4	7.9	5.9	7.6	7.7	11.0	17.0	11.0	32.8
Kazakhstan	8.7	13.0	10.9	10.4	10.8	9.0	9.2	9.5	57.0
Kyrgyz Republic	5.8	3.3	4.2	7.3	11.7	-	-	-	31.9
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	22.8	19.4	13.8	17.8	26.8	-	-	-	41.9
The Pacific									
Cook Islands	1.2	15.4	5.0	2.8	-	-	-	-	77.9
Fiji Islands	0.0	3.1	4.3	3.2	1.9	0.9	0.8	1.7	59.9
Kiribati	2.1	-2.3	8.0	-	-	-	-	-	-
Marshall Islands, Rep. of	69.5	68.9	68.5	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Palau, Rep. of	3.1	2.8	-4.7	1.3	-	-	-	-	83.2
Papua New Guinea	-1.6	5.7	-17.3	-0.1	2.0	2.0	2.4	2.4	28.5
Samoa	5.2	7.6	3.7	3.9	-	-	-	-	59.4
Solomon Islands	-6.2	-5.4	-5.5	-2.4	2.4	4.1	2.4	1.9	43.0
Timor-Leste, Dem. Rep. of	-	24.6	-10.7	-6.4	-	-	-	-	49.0
Tonga	6.6	3.4	1.6	2.2	-	-	-	-	57.4
Tuvalu	19.1	6.3	3.4	-	-	-	-	-	-
Vanuatu	1.4	-1.8	-3.9	0.1	1.9	2.1	2.0	2.0	71.6

- = not available.

Table A6 Unemployment rate (%)

	2000	2001	2002	2003	2004
East Asia					
China, People's Rep. of	3.1	3.6	4.0	4.3	4.2
Hong Kong, China	4.9	5.1	7.3	7.9	6.8
Korea, Rep. of	4.1	3.8	3.1	3.4	3.5
Mongolia	4.7	4.6	3.3	14.2	-
Taipei,China	3.0	4.6	5.2	5.0	4.4
Southeast Asia					
Cambodia	2.5	2.8	3.0	3.5	3.1
Indonesia	6.1	8.1	8.9	9.1	9.6
Lao People's Dem. Rep.	-	-	-	-	-
Malaysia	3.1	3.6	3.4	3.6	3.5
Myanmar	-	-	-	-	-
Philippines	11.1	11.1	11.4	11.4	11.8
Singapore	3.1	3.3	4.4	4.7	4.0
Thailand	3.6	3.3	2.4	2.2	2.1
Viet Nam	6.4	6.3	6.0	5.8	5.6
South Asia					
Afghanistan	-	3.4	3.4	3.3	3.4
Bangladesh	3.6	-	-	-	-
Bhutan	-	-	-	-	2.9
India	-	-	-	-	-
Maldives	-	2.0	-	-	-
Nepal	-	-	-	-	-
Pakistan	7.8	7.8	8.3	8.3	7.7
Sri Lanka	7.6	7.9	8.8	8.4	8.4
Central Asia					
Azerbaijan	1.2	1.3	1.4	1.4	1.5
Kazakhstan	12.8	10.4	9.4	8.8	8.4
Kyrgyz Republic	7.6	7.8	8.6	9.0	-
Tajikistan	2.7	2.3	2.5	2.5	2.0
Turkmenistan	2.4	2.6	2.5	-	-
Uzbekistan	0.3	0.3	0.3	0.2	0.2
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	27.0	-	-	-	-
Kiribati	1.5	-	-	-	-
Marshall Islands, Rep. of	-	-	-	-	-
Micronesia, Fed. States of	22.0	-	-	-	-
Nauru	-	-	-	-	-
Palau, Rep. of	2.3	-	-	-	-
Papua New Guinea	2.8	-	-	-	-
Samoa	-	4.9	-	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	5.3	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-	-	-	-	-

- = not available.

Table A7 Gross domestic investment (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	36.3	38.5	40.2	43.8	45.6	44.7	43.8	41.0
Hong Kong, China	28.1	25.9	23.4	22.8	23.0	23.5	23.3	22.6
Korea, Rep. of	31.0	29.3	29.1	30.0	29.1	30.3	30.4	30.2
Mongolia	26.1	28.3	29.0	27.0	27.0	27.0	28.0	28.0
Taipei,China	22.8	17.7	16.7	16.6	20.7	20.8	20.9	21.5
Southeast Asia								
Cambodia	17.2	21.2	22.2	21.0	20.7	18.5	19.0	19.5
Indonesia	21.3	23.5	20.4	17.3	21.3	22.3	24.2	26.1
Lao People's Dem. Rep.	20.5	21.0	21.2	21.2	22.0	22.0	20.7	20.7
Malaysia	27.1	23.9	23.8	21.4	22.5	21.6	21.0	21.5
Myanmar	12.4	11.6	10.1	11.0	-	-	-	-
Philippines	18.4	19.0	17.6	16.6	17.0	18.5	19.0	19.5
Singapore	32.4	26.0	22.8	14.8	18.3	21.7	23.0	24.1
Thailand	22.8	24.1	23.9	25.0	27.1	24.0	26.0	27.0
Viet Nam	23.7	25.7	31.3	33.7	35.5	36.1	37.1	37.7
South Asia								
Afghanistan	-	-	28.3	27.2	21.9	28.6	28.0	24.7
Bangladesh	23.0	23.1	23.1	23.4	23.6	24.0	26.0	26.0
Bhutan	48.4	52.0	53.3	-	-	-	-	-
India	23.8	22.6	24.8	26.3	26.5	26.5	27.0	27.5
Maldives	26.3	28.1	25.5	27.2	36.1	-	-	-
Nepal	24.3	24.1	24.1	26.0	27.3	26.2	28.0	29.9
Pakistan	17.4	17.2	16.8	16.7	18.1	20.7	22.0	22.7
Sri Lanka	28.0	22.0	21.3	22.3	25.9	27.0	27.0	27.0
Central Asia								
Azerbaijan	20.7	20.7	34.6	51.2	40.0	35.0	30.0	30.0
Kazakhstan	18.1	26.9	27.3	26.3	25.1	25.9	26.4	25.4
Kyrgyz Republic	20.0	18.0	17.6	16.2	19.0	22.4	22.6	22.7
Tajikistan	11.6	16.6	-	-	-	-	-	-
Turkmenistan	39.2	37.6	-	-	15.6	-	-	-
Uzbekistan	19.6	21.1	21.2	20.8	23.9	-	-	-
The Pacific								
Cook Islands	-	-	-	-	-	-	-	-
Fiji Islands	11.5	13.7	-	16.0	17.0	-	-	-
Kiribati	-	-	-	-	-	-	-	-
Marshall Islands, Rep. of	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-	-	-	-
Papua New Guinea	21.3	21.8	22.5	-	-	-	-	-
Samoa	-	-	-	-	-	-	-	-
Solomon Islands	-	-	-	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	30.2	33.5	29.6	-	-	-	-
Tonga	-	-	-	-	-	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-	-	-	-	-	-	-	-

- = not available.

