ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

3

CENTRAL ASIA

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

The economy came back from its sharp contraction of 2009, but only slowly owing to a sharp fall in agricultural output. As the recovery takes hold, the authorities will need to wind down their anticrisis measures and return to the stronger precrisis fiscal position while normalizing monetary policy. The outlook is for a gradual pickup in growth on the assumption that exports, foreign investment, and remittances continue to strengthen. Structurally, though, further acceleration of reforms is crucial for improving the business environment and boosting the economy's competitiveness.

Economic performance

The economy grew very rapidly in the early years of the decade, underpinned by the large inflows of foreign direct investment and remittances. Growth, however, plummeted in late 2008 and in 2009 under the weight of the global crisis. Countercyclical fiscal and monetary policies, as well as improved economic conditions around the world and in the Russian Federation particularly, have helped the country to stabilize and return to growth. GDP expanded by 2.6% in 2010, despite a slump in agriculture (Figure 3.1.1).

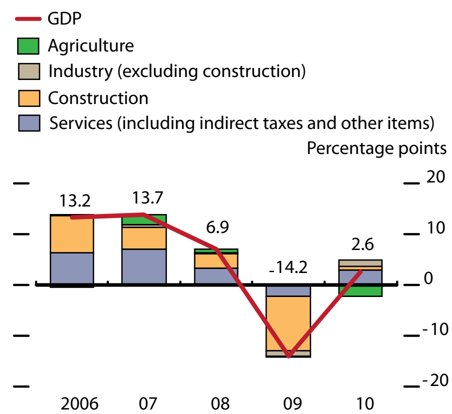
Agriculture contracted by 13.4%, reflecting poor weather that seriously damaged crops across the country. This left industry (excluding construction) to be the driving force of the recovery, expanding by 9.5%, much of which was generated by export-oriented mining and metallurgy. Increased volumes of foodstuffs, drinks, and pharmaceuticals helped buttress growth. Construction, which propelled high growth in earlier years before its collapse took down the economy by 14.2% in 2009 (Figure 3.1.2), expanded by 3.7% in 2010, mainly due to government anticrisis spending.

The trade and services sector grew by 4.4%, primarily on increased service volumes in such areas as financial, insurance and real estate activities and information and communications technology.

From the demand side, private expenditure and investment grew by an estimated 5%, reflecting the gradual recovery in global activity and its impact on the domestic economy. Remittance inflows from workers abroad picked up by 15.4% to $1.1 billion after a weak performance in 2009, though they remained below their 2008 peak level of $1.4 billion. Inflows of foreign direct investment amounted to around $750 million in 2010, up by 3.5% year on year, with communications, electricity, gas, and water the largest beneficiaries. Public consumption and investment moderated alongside a diminishing expansionary fiscal policy as anticrisis measures taken up a year earlier began to be wound down.

An inflation targeting framework underpins monetary policy. A

3.1.1 Contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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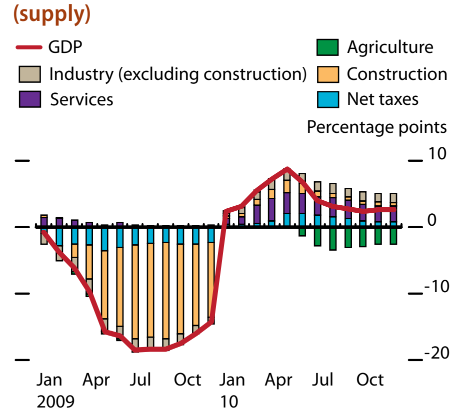
3.1.2 Monthly contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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This chapter was written by Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

sharp fall in domestic agricultural production and higher international wheat and other cereal costs led, however, to a spike in headline inflation to 9.4% in December 2010 from a year earlier (Figure 3.1.3), pushing inflation above the upper limit of the central bank's inflation target band (4% +/-1.5%). Average annual inflation was 8.2% for the year. Items keeping food inflation high were dairy, eggs, meat, and grain products, in that order, with price increases ranging from 18.7% to 13.1%. The higher food inflation was offset by moderating nonfood inflation, mainly due to weakening prices in private cars, medicines, garments and knitwear, footwear, detergents, and beauty items.