Table A8 Inflation (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	0.6	1.2	0.0	1.3	3.3	3.1	3.0	3.0
China, People's Rep. of	0.4	0.7	-0.8	1.2	3.9	3.6	3.3	3.2
Hong Kong, China	-3.7	-1.6	-3.0	-2.5	-0.4	1.5	1.6	2.1
Korea, Rep. of	2.3	4.1	2.7	3.6	3.6	3.0	3.3	3.6
Mongolia	11.6	8.0	1.6	4.7	10.6	5.0	5.0	5.0
Taipei,China	1.3	0.0	-0.2	-0.3	1.6	1.7	1.5	1.5
Southeast Asia	2.3	4.6	4.4	3.3	4.2	4.3	3.9	3.8
Cambodia	-0.9	0.3	3.3	1.2	3.9	3.5	3.0	3.0
Indonesia	3.8	11.5	11.9	6.6	6.2	5.9	5.4	5.5
Lao People's Dem. Rep.	8.4	7.8	10.7	15.8	10.6	7.0	5.0	5.0
Malaysia	1.6	1.4	1.8	1.2	1.4	2.4	2.5	2.5
Myanmar	-0.2	21.2	57.0	36.6	-	-	-	-
Philippines	4.0	6.8	3.0	3.0	5.5	6.5	6.0	5.5
Singapore	1.3	1.0	-0.4	0.5	1.7	1.4	1.2	1.2
Thailand	1.6	1.6	0.7	1.8	2.7	3.5	3.0	2.5
Viet Nam	-1.7	-0.4	3.9	3.2	7.7	5.7	5.2	5.2
South Asia	6.2	3.7	3.5	5.1	5.9	4.9	3.6	3.9
Afghanistan	-	-	-	10.5	10.2	-	-	-
Bangladesh	2.8	1.9	2.8	4.4	5.8	7.0	6.0	5.0
Bhutan	3.6	3.6	2.7	1.8	1.3	-	-	-
India	7.2	3.6	3.4	5.5	6.0	4.2	3.0	3.5
Maldives	-1.2	0.7	0.9	-2.9	6.4	-	-	-
Nepal	3.5	2.4	2.9	4.8	4.0	4.5	4.0	4.0
Pakistan	3.6	4.4	3.5	3.1	4.6	7.5	5.0	5.0
Sri Lanka	1.5	12.1	10.2	2.6	7.9	12.0	9.0	7.5
Central Asia	17.1	13.1	9.0	5.7	6.0	6.0	5.3	4.9
Azerbaijan	1.8	1.5	2.8	2.2	6.7	5.5	4.5	4.0
Kazakhstan	13.2	8.4	5.9	6.6	6.9	6.0	5.7	5.3
Kyrgyz Republic	18.7	6.9	2.0	3.0	4.0	4.6	4.0	4.0
Tajikistan	32.9	38.6	10.2	17.1	6.8	7.1	5.0	5.0
Turkmenistan	8.0	11.6	8.8	6.5	5.0	5.1	4.5	4.5
Uzbekistan	28.2	26.5	21.6	3.8	3.7	7.0	-	-
The Pacific	9.2	6.5	6.5	8.6	3.6	3.4	4.0	4.0
Cook Islands	-	-	3.9	2.4	0.3	2.9	2.0	2.0
Fiji Islands	1.1	4.3	0.7	4.2	3.5	3.0	3.0	3.0
Kiribati	0.9	7.1	1.6	2.6	2.5	2.5	2.5	2.5
Marshall Islands, Rep. of	-0.9	-1.8	0.4	1.2	2.4	-	-	-
Micronesia, Fed. States of	2.1	1.3	-0.1	-0.3	1.5	1.3	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-	-1.2	0.4	1.3	0.2	-	-	-
Papua New Guinea	15.6	9.3	11.8	14.7	2.9	3.8	4.8	4.9
Samoa	1.1	3.7	8.1	0.1	11.7	-	-	-
Solomon Islands	7.3	6.8	7.3	12.5	6.5	5.0	5.0	5.0
Timor-Leste, Dem. Rep. of	-	-	-	7.0	3.2	-	-	-
Tonga	6.3	8.3	10.4	11.6	11.0	-	-	-
Tuvalu	3.9	1.4	5.0	3.3	2.8	-	-	-
Vanuatu	2.5	3.6	2.0	3.0	1.8	2.5	2.5	2.5
Average	2.1	2.4	1.5	2.4	3.9	3.7	3.3	3.3

- = not available.

Table A9 Change in money supply (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	12.3	17.6	16.9	19.6	14.6	14.1	13.7	14.6
Hong Kong, China	7.8	-2.7	-0.9	8.4	9.3	-	-	-
Korea, Rep. of	5.2	8.1	14.0	3.0	5.2	9.2	8.9	9.7
Mongolia	17.6	27.9	42.0	49.7	16.5	19.3	-	-
Taipei,China	6.5	4.4	2.6	5.8	7.4	6.1	5.5	5.5
Southeast Asia								
Cambodia	26.9	20.4	31.1	15.3	30.1	17.0	22.0	25.0
Indonesia	15.6	13.0	4.7	8.1	8.1	12.0	12.0	12.0
Lao People's Dem. Rep.	45.8	20.1	27.0	19.2	21.3	18.0	20.0	20.0
Malaysia	5.2	2.2	5.8	11.1	25.4	13.5	11.7	13.3
Myanmar	47.4	43.2	18.4	11.0	-	-	-	-
Philippines	4.6	6.8	9.5	3.3	8.2	6.0	7.0	7.5
Singapore	-2.0	5.9	-0.3	8.1	6.2	6.0	6.0	6.0
Thailand	3.7	4.2	2.6	4.9	5.4	5.5	5.0	4.0
Viet Nam	39.0	25.5	17.6	21.0	28.0	28.0	27.0	25.0
South Asia								
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	18.6	16.6	13.1	15.6	13.8	14.0	15.0	14.0
Bhutan	21.4	5.5	17.6	29.7	4.1	-	-	-
India	16.8	14.1	14.7	16.6	14.6	14.5	12.5	13.9
Maldives	4.1	9.0	19.3	14.6	32.6	-	-	-
Nepal	21.8	15.2	4.4	9.8	12.8	11.7	12.5	13.5
Pakistan	9.4	9.0	15.4	18.0	19.6	13.0	11.0	10.0
Sri Lanka	12.9	13.6	13.4	15.3	19.6	16.5	13.0	10.0
Central Asia								
Azerbaijan	86.7	-12.1	14.3	29.8	47.5	31.0	35.0	38.0
Kazakhstan	45.0	45.1	32.8	27.0	36.4	26.7	22.4	22.6
Kyrgyz Republic	12.1	11.3	34.1	33.5	32.0	15.0	15.0	15.0
Tajikistan	64.5	33.4	27.8	26.6	26.7	17.8	-	-
Turkmenistan	68.3	-	-	-	-	-	-	-
Uzbekistan	37.2	54.3	29.7	27.1	22.0	-	-	-
The Pacific								
Cook Islands	4.8	14.4	3.2	9.9	9.6	-	-	-
Fiji Islands	-2.1	-3.1	7.9	25.2	7.3	7.3	7.3	7.3
Kiribati	20.0	-3.9	29.0	-	-	-	-	-
Marshall Islands, Rep. of	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-2.7	2.9	-8.6	-2.4	-	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-	-	-	-
Papua New Guinea	7.1	4.2	9.4	-0.9	17.7	-	-	-
Samoa	13.4	20.1	3.6	6.6	12.7	-	-	-
Solomon Islands	0.4	-13.3	3.9	25.4	21.2	17.8	7.6	10.6
Timor-Leste, Dem. Rep. of	-	155.5	6.8	32.4	16.2	-	-	-
Tonga	8.4	26.5	7.9	13.4	18.6	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	5.5	5.6	-1.7	-0.8	9.4	-	-	-

- = not available.

Table A10 Growth rate of merchandise exports (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	22.0	-5.8	12.1	22.5	28.0	15.9	12.4	11.8
China, People's Rep. of	27.9	6.8	22.4	34.6	35.4	20.4	14.8	12.5
Hong Kong, China	16.0	-5.8	4.9	12.1	15.9	12.2	12.3	14.2
Korea, Rep. of	21.2	-14.0	7.9	20.7	30.6	11.8	9.6	9.0
Mongolia	30.1	12.3	3.2	16.1	36.0	-0.8	-	-
Taipei,China	21.8	-17.3	6.4	10.5	20.7	12.1	8.2	9.5
Southeast Asia	19.4	-10.0	5.0	12.8	20.2	9.1	7.9	9.0
Cambodia	24.1	12.1	11.4	16.9	21.7	-9.1	1.7	5.2
Indonesia	27.6	-12.3	3.1	7.2	9.4	6.0	7.0	8.0
Lao People's Dem. Rep.	9.6	-3.3	-5.9	11.6	7.6	27.4	17.8	3.0
Malaysia	17.0	-10.6	7.2	11.3	20.5	12.0	10.2	12.6
Myanmar	35.8	35.2	9.8	3.0	-	-	-	-
Philippines	9.0	-16.2	10.0	2.8	9.6	8.0	8.0	7.0
Singapore	20.1	-10.5	2.9	15.1	24.2	8.0	8.0	8.0
Thailand	19.5	-7.1	4.8	18.2	23.0	10.0	5.0	8.0
Viet Nam	25.2	6.5	7.4	20.4	30.3	11.4	8.9	8.6
South Asia	18.0	0.1	12.9	18.3	20.8	13.5	12.9	12.4
Afghanistan	-	-	-	45.8	11.6	-1.3	-8.0	-7.5
Bangladesh	7.9	12.6	-7.6	9.5	15.9	15.0	10.0	8.0
Bhutan	9.1	-12.9	4.1	8.9	39.7	-	-	-
India	21.1	-1.6	20.3	20.4	23.2	14.1	13.8	13.2
Maldives	18.8	1.4	20.1	14.9	13.0	-	-	-
Nepal	-	11.7	-20.3	-13.8	12.4	10.0	10.0	10.0
Pakistan	8.8	9.1	2.7	19.6	13.5	11.0	10.0	10.0
Sri Lanka	19.8	-12.8	-2.4	9.2	12.7	9.0	11.0	12.0
Central Asia	47.1	-2.0	8.2	25.0	38.9	14.9	19.8	21.9
Azerbaijan	75.5	13.7	12.7	13.9	31.5	24.5	50.5	45.0
Kazakhstan	55.1	-3.9	12.3	31.6	53.7	14.2	15.0	17.3
Kyrgyz Republic	10.4	-6.0	3.7	18.5	23.8	3.9	10.0	9.7
Tajikistan	18.5	-17.3	7.3	14.3	15.4	2.2	5.4	6.8
Turkmenistan	111.1	4.6	9.0	10.7	9.0	-	-	-
Uzbekistan	5.2	-6.6	-8.4	29.1	22.3	-	-	-
The Pacific	0.6	-13.3	-4.4	30.6	9.8	4.5	-6.3	6.5
Cook Islands	155.9	-25.7	-25.3	67.3	4.3	-	-	-
Fiji Islands	-4.9	-13.7	11.5	21.9	0.5	3.2	-5.0	17.5
Kiribati	-60.7	3.4	10.9	31.6	16.9	3.2	4.6	2.9
Marshall Islands, Rep. of	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	22.6	17.9	6.3	-9.2	-9.3	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	57.5	62.6	8.6	-41.4	3.4	-	-	-
Papua New Guinea	8.3	-13.3	-9.6	35.1	12.7	5.1	-7.1	3.5
Samoa	-24.3	9.5	-8.6	7.9	-26.5	-	-	-
Solomon Islands	-53.1	-32.0	22.6	29.0	15.0	-2.7	6.0	19.3
Timor-Leste, Dem. Rep. of	-90.4	-20.0	50.0	16.7	-	-	-	-
Tonga	-9.6	7.3	52.1	-1.3	-21.1	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	6.0	-27.0	1.1	24.0	24.6	-5.1	2.0	-
Average	21.1	-6.9	9.8	19.3	25.5	13.8	11.3	11.2