As inflation picked up, the central bank tightened monetary policy and gradually raised its refinancing rate by 225 basis points in January–May 2010 to 7.25% and kept it there through December. Despite this tightening and measures to de-dollarize the economy, the share of foreign currency loans in banks stayed high, increasing from 51.9% at end-2009 to 57.4% 12 months later, while the share of foreign currency deposits fell from 73.4% to 69.0%.

Broad money supply grew by 11.8% in 2010. Credit to the economy jumped by about 28%, reflecting positive macroeconomic trends and a slight decline in interest rates due to allocation of funds attracted by banks. The contribution of net foreign assets to monetary growth was negative, mainly due to the central bank's interventions, which aimed to smooth large exchange rate movements (Figure 3.1.4).

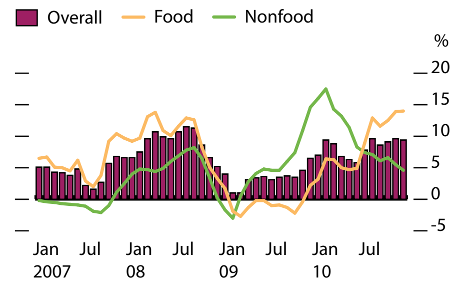
Fiscal policy aimed to continue supporting the recovery while addressing medium-term fiscal and debt vulnerabilities. A 14.5% increase in tax revenue and restrained spending have significantly eased the fiscal imbalance. Improvements in tax and customs administration, progress in introducing an electronic tax-filing system, and strengthened taxpayer services (such as "taxpayer service centers") along with greater economic activity boosted tax receipts. But despite climbing slightly from 16.7% in 2009 to 16.9%, the tax-to-GDP ratio is still low internationally. Total budget revenue rose by 10%, but as a share of GDP declined from 22.9% in 2009 to 22.2% in 2010.

Total expenditure increased by a mere 0.5% from 2009. A budget deficit of 4.9% of GDP recorded in 2010 was well below the 6% of GDP projected by the government in late 2009 and a sizable 7.6% recorded in 2009 (Figure 3.1.5). About 60% of the deficit in 2010 was financed through domestic resources.

Outstanding public external debt climbed quickly to nearly $3.0 billion in 2009 and rose by another $300 million in 2010, reaching about 35.1% of GDP (Figure 3.1.6), with about 22.5% coming from central bank borrowing. Domestic public debt edged up to $428 million in 2010, and is relatively small at 4.5% of GDP. Although the level of total public debt is high, given that most is on concessional terms, debt service is manageable. Debt projections from the International Monetary Fund indicate that the total debt ratio will move up to about 50% of GDP in 2012, reflecting an increase in external borrowing, before declining to 43.5% of GDP in 2013.

While the public finance situation is improving, weaknesses remain in the balance of payments. Exports surged by 46.9%, much of which was generated by export-oriented mining and metallurgy,

3.1.3 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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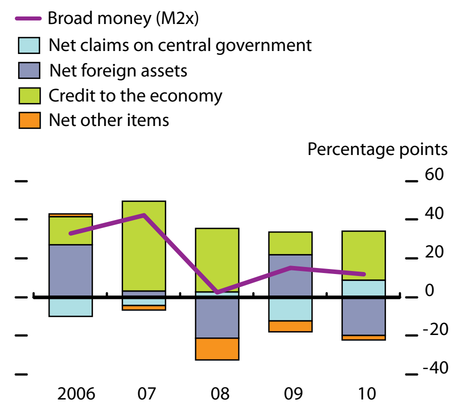
3.1.4 Contributions to money supply (M2x) growth



Source: Central Bank of Armenia. http://www.cba.am (accessed 1 March 2011).

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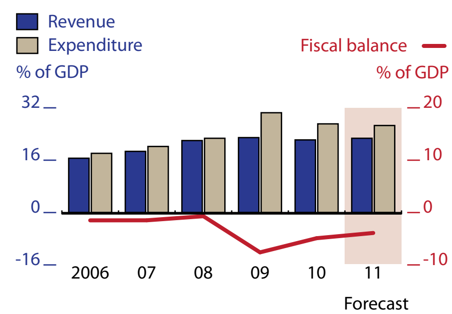
3.1.5 Fiscal balance indicators



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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3.1.6 External debt

Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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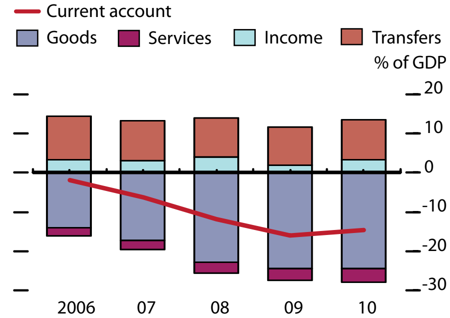
primarily due to soaring international prices of copper, molybdenum, and other nonferrous metals (but also due to a better global economic environment). After tumbling by 25.0% in 2009, imports showed growth of 19.8% in 2010, boosted by domestic demand that was lifted by improving investment and rebounding remittances.

The trade deficit pushed out slightly to an estimated $2.3 billion, but larger remittances and factor income helped narrow the current account deficit to 14.6% of GDP in 2010 from 16.0% (Figure 3.1.7). The large current account gap was financed primarily by donor inflows and foreign direct investment.

The central bank maintains a floating exchange rate regime. Given the large import content of consumption, its interventions in the foreign exchange market aimed to prevent steep fluctuations in the value of the dram while safeguarding reserves. Over the year, the nominal effective exchange rate appreciated by 9.7%, and the real effective exchange rate by 11.4%, reflecting higher inflation in Armenia than in its main trading partners (Figure 3.1.8).

Gross international reserves contracted by about $150 million to $1.8 billion at end-December 2010, equivalent to about 5 months of import cover. Three-year arrangements equivalent to $395 million with the International Monetary Fund were approved in June 2010, following a $540 million stand-by arrangement approved in March 2009. These arrangements have helped to replenish reserves as the authorities seek to strengthen the external position. Their economic program aims to restore fiscal and external sustainability, preserve financial stability, and support growth and poverty reduction.

3.1.7 Balance-of-payment components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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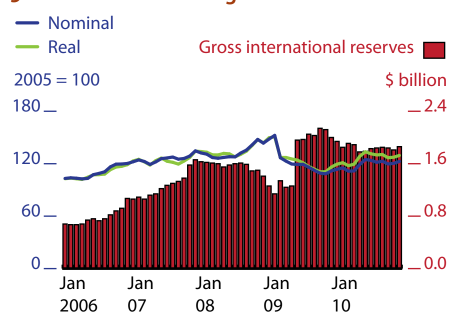
3.1.8 Effective exchange rates and reserves



Sources: International Monetary Fund. International Financial Statistics online database; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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Economic prospects

Continued growth in Armenia depends heavily on that in the Russian Federation. Strong performance there will boost foreign direct investment inflows, migrants' remittances, and demand for exports. As a result of improved external conditions—along with a rebound in agriculture, which is expected to grow by 10% this year—GDP is projected to expand by 4.0% in 2011 and 4.5% in 2012.

The government's efforts toward diversifying the economy and stimulating exports will provide additional impetus to growth and should make it less volatile. Investments in large-scale infrastructure, such as highways and rural roads, as well as the water-supply system, will continue to bolster public spending.

Fiscal policy is expected to be gradually tightened in 2011 and 2012 given concerns on the large buildup of external debt. This year's fiscal consolidation should be achieved through stronger revenue collection, stemming from the positive economic outlook and improving tax administration. The 3-year midterm spending program calls for suspension of public sector salary increases up to 2013 and freezing spending on purchases of equipment and property. The government envisages reducing the budget deficit to about 4% in 2011. The priority areas for expenditure include support for social programs and infrastructure.

Due to strengthening domestic activity and fast-rising global

3.1.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.0	4.5
Inflation	7.5	5.5
Current account balance (share of GDP)	-13.0	-12.3

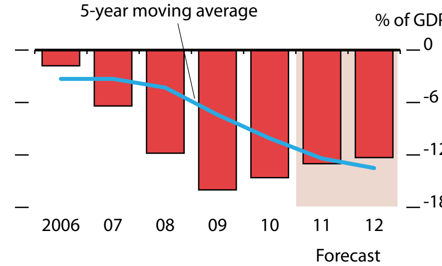
Source: ADB estimates.

commodity prices, inflation pressures will persist in 2011, though inflation is expected to come down from its 2010 high. Monetary policy is shifting to a tighter stance to combat these pressures: in February this year, the central bank increased the refinancing rate by 0.5 percentage points, to 7.75%. Inflation is forecast at 7.5% in 2011 and 5.5% in 2012.