- = not available.

Table A11 Direction of exports (% of total)

From \ To	DMCs 1995	DMCs 2003	People's Rep. of China 1995	People's Rep. of China 2003	Japan 1995	Japan 2003	United States 1995	United States 2003	European Union 1995	European Union 2003	Others 1995	Others 2003
East Asia	26.4	25.0	11.9	15.2	12.3	10.1	20.0	19.5	13.9	15.4	15.5	14.7
China, People's Rep. of	37.6	31.3			19.1	13.6	16.6	21.1	13.6	17.9	13.0	16.1
Hong Kong, China	9.6	9.4	33.3	42.6	6.1	5.4	21.8	18.7	15.3	13.7	13.9	10.2
Korea, Rep. of	23.9	20.7	7.0	18.2	13.0	9.0	18.5	17.8	13.3	14.0	24.3	20.3
Mongolia	22.4	7.9	16.4	46.2	9.9	1.4	5.5	23.2	15.0	7.3	30.9	14.1
Taipei,China	40.4	36.2	0.3	14.9	11.8	8.3	23.7	18.1	12.7	12.5	11.0	9.9
Southeast Asia	35.7	35.4	2.7	6.7	13.9	12.1	18.7	16.7	14.7	14.6	14.2	14.6
Cambodia	74.0	8.4	1.5	1.1	1.9	3.9	1.4	58.2	14.5	24.2	6.7	4.1
Indonesia	25.9	30.8	3.8	6.2	27.1	22.3	13.9	12.1	15.2	13.5	14.0	15.0
Lao People's Dem. Rep.	55.0	37.5	2.8	2.2	1.7	1.5	1.7	0.9	10.9	27.7	27.9	30.3
Malaysia	37.8	37.7	2.6	6.5	12.5	10.7	20.8	19.6	14.4	12.6	12.0	13.0
Myanmar	51.1	52.6	11.3	5.6	7.1	4.6	6.6	9.8	6.1	13.9	17.7	13.5
Philippines	21.1	30.7	1.2	5.9	15.8	15.9	35.8	20.1	17.7	16.6	8.4	10.7
Singapore	43.5	42.6	2.3	7.0	7.8	6.7	18.3	14.3	13.9	14.2	14.3	15.1
Thailand	29.2	29.8	2.9	7.1	16.6	14.2	17.6	17.0	16.1	15.2	17.7	16.7
Viet Nam	28.8	16.6	6.4	6.5	26.0	13.7	3.0	21.8	12.6	23.9	23.2	17.6
South Asia	18.4	19.4	1.0	3.5	6.5	2.5	19.5	20.7	29.9	25.6	24.8	28.3
Afghanistan	55.9	32.4	9.2	0.3	0.6	0.9	3.2	27.4	20.6	28.1	10.5	10.9
Bangladesh	8.2	4.8	0.6	0.2	3.3	0.8	31.9	23.9	44.8	47.2	11.2	23.1
Bhutan	-	-	-	-	-	-	-	-	-	-	-	-
India	20.2	21.9	0.9	4.5	7.0	2.9	17.4	18.6	27.5	22.5	27.0	29.6
Maldives	31.4	40.6	0.0	0.0	5.7	10.4	19.2	32.5	38.4	15.3	5.3	1.2
Nepal	9.8	46.0	0.1	0.9	0.5	1.1	30.5	29.6	53.3	16.6	5.8	5.8
Pakistan	19.6	16.2	1.5	2.2	6.8	1.2	15.1	23.1	31.0	28.8	26.1	28.6
Sri Lanka	8.9	11.2	0.1	0.3	5.3	3.1	35.6	34.6	32.4	28.5	17.7	22.2
Central Asia	15.6	7.7	3.3	8.8	1.3	0.5	0.9	1.2	28.3	24.2	50.6	57.7
Azerbaijan	6.7	6.4	0.3	1.7	0.0	0.1	0.2	0.6	19.0	72.6	73.8	18.6
Kazakhstan	9.4	5.6	5.7	12.8	0.9	0.1	0.8	0.8	26.6	19.0	56.7	61.7
Kyrgyz Republic	47.2	18.1	0.6	4.0	0.0	0.0	0.5	1.1	16.3	5.4	35.3	71.4
Tajikistan	20.7	11.3	0.8	0.0	1.1	0.1	2.0	0.1	53.5	40.0	22.0	48.5
Turkmenistan	16.2	3.8	0.4	0.1	0.0	0.0	1.7	1.6	26.7	20.0	55.0	74.5
Uzbekistan	22.2	24.6	2.4	9.2	3.7	4.3	0.5	4.0	29.8	18.3	41.6	39.7
The Pacific	14.0	12.7	1.9	5.2	19.8	7.7	3.2	5.4	17.1	10.4	44.1	58.7
Cook Islands	-	-	-	-	-	-	-	-	-	-	-	-
Fiji Islands	13.7	16.5	1.0	0.7	5.8	4.8	11.5	23.3	24.5	15.2	43.4	39.5
Kiribati	44.5	9.0	0.0	0.0	17.0	74.2	10.5	7.1	25.9	1.8	2.1	7.8
Marshall Islands, Rep of	-	-	-	-	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-	-	-	-
Nauru	15.3	25.8	0.0	0.0	1.5	57.2	0.0	1.4	2.2	4.1	81.0	11.5
Palau, Rep. of	-	-	-	-	-	-	-	-	-	-	-	-
Papua New Guinea	12.9	9.7	2.3	5.7	21.2	7.3	1.6	1.8	16.3	10.0	45.7	65.5
Samoa	1.5	16.3	0.0	0.3	1.8	1.3	0.9	4.8	2.1	2.7	93.7	74.6
Solomon Islands	35.5	50.3	0.4	25.2	46.6	13.8	2.4	1.2	10.3	2.4	4.8	7.1
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-	-	-	-	-	-	-
Tonga	1.6	5.8	0.0	0.2	47.8	33.3	25.8	47.5	0.0	4.2	24.7	9.1
Tuvalu	17.4	18.0	0.0	0.0	0.3	0.0	0.0	0.0	22.6	70.5	59.6	11.5
Vanuatu	8.3	62.6	0.0	0.3	25.1	10.8	0.0	1.6	37.9	10.3	28.7	14.4
DMCs	28.9	27.4	8.1	12.0	12.4	10.1	19.3	18.5	15.1	15.9	16.1	16.1

- = not available.

Table A12 Growth rate of merchandise imports (% per year)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	28.4	-6.6	10.4	23.8	28.7	17.8	15.4	12.7
China, People's Rep. of	35.4	8.1	21.3	39.8	36.0	22.1	19.6	14.1
Hong Kong, China	18.6	-5.5	3.1	12.2	17.0	12.6	12.1	13.5
Korea, Rep. of	36.2	-13.4	7.7	18.0	25.2	13.5	10.6	10.8
Mongolia	19.8	12.8	8.6	9.8	22.4	2.5	-	-
Taipei,China	25.9	-23.7	3.4	12.2	32.2	18.2	12.6	8.9
Southeast Asia	25.1	-9.5	5.0	12.1	23.6	10.6	9.2	10.2
Cambodia	21.9	8.0	10.5	11.4	22.2	-4.8	4.7	7.6
Indonesia	31.9	-14.1	2.8	9.4	13.3	9.6	11.0	12.0
Lao People's Dem. Rep.	-3.4	-4.7	-12.4	3.4	9.5	12.7	13.1	6.6
Malaysia	26.3	-10.3	8.3	5.2	25.8	15.8	13.5	15.3
Myanmar	-12.7	11.6	-8.8	-4.9	-	-	-	-
Philippines	14.5	-4.5	6.2	20.1	10.6	5.5	6.0	6.5
Singapore	22.0	-13.7	1.8	8.5	27.1	7.6	8.5	8.5
Thailand	31.3	-3.0	4.6	17.4	26.9	13.5	6.0	8.0
Viet Nam	34.5	6.0	19.5	37.4	26.0	12.0	10.0	10.0
South Asia	5.4	-1.7	7.9	21.6	33.5	20.4	14.3	13.5
Afghanistan	-	-	-	41.8	0.3	15.2	-4.2	-3.8
Bangladesh	4.8	11.4	-8.7	13.1	13.0	20.0	16.0	13.0
Bhutan	14.0	-8.3	9.9	1.7	29.6	-	-	-
India	4.6	-2.8	14.5	24.4	39.0	19.7	15.4	14.4
Maldives	-3.4	1.3	-0.5	20.2	30.7	-	-	-
Nepal	-	6.7	-15.3	7.1	18.4	5.0	20.0	20.0
Pakistan	-0.1	6.2	-7.5	20.1	21.2	30.0	8.0	10.0
Sri Lanka	22.4	-18.4	2.2	9.3	19.3	17.2	8.5	6.0
Central Asia	12.6	8.8	0.3	19.0	38.1	13.8	13.5	17.8
Azerbaijan	7.4	-4.8	24.5	49.3	25.2	7.5	-2.5	-5.0
Kazakhstan	21.2	11.1	1.6	16.9	47.7	16.3	18.2	23.7
Kyrgyz Republic	-8.0	-13.1	25.4	31.1	24.6	9.3	7.8	6.7
Tajikistan	20.6	-7.3	6.5	21.9	20.8	7.9	6.6	7.2
Turkmenistan	20.7	31.6	-9.8	5.8	-	-	-	-
Uzbekistan	-5.6	4.6	-14.4	10.0	28.2	-	-	-
The Pacific	-1.3	-2.0	8.9	16.1	7.7	4.5	-1.8	5.0
Cook Islands	22.7	-8.1	0.5	49.2	9.6	-	-	-
Fiji Islands	-11.1	-7.1	17.2	31.3	2.6	2.0	-0.2	4.6
Kiribati	-3.3	13.7	19.8	40.6	-23.3	2.6	2.5	2.5
Marshall Islands, Rep. of	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	10.4	8.7	-9.0	21.6	9.1	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-5.6	-21.5	0.9	-7.0	16.1	-	-	-
Papua New Guinea	-6.1	-6.0	15.5	10.1	10.7	6.2	-2.9	5.6
Samoa	-8.1	21.0	5.0	1.1	20.6	-	-	-
Solomon Islands	-14.8	-11.5	-41.8	79.8	19.7	17.6	-2.5	0.9
Timor-Leste, Dem. Rep. of	101.7	11.7	-6.3	-19.1	-	-	-	-
Tonga	12.7	-3.6	1.8	21.0	11.5	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-8.3	0.5	0.5	9.3	18.4	-6.7	1.5	-
Average	25.2	-6.9	8.4	20.2	27.7	16.1	13.7	12.2

- = not available.

Table A13 Trade balance (US$ million)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	56,710	58,868	77,872	85,528	103,198	96,942	67,636	60,193
China, People's Rep. of	34,474	34,017	44,167	44,652	58,040	60,748	38,263	30,242
Hong Kong, China	-8,193	-8,331	-5,053	-5,775	-9,311	-11,525	-12,335	-11,705
Korea, Rep. of	16,954	13,488	14,777	21,952	38,161	38,931	40,145	38,688
Mongolia	-148	-170	-213	-200	-159	-191	-	-
Taipei,China	13,624	19,864	24,193	24,899	16,468	8,979	1,564	2,969
Southeast Asia	67,288	58,493	61,787	72,132	72,643	71,838	70,631	70,428
Cambodia	-538	-523	-563	-531	-660	-737	-838	-959
Indonesia	25,042	22,697	23,512	24,439	25,179	25,098	24,917	24,759
Lao People's Dem. Rep.	-205	-191	-146	-127	-145	-110	-201	-238
Malaysia	20,827	18,383	18,978	25,711	26,779	26,211	25,073	24,692
Myanmar	-226	180	626	810	-	-	-	-
Philippines	3,814	-743	407	-5,455	-6,381	-5,764	-5,273	-5,390
Singapore	12,732	15,722	17,530	28,125	31,128	34,281	36,133	38,056
Thailand	5,466	2,494	2,739	3,759	1,682	-1,453	-2,597	-2,805
Viet Nam	377	473	-1,295	-4,600	-4,940	-5,688	-6,582	-7,688
South Asia	-18,597	-17,084	-16,275	-22,403	-40,435	-55,670	-65,076	-75,131
Afghanistan	-	-	-1,159	-1,595	-1,395	-1,941	-1,936	-1,930
Bangladesh	-1,865	-2,011	-1,768	-2,215	-2,319	-3,159	-4,183	-5,203
Bhutan	-71	-70	-83	-77	-88	-	-	-
India	-12,460	-11,574	-10,690	-15,454	-31,707	-42,397	-50,328	-58,818
Maldives	-233	-236	-212	-262	-370	-	-	-
Nepal	-758	-766	-695	-902	-1,107	-1,126	-1,432	-1,807
Pakistan	-1,412	-1,269	-261	-359	-1,279	-4,030	-4,080	-4,490
Sri Lanka	-1,798	-1,158	-1,407	-1,539	-2,170	-3,018	-3,117	-2,884
Central Asia	3,873	2,277	3,665	5,488	8,013	7,716	10,586	13,910
Azerbaijan	260	581	482	-98	44	635	2,887	5,968
Kazakhstan	2,440	1,321	2,301	4,171	7,006	7,674	8,327	8,594
Kyrgyz Republic	4	40	-54	-134	-171	-226	-227	-217
Tajikistan	-46	-121	-124	-204	-290	-366	-401	-434
Turkmenistan	721	272	736	918	546	-	-	-
Uzbekistan	494	185	324	835	878	-	-	-
The Pacific	154	-127	-454	-167	125	583	407	548
Cook Islands	-42	-40	-42	-62	-69	-82	-85	-90
Fiji Islands	-190	-210	-271	-402	-424	-425	-454	-399
Kiribati	-36	-41	-49	-69	-51	-52	-54	-55
Marshall Islands, Rep. of	-42	-40	-41	-47	-51	-	-	-
Micronesia, Fed. States of	-83	-88	-77	-101	-114	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-116	-81	-80	-82	-97	-	-	-
Papua New Guinea	1,114	891	565	1,041	1,199	1,246	1,096	1,105
Samoa	-92	-113	-121	-122	-112	-	-	-
Solomon Islands	-23	-34	10	-11	-17	-37	-29	-13
Timor-Leste, Dem. Rep. of	-235	-264	-245	-196	-	-	-	-
Tonga	-52	-49	-44	-57	-69	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-50	-58	-58	-61	-70	-65	-66	-
Total	109,429	102,427	126,595	140,577	143,544	121,410	84,185	69,949

- = not available.