Recovering remittance inflows and transfers as well as the large infrastructure projects are seen boosting domestic demand for imports, such that they rise by about 12.0% in 2011 and 10.0% in 2012.

Given the expected growth in major trade partners and expected outcomes of the government's export diversification and promotion actions, exports are expected to expand by 15.0% in 2011 and by about 10.0% in 2012. This increase will be backed by strengthening from new investments in chemicals and metallurgy. The trade deficit is seen narrowing moderately. Backed by the robust remittance inflows, the current account deficit is forecast to ease to 13.0% of GDP in 2011 and to 12.3% of GDP in 2012 (Figure 3.1.9).

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011); ADB estimates.

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Development challenges

The immediate to midterm macroeconomic challenges include tightening the monetary and fiscal stances, ensuring debt sustainability through concessional financing, and reducing external imbalances.

Fiscal consolidation will require action on both the revenue and expenditure sides. The authorities acknowledge the need for a faster pace of reforms in the areas of tax and customs administration.

Further efforts for better governance will likewise be important to improve social policy, improve the distribution of resources, and reduce poverty. The government is aware of oligopolies in key sectors of the economy that have strong links with entrenched elites. It therefore intends to continue its efforts to reduce corruption, enforce competition, modernize public expenditure management, and strengthen the civil service and judiciary.

For reducing reliance on minerals and metals, which account for the bulk of exports, the government needs urgently to take steps to diversify the industrial base. A one-stop shop for business registration is set to come into effect this year, which should reduce barriers to entry for new businesses.

Azerbaijan

Although growth in oil output slowed in 2010, higher oil prices led to a large balance-of-payments surplus, while a revival in the non-oil economy, driven by public expenditure, led to solid but slower overall growth. Growth and the balance of payments are both predicted to remain strong in 2011 and 2012. Inflation was moderate but local and external factors will stoke price pressures in 2011. Supporting growth in the non-oil sector and reducing dependence on oil revenue represent a significant long-term challenge.

Economic performance

GDP growth at 5.0% in 2010 was markedly lower than the very high rates of the previous few years when large investments rapidly expanded Azerbaijan's oil and gas resources. Growth in the oil economy (defined to include gas production) is estimated to have slowed to 1.8%. The non-oil economy performed well, growing by 7.9%, as it recovered from the headwinds of the global recession. With oil and gas production growth leveling off (oil production in 2010 was at 377.4 million barrels), the outlook is for moderate overall growth based largely on non-oil activity (Figure 3.2.1).

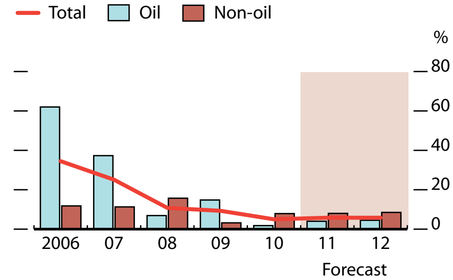
Robust growth in the non-oil economy in 2010 was driven largely by public investment, mainly in infrastructure projects that led to a 20.3% expansion in construction activity (Figure 3.2.2). This was a marked recovery from the 8.3% contraction in investment in 2009, when much lower oil prices and global crisis–related uncertainty reined in public and private investment. Non-oil manufacturing is estimated to have grown by about 6.8%, after 2009's 12.6% contraction. Several public and private industrial plants started operations and SOCAR, the state-owned oil company, expanded into non-oil manufacturing.

Services growth was robust at 7.2%, driven by the strong expansion in the non-oil economy as well as gains in gas transport services and new technologies in mobile communications and Internet access.

Agriculture performed poorly, contracting by 2.2% in 2010 after 3.5% growth in 2009. This reflected a 33% drop in grain production that was caused by flooding, a decline in the area cultivated, and falling yields. Production of other agricultural products such as cotton and tobacco picked up.

Public investment, mainly in the non-oil sector, rose to 13% of GDP, accounting for nearly three-quarters of overall domestic investment. Although private investment fell slightly as a share of total investment, it was well above its low of 2008. Foreign direct investment in oil has been declining since 2006 with the completion of large investment

3.2.1 Oil and non-oil GDP growth



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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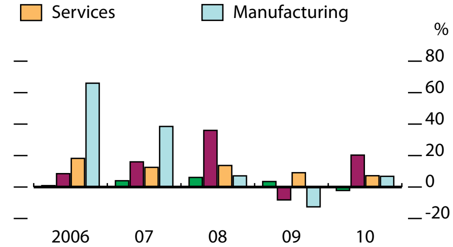
3.2.2 Non-oil GDP growth, by production



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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projects as well as SOCAR's self-financing of new projects. Inflows into manufacturing, transport, and communications went up.

Inflation crept up steadily during the year, to 5.7% in December 2010 year on year from 1.5% in December 2009 (Figure 3.2.3). The upturn was largely driven by rising prices of basic food items, including wheat, reflecting both higher import prices and the poor grain harvest. Nonfood prices increased moderately over the year. Demand factors, such as a pay hike for public servants and a robust expansion in credit to the private sector, appear to have put some additional pressure on these supply-side factors.

The State Oil Fund of Azerbaijan (SOFAZ), set up to save a part of the nation's hydrocarbon earnings, is channeling some of its revenue to the budget for financing public investment projects. Despite large transfers of this nature in 2010, SOFAZ assets surged by 52.8% to $22.8 billion at year-end, buoyed by higher oil prices.

Budget expenditure rose by 11.3% in 2010, though as a share of GDP it moderated by about 1 percentage point to 28.3% (Figure 3.2.4). Besides the salary hike, 2010 saw markedly higher social and defense outlays; public investment came in at 13% of GDP. Tax collection increased by only 4.4% in 2010, as customs revenue contracted because of lower imports of machinery and equipment. Total budget revenue declined by 2 percentage points to 27.4% of GDP. The large gap between budget expenditure and revenue was again bridged by substantial SOFAZ transfers, keeping the overall budget deficit small (0.9% of GDP).

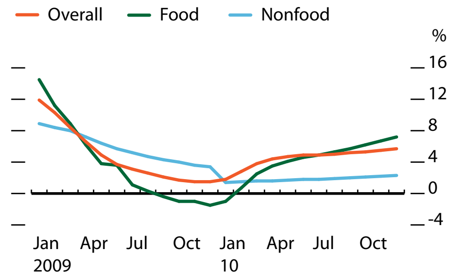
Without the SOFAZ transfers the deficit would have been 15.1% of GDP, and these transfers have been rising in absolute terms and relative to GDP in recent years. They now make up over one-half of the government resources that finance budget expenditure. To arrest this trend, the government would need to increase revenue from taxes and other charges, though a substantial move would stymie policies that seek strong expansion in non-oil economic activity.

The Central Bank of Azerbaijan adopted an expansionary monetary policy in 2009, aiming to counter the impact of the downdraft on growth from lower oil prices and an uncertain economic outlook. It set the refinancing rate at 2.0% and the reserve requirement at 0.5%. It raised the refinancing rate to 3.0% in November 2010 and to 5% in March 2011, responding to the strengthening in the non-oil economy and inflation pressures. It continues, however, to provide long-term loans and additional special financing support to private companies and banks at its discretion.

Evidence of recovery is seen in a 9.7% rise in credit to the private sector and a 24% expansion in the broad money supply (Figure 3.2.5), which in part reflected a rebound in net foreign assets as the overall balance returned to a large surplus. A sign of financial deepening and greater confidence in the banking system was that the ratio of broad money to GDP rose from 23.8% in 2009 to 25.3% in 2010.

In overseeing the commercial banks, the central bank is implementing Basel standards to improve banking regulation and stability, as well as to strengthen public trust in the banking system. Banks have therefore boosted their capital position. Similarly, to extend access to financial and banking services in rural areas particularly, the government has initiated

3.2.3 Monthly inflation



Sources: International Monetary Fund. International Financial Statistics online database (accessed 10 March 2011); State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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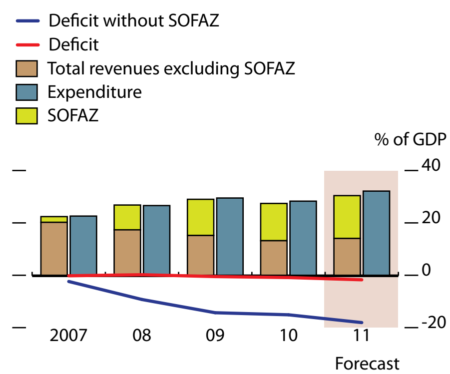
3.2.4 Fiscal indicators



SOFAZ = State Oil Fund of Azerbaijan.