Table A14 Current account balance (US$ million)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	48,536	53,449	78,867	103,881	116,200	94,842	80,996	66,769
China, People's Rep. of	20,518	17,405	35,422	45,875	53,746	21,902	8,884	-3,762
Hong Kong, China	7,084	9,942	12,597	16,980	16,040	12,913	13,305	11,210
Korea, Rep. of	12,251	8,033	5,394	11,950	27,613	36,848	34,107	34,853
Mongolia	-169	-169	-175	-190	-212	-229	-	-
Taipei,China	8,851	18,239	25,630	29,266	19,013	23,408	24,700	24,468
Southeast Asia	45,203	36,062	41,613	54,514	55,803	52,398	48,580	47,163
Cambodia	-417	-344	-353	-417	-445	-550	-645	-755
Indonesia	7,992	6,901	7,822	7,709	6,777	5,684	4,435	3,151
Lao People's Dem. Rep.	-126	-28	-26	-30	-12	-50	-304	-335
Malaysia	8,487	7,286	8,025	13,381	14,749	13,160	11,593	10,154
Myanmar	-71	-158	12	71	-	-	-	-
Philippines	6,258	1,323	4,383	1,396	2,080	2,581	1,987	1,897
Singapore	13,246	14,402	15,693	26,952	27,805	29,958	31,809	33,733
Thailand	9,328	6,205	7,008	7,965	7,289	4,243	2,701	3,084
Viet Nam	505	475	-950	-2,513	-2,441	-2,628	-2,997	-3,767
South Asia	-4,312	2,534	8,995	14,712	-5,707	-11,794	-16,400	-22,157
Afghanistan	-	-	-84	-81	-185	-231	-243	-245
Bangladesh	-583	-1,170	88	94	115	-602	-644	-1,039
Bhutan	24	7	-14	51	49	-	-	-
India	-2,666	3,400	6,345	10,561	-6,943	-8,045	-12,472	-17,605
Maldives	-52	-59	-36	-32	-90	-	-	-
Nepal	248	274	237	149	163	138	22	-103
Pakistan	-217	326	2,723	4,070	1,811	-1,775	-1,790	-2,360
Sri Lanka	-1,066	-244	-265	-101	-626	-1,278	-1,274	-804
Central Asia	745	-1,415	-1,367	-1,306	-1,131	-1,682	-147	1,498
Azerbaijan	-187	-50	-769	-2,021	-2,613	-2,055	-741	687
Kazakhstan	675	-1,109	-696	-69	682	492	745	989
Kyrgyz Republic	-80	-19	-35	-77	-115	-	-	-
Tajikistan	-62	-74	-32	-20	-46	-120	-150	-179
Turkmenistan	184	-50	47	-	-	-	-	-
Uzbekistan	215	-113	117	881	961	-	-	-
The Pacific	360	279	-153	50	-60	-44	-115	-40
Cook Islands	9	14	14	12	-	-	-	-
Fiji Islands	12	-5	-66	-120	-138	-111	-95	16
Kiribati	6	-4	1	-16	-8	-9	-10	-11
Marshall Islands, Rep. of	26	30	21	22	14	-	-	-
Micronesia, Fed. States of	1	-12	16	2	-26	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-36	-7	-17	-5	-23	-	-	-
Papua New Guinea	357	286	-132	143	157	118	22	-39
Samoa	-12	-27	-19	-2	-21	-	-	-
Solomon Islands	-44	-33	-3	3	3	-23	-13	-7
Timor-Leste, Dem. Rep. of	48	54	44	43	-	-	-	-
Tonga	-10	-13	7	-5	8	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	2	-3	-19	-28	-26	-19	-20	-
Total	90,532	90,909	127,955	171,851	165,106	133,720	112,914	93,233

- = not available.

Table A15 Current account balance (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia	2.4	2.6	3.5	4.3	4.2	2.9	2.4	1.7
China, People's Rep. of	1.9	1.5	2.8	3.2	3.3	1.2	0.4	-0.2
Hong Kong, China	4.3	6.1	7.9	10.8	9.7	7.7	7.3	5.4
Korea, Rep. of	2.4	1.7	1.0	2.0	4.0	3.9	3.5	2.8
Mongolia	-17.8	-16.6	-15.9	-14.9	-14.0	-13.5	-	-
Taipei,China	2.9	6.5	9.1	10.2	6.2	6.8	6.7	6.3
Southeast Asia	7.9	6.5	6.7	7.8	7.1	6.2	5.3	4.9
Cambodia	-11.8	-9.2	-8.9	-10.1	-9.8	-11.7	-11.3	-10.5
Indonesia	4.8	4.2	3.8	3.2	2.6	2.1	1.5	1.0
Lao People's Dem. Rep.	-7.3	-4.6	-2.3	-0.3	-0.5	-1.8	-13.3	-13.5
Malaysia	9.4	8.3	8.4	12.9	12.5	10.2	8.3	6.7
Myanmar	0.0	0.0	0.0	0.0	-	-	-	-
Philippines	8.4	1.9	5.7	1.8	2.4	3.0	2.2	2.0
Singapore	14.3	16.8	17.7	29.2	26.1	26.0	25.7	26.2
Thailand	7.6	5.4	5.5	5.6	4.5	2.3	1.3	1.3
Viet Nam	1.6	1.5	-2.8	-6.9	-5.7	-5.6	-5.8	-6.6
South Asia	-0.7	0.4	1.3	1.9	-0.7	-1.2	-1.5	-1.9
Afghanistan	-	-	-2.1	-1.8	-3.4	-3.6	-3.2	-2.8
Bangladesh	-1.2	-2.5	0.2	0.2	0.2	-1.0	-1.0	-1.5
Bhutan	5.6	1.6	-2.6	9.0	7.1	-	-	-
India	-0.6	0.7	1.2	1.8	-1.0	-1.0	-1.4	-1.9
Maldives	-8.2	-9.4	-5.6	-4.6	-12.0	-	-	-
Nepal	4.5	4.9	4.3	2.5	2.4	1.9	0.3	-1.1
Pakistan	-0.3	0.5	3.8	4.9	1.9	-1.7	-1.6	-1.9
Sri Lanka	-6.4	-1.6	-1.6	-0.6	-3.2	-5.8	-5.2	-3.0
Central Asia	1.6	-3.0	-2.8	-2.5	-1.9	-3.2	-0.5	1.8
Azerbaijan	-3.5	-0.9	-12.3	-28.3	-30.7	-20.0	-6.0	4.5
Kazakhstan	3.7	-5.0	-2.8	-0.2	1.6	1.0	1.3	1.5
Kyrgyz Republic	-5.8	-1.3	-2.2	-4.0	-5.2	-5.8	-4.6	-3.3
Tajikistan	-6.5	-6.7	-2.7	-1.3	-2.3	-5.2	-5.9	-6.5
Turkmenistan	3.7	-0.7	0.5	-	-	-	-	-
Uzbekistan	1.6	-1.0	1.2	8.9	8.4	-	-	-
The Pacific	4.4	3.4	-2.0	0.3	-0.7	-0.8	-1.5	-0.5
Cook Islands	11.5	16.3	14.0	8.7	-	-	-	-
Fiji Islands	0.7	-0.3	-3.5	-4.8	-5.3	-4.1	-3.3	0.6
Kiribati	13.8	-8.6	1.4	-27.6	-12.5	-13.7	-14.5	-15.6
Marshall Islands, Rep. of	26.1	29.8	19.9	21.2	13.3	-	-	-
Micronesia, Fed. States of	0.3	-5.3	7.2	0.8	-11.6	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-29.7	-6.1	-13.6	-4.2	-	-	-	-
Papua New Guinea	9.1	8.0	-4.3	3.8	3.7	2.5	0.5	-0.8
Samoa	-4.7	-10.9	-7.3	-0.5	-	-	-	-
Solomon Islands	-14.7	-11.9	-1.5	1.4	1.1	-7.9	-4.1	-1.9
Timor-Leste, Dem. Rep. of	12.2	13.1	11.4	11.1	-	-	-	-
Tonga	-6.0	-9.2	5.0	-3.0	3.8	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	0.7	-1.4	-7.9	-10.6	-8.0	-6.1	-6.2	-
Average	2.7	2.8	3.6	4.3	3.7	2.6	2.1	1.6

- = not available.

Table A16 Foreign direct investment (US$ million)

	2000	2001	2002	2003	2004
East Asia					
China, People's Rep. of	40,715	46,878	52,743	53,510	60,600
Hong Kong, China	2,562	12,431	-7,782	8,139	-5,702
Korea, Rep. of	4,285	1,108	-224	100	3,397
Mongolia	54	63	58	132	132
Taipei,China	-1,773	-1,371	-3,441	-5,229	-5,189
Southeast Asia					
Cambodia	142	141	139	77	115
Indonesia	-4,550	-2,977	145	-597	1,046
Lao People's Dem. Rep.	34	24	5	20	17
Malaysia	1,762	287	1,299	1,104	2,074
Myanmar	208	192	191	128	-
Philippines	1,348	1,953	1,026	150	57
Singapore	11,919	-7,596	1,727	5,625	5,378
Thailand	3,372	3,540	841	1,466	656
Viet Nam	459	273	397	1,222	1,730
South Asia					
Afghanistan	-	-	-	-	-
Bangladesh	383	550	391	376	385
Bhutan	0	0	2	2	3
India	3,272	4,741	3,611	3,420	4,374
Maldives	13	12	12	12	-
Nepal	3	0	-4	12	0
Pakistan	473	286	483	771	906
Sri Lanka	173	82	181	171	133
Central Asia					
Azerbaijan	148	298	1,048	2,293	2,311
Kazakhstan	1,278	2,861	2,157	2,188	3,477
Kyrgyz Republic	-7	-1	5	46	122
Tajikistan	-	-	-	-	-
Turkmenistan	-	-	-	-	-
Uzbekistan	75	83	65	70	115
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	37	45	21	29	-
Kiribati	0	0	0	0	-
Marshall Islands, Rep. of	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau, Rep. of	2	1	2	1	1
Papua New Guinea	-	-	-	-	-
Samoa	-	-	-	-	-
Solomon Islands	1	-12	-1	0	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	20	18	-	-	-

- = not available.

Table A17 External debt outstanding (US$ million)

	2000	2001	2002	2003	2004
East Asia					
China, People's Rep. of	145,706	170,110	168,538	193,634	228,600
Hong Kong, China	366,998	340,024	350,732	371,575	432,199
Korea, Rep. of	148,454	130,834	143,949	158,870	146,838
Mongolia	754	899	986	1,237	1,338
Taipei,China	34,757	34,336	45,033	63,054	75,464
Southeast Asia					
Cambodia	2,394	2,489	2,735	2,981	3,103
Indonesia	141,693	133,074	131,343	135,401	-
Lao People's Dem. Rep.	1,122	1,205	1,284	1,390	1,961
Malaysia	42,385	45,636	48,853	49,037	51,121
Myanmar	5,928	5,670	6,556	-	-
Philippines	51,206	51,900	53,645	57,395	54,800
Singapore	159,812	162,416	161,789	174,017	187,242
Thailand	79,715	67,509	59,459	51,783	50,592
Viet Nam	11,915	13,242	13,100	14,100	14,410
South Asia					
Afghanistan	7,203	7,224	7,297	-	-
Bangladesh	15,791	14,902	15,885	16,953	17,175
Bhutan	174	237	292	406	529
India	101,326	98,843	105,353	111,830	131,923
Maldives	178	182	223	273	290
Nepal	2,573	2,661	2,744	2,968	3,120
Pakistan	32,196	32,124	33,400	33,352	33,307
Sri Lanka	9,031	8,371	9,333	10,644	11,742
Central Asia					
Azerbaijan	1,162	1,270	1,356	1,568	1,625
Kazakhstan	12,685	15,158	18,190	22,884	26,580
Kyrgyz Republic	1,704	1,677	1,784	1,966	2,028
Tajikistan	1,226	1,017	982	1,031	822
Turkmenistan	-	-	-	-	-
Uzbekistan	3,646	3,815	3,925	3,815	-
The Pacific					
Cook Islands	58	53	63	65	66
Fiji Islands	242	225	244	271	276
Kiribati	8	11	14	24	30
Marshall Islands, Rep. of	92	77	85	91	90
Micronesia, Fed. States of	86	67	58	59	60
Nauru	-	-	-	-	-
Palau, Rep. of	20	20	20	19	-
Papua New Guinea	1,391	1,483	1,439	1,326	1,374
Samoa	148	144	154	153	154
Solomon Islands	126	134	152	164	160
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	61	53	69	81	81
Tuvalu	-	-	-	-	16
Vanuatu	75	69	74	87	90

- = not available.

Table A18 Debt service ratio (% of exports of goods and services)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	7.4	8.0	7.3	7.5	7.5	-	-	-
Hong Kong, China	-	-	-	-	-	-	-	-
Korea, Rep. of	11.2	14.4	7.8	6.5	5.7	5.9	5.6	5.4
Mongolia	4.5	5.3	4.5	3.4	8.7	4.2	4.2	4.0
Taipei,China	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Southeast Asia								
Cambodia	8.0	3.1	2.8	2.9	2.3	1.9	2.1	2.2
Indonesia	41.3	36.0	32.1	29.8	31.2	30.0	30.0	30.0
Lao People's Dem. Rep.	5.7	7.8	8.9	6.8	9.4	16.3	14.6	13.6
Malaysia	5.8	6.8	6.6	6.2	4.6	5.6	5.8	5.7
Myanmar	3.7	3.1	-	-	-	-	-	-
Philippines	12.4	15.8	16.4	17.2	13.9	14.0	14.0	14.0
Singapore	-	-	-	-	-	-	-	-
Thailand	15.4	20.8	19.6	16.0	8.4	8.0	7.0	6.0
Viet Nam	10.5	10.6	8.3	8.0	6.7	6.1	6.0	5.7
South Asia								
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	7.3	6.6	6.3	5.8	4.8	5.0	5.5	5.5
Bhutan	4.9	4.7	4.9	5.0	4.1	-	-	-
India	17.2	13.9	15.1	18.3	-	-	-	-
Maldives	4.2	4.3	4.3	3.7	3.8	4.1	-	-
Nepal	6.0	6.8	8.5	10.3	10.0	9.6	9.5	9.5
Pakistan	37.2	38.0	44.7	28.7	39.9	26.2	24.2	22.2
Sri Lanka	14.7	13.2	13.2	11.6	11.4	-	-	-
Central Asia								
Azerbaijan	4.6	4.9	4.4	5.0	3.7	–	–	–
Kazakhstan	31.5	37.5	35.2	35.0	26.6	34.1	24.7	21.8
Kyrgyz Republic	28.1	30.8	20.7	21.8	19.8	-	-	-
Tajikistan	17.5	25.6	22.9	18.2	49.2	13.0	10.6	10.1
Turkmenistan	13.9	-	-	-	-	-	-	-
Uzbekistan	25.7	25.8	23.4	22.0	-	-	-	-
The Pacific								
Cook Islands	3.5	3.5	-	-	-	-	-	-
Fiji Islands	2.9	2.0	2.0	1.9	1.4	-	-	-
Kiribati	6.6	4.3	2.5	2.7	2.3	2.5	2.7	2.8
Marshall Islands, Rep. of	130.4	150.6	16.8	20.0	18.1	-	-	-
Micronesia, Fed. States of	20.7	18.9	5.1	5.2	5.6	-	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	2.2	0.9	1.0	1.8	3.0	-	-	-
Papua New Guinea	6.8	8.0	7.9	7.3	8.0	-	-	-
Samoa	10.0	8.8	9.2	7.2	9.0	-	-	-
Solomon Islands	3.8	5.9	10.6	8.9	6.3	7.1	6.2	5.8
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-	-	-
Tonga	10.0	18.7	6.0	5.2	6.4	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	5.9	6.5	10.8	18.4	16.3	-	-	-

- = not available.