Source: Ministry of Finance. http://www.finance.gov.az

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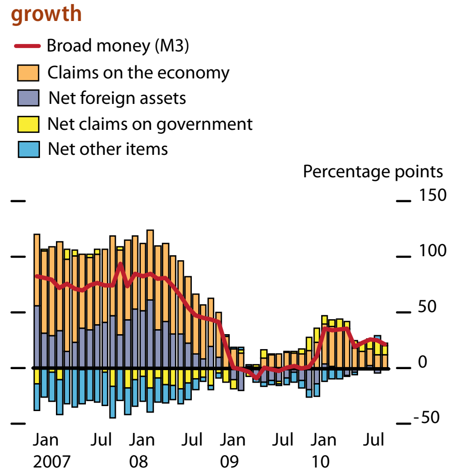
3.2.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 1 March 2011).

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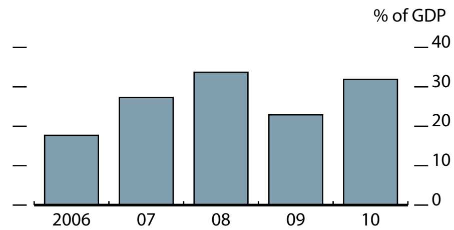
the Azerpost project, which offers services (including microcredit, money transfers, and distribution of pensions) through post offices.

On the external front, the marked global increase in oil prices led to an estimated 24% gain in exports (oil and gas account for about 95% of goods exports). Non-oil exports saw a small gain despite agriculture's contraction. Imports witnessed virtually no upturn despite the revival in non-oil growth.

Similarly, net services and income payments were little changed from a year earlier while workers' remittances, a marginal item in the balance of payments but an important source of support for rural households, tumbled. Resting mainly on strength in oil pricing, the current account surplus was boosted to $16.5 billion in 2010, about 31.9% of GDP, from $10.2 billion a year earlier (Figure 3.2.6).

Gross international reserves jumped by nearly 20% to $6.4 billion at end-2010. With the surge in SOFAZ assets, total foreign assets now amount to about 56% of GDP. Public external debt is relatively small at $3.7 billion, about 9% of GDP.

3.2.6 Current account balance



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 1 March 2011).

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Economic prospects

As oil prices are projected to go up in 2011 and remain high in 2012, the main challenge for the government will be to maintain macroeconomic stability. Growth in oil revenue will allow a continued rise in social expenditure and investment in infrastructure that should spur private activity and improve the investment climate.

The hydrocarbon economy is expected to grow steadily at about 3%–4% in the forecast period as oil and gas development sets the stage for faster expansion in later years. Robust growth of the non-oil economy is expected to stay driven by public sector investment. The government is planning investment spending of $4.2 billion in 2011, which will drive a rapid expansion in construction with positive knock-on effects on the rest of the economy.

Agriculture is seen growing steadily on the assumption of good weather and continued government support, including reductions in value-added tax on agricultural inputs and in the lending rate of the main agro-leasing company, and completion of irrigation and infrastructure initiatives. Growth of 8% is foreseen in the non-oil sector in 2011 and 2012. Overall GDP growth is projected at 5.8% in both years.

3.2.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.8	5.8
Inflation	7.5	7.0
Current account balance (share of GDP)	27.8	25.0

Source: ADB estimates.

The central bank will aim to meet the credit demands of the non-oil economy while keeping consumer price inflation in check, though price rises will probably be driven mainly by external factors. The exchange rate may come under some upward pressure because of larger surpluses in the balance of payments, but the bank will resist a marked appreciation as it would retard non-oil export development. Inflation is seen reaching 7.5% in 2011 as global price pressures increase, gliding down to 7.0% in 2012 as they moderate.

Higher oil export revenue will outweigh the import growth arising from strengthening investment and the rising income–related consumer spending. The current account surplus is expected to be 27.8% of GDP in 2011 and 25.0% in 2012, as import demand rises in response to growth of incomes and appreciation of the manat, and as growth in oil revenue slows.