Table A19 Exchange rates to the US dollar (annual average)

	Currency	Symbol	2000	2001	2002	2003	2004
East Asia							
China, People's Rep. of	Yuan	CNY	8.3	8.3	8.3	8.3	8.3
Hong Kong, China	Hong Kong dollar	HK$	7.8	7.8	7.8	7.8	7.8
Korea, Rep. of	Won	W	1,131.1	1,291.0	1,250.7	1,191.9	1,143.7
Mongolia	Togrog	MNT	1,076.7	1,097.7	1,125.0	1,147.0	1,193.0
Taipei,China	New Taiwan dollar	NT$	31.2	33.8	34.6	34.4	33.4
Southeast Asia							
Cambodia	Riel	KR	3,859.0	3,924.0	3,921.0	3,980.0	4,019.0
Indonesia	Rupiah	Rp	8,421.8	10,260.8	9,311.2	8,577.1	8,940.0
Lao People's Dem. Rep.	Kip	KN	7,887.6	8,954.6	10,056.3	10,652.0	10,380.0
Malaysia	Ringgit	RM	3.8	3.8	3.8	3.8	3.8
Myanmar	Kyat	MK	6.4	6.7	6.6	6.1	5.7
Philippines	Peso	P	44.2	51.0	51.6	54.2	56.0
Singapore	Singapore dollar	S$	1.7	1.8	1.8	1.7	1.7
Thailand	Baht	B	40.2	44.5	43.0	41.5	40.3
Viet Nam	Dong	D	14,167.7	14,725.2	15,279.5	15,656.0	15,781.0
South Asia							
Afghanistan	Afghani	AF	67.3	55.7	44.8	49.0	47.9
Bangladesh	Taka	Tk	50.3	54.0	57.4	57.9	58.9
Bhutan	Ngultrum	Nu	43.6	46.4	48.2	47.9	45.4
India	Indian rupee/s	Re/Rs	45.7	47.7	48.4	45.9	44.9
Maldives	Rufiyaa	Rf	11.8	12.2	12.8	12.8	12.8
Nepal	Nepalese rupee/s	NRe/NRs	69.0	73.7	76.7	77.9	73.8
Pakistan	Pakistan rupee/s	PRe/PRs	51.8	58.4	61.4	58.5	57.6
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	75.8	89.4	95.7	96.5	101.2
Central Asia							
Azerbaijan	Azerbaijan manat	AZM	4,474.2	4,656.7	4,860.8	4,910.7	4,913.4
Kazakhstan	Tenge	T	142.3	146.9	153.5	149.5	136.7
Kyrgyz Republic	Som	Som	47.7	48.4	46.9	43.7	42.7
Tajikistan	Somoni	TJS	1.8	2.4	2.8	3.1	2.9
Turkmenistan	Turkmen manat	TMM	5,200.0	5,200.0	5,200.0	5,200.0	5,200.0
Uzbekistan	Sum	SUM	237.3	423.3	772.0	971.0	1,020.0
The Pacific							
Cook Islands	New Zealand dollar	NZ$	2.2	2.4	2.2	1.7	1.5
Fiji Islands	Fiji dollar	F$	2.2	2.3	2.1	1.7	1.8
Kiribati	Australian dollar	A$	1.7	2.0	1.8	1.5	1.4
Marshall Islands, Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	-	-	-	-	-
Palau, Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Papua New Guinea	Kina	K	2.7	3.3	3.8	3.5	3.2
Samoa	Tala	ST	3.3	3.5	3.4	3.0	2.8
Solomon Islands	Sol. Islands dollar	SI$	5.1	5.3	6.8	7.5	7.3
Timor-Leste, Dem. Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Tonga	Pa'anga	T$	1.6	2.0	2.2	2.2	2.0
Tuvalu	Australian dollar	A$	1.7	2.0	1.8	1.5	1.4
Vanuatu	Vatu	Vt	137.8	145.7	139.1	130.6	109.7

- = not available.

Table A20 Gross international reserves (US$ million)

	2000	2001	2002	2003	2004
East Asia					
China, People's Rep. of	165,574	212,165	286,400	403,251	609,932
Hong Kong, China	107,583	111,159	111,919	118,388	123,569
Korea, Rep. of	96,130	102,753	121,343	155,281	198,994
Mongolia	188	207	226	178	205
Taipei,China	106,742	122,211	161,656	206,632	241,738
Southeast Asia					
Cambodia	484	548	663	737	812
Indonesia	29,394	28,016	31,571	36,246	36,321
Lao People's Dem. Rep.	141	133	196	216	225
Malaysia	29,886	30,848	34,583	44,862	66,713
Myanmar	167	223	312	456	424
Philippines	15,024	15,658	16,180	16,866	16,029
Singapore	80,362	75,800	82,276	96,324	112,808
Thailand	32,661	33,048	38,924	42,148	49,832
Viet Nam	2,831	3,540	3,815	5,577	6,027
South Asia					
Afghanistan	-	-	426	816	1,105
Bangladesh	1,602	1,307	1,583	2,470	2,705
Bhutan	291	293	315	373	383
India	39,554	51,049	71,890	107,448	134,584
Maldives	124	94	135	161	205
Nepal	927	1,002	1,031	1,159	1,447
Pakistan	991	1,677	4,333	9,525	10,554
Sri Lanka	1,044	1,307	1,700	2,329	1,824
Central Asia					
Azerbaijan	951	1,218	1,414	1,620	1,904
Kazakhstan	2,096	2,508	3,141	4,959	9,281
Kyrgyz Republic	261	285	317	389	565
Tajikistan	87	96	96	135	193
Turkmenistan	1,854	1,935	-	-	-
Uzbekistan	1,273	1,212	1,215	1,659	2,100
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	411	366	359	423	416
Kiribati	396	342	332	408	360
Marshall Islands, Rep. of	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	304	440	361	499	589
Samoa	51	46	53	52	69
Solomon Islands	31	19	18	36	73
Timor-Leste, Dem. Rep. of	-	24	44	61	195
Tonga	16	13	18	17	44
Tuvalu	-	-	-	-	-
Vanuatu	39	38	36	44	54

- = not available.

Table A21 Central government expenditures (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	17.8	19.4	21.0	21.0	20.8	19.7	19.5	19.2
Hong Kong, China	18.1	18.8	19.2	20.3	19.5	19.0	18.4	17.6
Korea, Rep. of	22.3	22.0	19.9	22.6	22.2	23.2	-	-
Mongolia	40.5	42.1	44.7	42.2	39.7	40.0	-	-
Taipei,China	24.6	25.1	24.3	23.9	23.1	22.8	21.9	21.1
Southeast Asia								
Cambodia	15.3	16.3	17.9	17.4	17.3	18.0	18.5	18.7
Indonesia	15.9	19.8	17.2	18.3	21.6	18.2	16.5	15.8
Lao People's Dem. Rep.	18.4	20.2	21.7	18.8	16.7	19.3	17.7	18.0
Malaysia	23.8	29.3	28.7	28.8	26.3	23.8	21.7	19.7
Myanmar	13.6	10.5	8.6	9.5	-	-	-	-
Philippines	19.6	19.6	19.6	19.2	18.3	11.4	12.1	12.7
Singapore	21.0	23.5	19.1	14.1	16.4	16.1	15.8	15.5
Thailand	17.5	17.2	18.2	16.2	17.3	15.0	15.0	16.0
Viet Nam	22.8	24.4	26.4	29.0	27.9	28.3	27.9	27.5
South Asia								
Afghanistan	-	-	9.5	9.8	11.3	-	-	-
Bangladesh	14.7	14.0	14.8	13.7	13.4	15.4	15.8	16.2
Bhutan	46.5	52.4	41.3	35.8	27.5	-	-	-
India	27.8	27.7	28.1	29.1	29.1	29.0	28.9	28.7
Maldives	36.7	37.7	38.0	38.8	38.3	-	-	-
Nepal	15.5	17.6	17.0	16.0	16.1	16.6	18.4	22.0
Pakistan	18.9	17.6	18.5	18.7	17.8	-	-	-
Sri Lanka	26.7	27.5	25.4	23.7	23.7	26.0	26.5	26.0
Central Asia								
Azerbaijan	20.8	20.1	20.8	27.2	27.0	19.8	21.0	21.0
Kazakhstan	22.8	23.0	21.7	23.2	23.8	26.0	25.5	26.5
Kyrgyz Republic	24.9	22.8	24.8	25.0	24.1	-	-	-
Tajikistan	14.2	15.3	16.8	16.3	-	-	-	-
Turkmenistan	23.9	21.7	17.5	19.4	-	-	-	-
Uzbekistan	29.0	26.7	25.8	24.6	22.9	-	-	-
The Pacific								
Cook Islands	36.6	37.7	35.1	34.7	32.5	34.8	-	-
Fiji Islands	29.1	30.5	30.8	30.6	30.0	29.8	27.6	26.6
Kiribati	113.6	148.6	135.3	150.0	117.2	-	-	-
Marshall Islands, Rep. of	66.3	72.2	65.6	71.4	84.0	85.2	84.7	83.3
Micronesia, Fed. States of	74.7	72.4	66.0	65.6	59.1	62.0	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	70.6	65.7	64.7	57.5	66.3	-	-	-
Papua New Guinea	29.8	30.2	31.8	29.2	30.1	33.0	31.7	29.9
Samoa	38.6	38.4	37.4	35.5	33.8	52.9	-	-
Solomon Islands	29.6	35.8	28.3	37.9	43.5	58.9	-	-
Timor-Leste, Dem. Rep. of	-	-	15.8	21.7	20.9	20.1	22.1	22.7
Tonga	26.8	29.0	31.3	30.6	25.3	27.1	-	-
Tuvalu	248.8	132.4	89.8	88.1	82.8	88.2	83.1	86.1
Vanuatu	29.0	25.2	24.1	22.4	20.5	21.7	20.3	19.7

- = not available.

Table A22 Central government revenues (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	15.0	16.8	18.0	18.5	19.3	18.8	18.8	19.0
Hong Kong, China	17.5	13.8	14.2	17.0	18.4	17.8	17.6	17.7
Korea, Rep. of	20.9	20.3	20.3	21.0	20.2	20.4	-	-
Mongolia	33.4	37.2	38.7	37.9	38.6	37.5	-	-
Taipei,China	19.9	18.4	19.9	21.0	19.7	17.9	17.4	16.5
Southeast Asia								
Cambodia	10.4	10.7	11.2	10.4	10.9	11.7	12.5	13.3
Indonesia	14.7	17.8	15.8	16.7	20.3	17.4	15.5	15.3
Lao People's Dem. Rep.	12.4	12.6	13.4	11.0	11.9	14.0	11.9	12.3
Malaysia	18.0	23.8	23.1	23.5	22.2	20.7	19.5	18.3
Myanmar	5.3	4.7	5.0	4.6	-	-	-	-
Philippines	15.6	15.5	14.3	14.6	14.4	15.0	15.3	15.5
Singapore	29.5	28.4	23.4	20.6	19.8	19.4	19.0	18.6
Thailand	15.4	15.0	15.8	16.6	17.6	14.0	15.0	16.0
Viet Nam	20.4	21.4	22.6	24.4	24.1	23.4	22.9	22.8
South Asia								
Afghanistan	-	-	3.2	4.5	5.6	-	-	-
Bangladesh	8.5	9.0	10.1	10.3	10.2	10.7	11.2	11.7
Bhutan	42.4	40.7	36.3	25.3	32.0	-	-	-
India	18.2	17.8	18.4	19.7	20.0	20.2	20.4	20.7
Maldives	32.3	33.0	33.1	34.6	33.8	-	-	-
Nepal	12.2	13.0	13.1	14.5	14.6	14.9	15.4	18.5
Pakistan	13.5	13.3	14.2	14.9	14.6	-	-	-
Sri Lanka	17.2	17.0	17.1	16.1	16.1	18.0	18.5	19.0
Central Asia								
Azerbaijan	18.6	18.0	18.7	24.2	25.0	18.6	20.0	20.0
Kazakhstan	22.7	22.6	21.4	22.2	23.5	24.8	24.5	25.6
Kyrgyz Republic	15.1	17.0	19.1	19.4	19.0	-	-	-
Tajikistan	13.6	15.2	16.7	17.2	-	-	-	-
Turkmenistan	23.5	22.3	17.7	18.6	-	-	-	-
Uzbekistan	28.0	25.7	25.0	24.2	23.7	-	-	-
The Pacific								
Cook Islands	39.2	41.1	37.8	36.6	35.3	37.4	-	-
Fiji Islands	25.9	23.9	24.6	24.6	25.1	25.5	25.2	25.2
Kiribati	134.4	129.9	134.7	119.8	97.3	-	-	-
Marshall Islands, Rep. of	75.3	82.4	78.1	86.1	84.1	91.5	91.2	90.1
Micronesia, Fed. States of	68.1	63.6	71.8	70.5	52.4	59.8	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	51.0	43.7	41.3	51.5	56.4	-	-	-
Papua New Guinea	28.0	27.1	27.9	28.2	31.2	32.0	31.2	29.7
Samoa	37.8	35.9	35.2	34.9	32.9	52.0	-	-
Solomon Islands	22.1	23.5	17.9	38.0	46.0	55.1	-	-
Timor-Leste, Dem. Rep. of	-	-	15.5	23.3	28.4	49.8	44.5	42.5
Tonga	26.4	27.5	29.8	27.5	26.5	24.8	-	-
Tuvalu	265.9	153.5	155.6	77.2	73.9	83.1	68.2	69.6
Vanuatu	22.1	21.6	22.0	20.7	20.9	21.4	20.8	20.2

- = not available.

Table A23 Fiscal balance of central government (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
East Asia								
China, People's Rep. of	-2.8	-2.6	-3.0	-2.5	-1.5	-0.9	-0.7	-0.2
Hong Kong, China	-0.6	-5.0	-4.9	-3.3	-1.0	-1.2	-0.8	0.1
Korea, Rep. of	-1.4	-1.7	0.4	-1.7	-2.0	-2.8	-	-
Mongolia	-6.8	-4.1	-6.0	-4.2	-1.2	-2.5	-	-
Taipei,China	-4.7	-6.7	-4.5	-2.9	-3.4	-4.9	-4.5	-4.6
Southeast Asia								
Cambodia	-4.9	-5.6	-6.7	-7.0	-6.4	-6.3	-6.0	-5.4
Indonesia	-1.2	-2.0	-1.4	-1.7	-1.3	-0.8	-1.0	-0.5
Lao People's Dem. Rep.	-6.0	-7.6	-8.3	-7.8	-4.8	-5.3	-3.9	-3.8
Malaysia	-5.7	-5.5	-5.6	-5.3	-4.1	-3.1	-2.2	-1.5
Myanmar	-8.3	-5.8	-3.6	-4.9	-	-	-	-
Philippines	-4.1	-4.0	-5.3	-4.6	-3.8	-3.6	-3.2	-2.8
Singapore	8.6	4.8	4.3	6.5	3.4	3.3	3.2	3.1
Thailand	-2.4	-2.1	-2.2	0.6	0.3	0.0	0.2	0.2
Viet Nam	-2.4	-3.0	-3.8	-4.6	-3.8	-4.9	-5.0	-4.8
South Asia								
Afghanistan	-	-	-6.3	-5.3	-5.7	-	-	-
Bangladesh	-6.2	-5.0	-4.6	-3.4	-3.2	-4.7	-4.6	-4.5
Bhutan	-4.1	-11.7	-5.0	-10.4	4.5	-	-	-
India	-9.6	-10.0	-9.5	-9.4	-9.1	-8.8	-8.5	-8.0
Maldives	-4.4	-4.7	-4.9	-4.1	-4.4	-	-	-
Nepal	-3.3	-4.5	-3.9	-1.5	-1.5	-1.7	-3.0	-3.5
Pakistan	-5.4	-4.3	-4.3	-3.8	-3.2	-3.1	-3.0	-3.0
Sri Lanka	-9.5	-10.4	-8.3	-7.5	-7.6	-8.0	-8.0	-7.0
Central Asia								
Azerbaijan	-2.2	-2.1	-2.1	-3.1	-2.0	-1.1	-1.0	-1.0
Kazakhstan	-0.1	-0.4	-0.3	-1.0	-0.3	-1.2	-1.0	-0.9
Kyrgyz Republic	-9.9	-5.0	-5.4	-5.1	-4.3	-4.3	-4.1	-3.7
Tajikistan	-0.6	0.1	0.7	1.1	0.3	-0.5	-0.2	-0.1
Turkmenistan	-0.3	0.6	0.2	-1.0	-1.0	-	-	-
Uzbekistan	-1.0	-0.9	-0.8	-0.4	0.8	-	-	-
The Pacific								
Cook Islands	2.6	3.3	2.7	1.9	2.8	2.6	-	-
Fiji Islands	-3.2	-6.6	-6.2	-5.9	-4.8	-4.3	-2.4	-1.4
Kiribati	20.7	-18.7	-0.6	-30.2	-19.9	-	-	-
Marshall Islands, Rep. of	9.0	10.2	12.5	14.7	0.1	6.3	6.5	6.8
Micronesia, Fed. States of	-6.6	-8.8	5.9	5.0	-6.7	-2.2	-	-
Nauru	-	-	-	-	-	-	-	-
Palau, Rep. of	-19.6	-22.0	-23.3	-6.1	-9.9	-	-	-
Papua New Guinea	-1.8	-3.1	-3.8	-1.0	1.1	-1.0	-0.6	-0.2
Samoa	-0.8	-2.5	-2.2	-0.6	-0.9	-0.9	-	-
Solomon Islands	-7.5	-12.3	-10.3	0.1	2.5	-3.8	-	-
Timor-Leste, Dem. Rep. of	-	-	-0.3	1.5	7.5	29.8	22.4	19.8
Tonga	-0.3	-1.5	-1.5	-3.1	1.2	-2.2	-	-
Tuvalu	17.1	21.1	65.8	-10.9	-9.0	-5.1	-14.9	-16.6
Vanuatu	-7.0	-3.7	-2.1	-1.7	0.4	-0.2	0.5	0.5

- = not available.