Development challenges

Developing the non-oil sector and diversifying the economy is the government's longer-term priority. Agriculture, manufacturing, telecommunications, and tourism all have potential for growth. Agriculture is particularly crucial, as 40% of the population still lives in rural areas. Although government programs have attempted to support the sector, the rural population depends largely on remittances. Further steps include rehabilitating and maintaining irrigation and other infrastructure, improving land-management practices, enhancing inputs as well as credit and agricultural services, and boosting incentives for private participation.

Improved physical infrastructure, particularly roads, railways, and energy, is also essential for the non-oil sector. Additionally, medium- and long-term private sector growth will depend on a stable macroeconomic environment and a better legal and regulatory framework, among other measures. Azerbaijan is now ranked 54 out of 183 in the World Bank's *Doing Business 2011* report, ahead of most countries in the region. This ranking reflects progress over the past year in providing access to credit and simplifying tax payment procedures.

The report shows that trade facilitation, too, requires work, as Azerbaijan is one of the 10 hardest countries from which to trade across borders. If it is to become a successful exporter, it needs to reduce both formal and informal barriers to trade. In addition, the procedures and permits required for certain sectors or operations need to be streamlined, while governance and transparency should be improved to ensure that the large public investment program provides its maximum potential benefit.

3.2.2 Global rankings on the ease of trading across borders, 2011

Niger	174
Burkina Faso	175
Burundi	176
Azerbaijan	177
Tajikistan	178
Iraq	179
Congo, Republic of	180
Kazakhstan	181
Central African Republic	182
Afghanistan	183

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.

Georgia

On the back of stronger trade demand and remittances, as well as a fiscal stimulus, the economy bounced back to solid growth in 2010, though inflation also accelerated, largely on global price pressures. The outlook is for measured growth with increased reliance on the private sector (including remittances from abroad) and for continued inflation pressures. Major risks relate to a weak recovery in foreign investment and other capital flows.

Economic performance

The economy recovered from the sharp contraction in the second half of 2008 and in 2009 to grow at 6.4% in 2010 (Figure 3.3.1). The broad-based recovery was underpinned by a marked pickup in export demand and robust remittances, strong government investment, and a rebound in credit to the private sector. A striking revival in gross fixed capital formation of 22.5%, after a 32.8% drop in 2009, was the main impetus.

On the production side, industry and services grew steadily at about the same pace. Industry advanced by 9.7%, led by high growth in manufacturing due to the rebound in export demand and to strengthening consumer demand. Services picked up by 7.1% on account of high growth in trade, transport, and tourism as Georgia's west coast tourist venues bounced back to a highly successful season. By contrast, agriculture contracted marginally. Once a strong exporter, it has become a low-profit sector as it cannot compete with grain and livestock imports.

Headline inflation accelerated from around mid-2010 to 13.7% by February 2011 (Figure 3.3.2). The uptick was largely attributable to food items (with a weight of 40.5% in the index), which rose by 28.4% owing to mounting global food prices. Price increases in other sectors were moderate, pointing to limited pressures from the demand side.

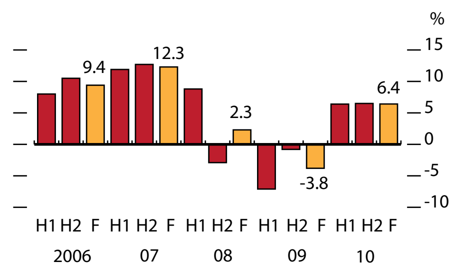
In light of the renewed inflation pressures and economic recovery, the National Bank of Georgia switched to monetary tightening in the second half of 2010, raising the policy rate in steps to 8% by February 2011. It also doubled the reserve requirements to 10% on lari-denominated deposits in April 2010 and on deposits in other currencies to 15% in February 2011.

Despite these policies, credit to the economy grew by 20.4% in 2010 owing to rising business and bank confidence. The M3 broad money aggregate rose by 34.8% as both local and foreign currency deposits climbed (Figure 3.3.3). Dollarization of deposits declined by 1.3 percentage points to 72.1%.

Interest rates on both deposits and lending decreased during 2010, by 150 and 300 basis points, respectively (Figure 3.3.4). As with the reduction in dollarization, the change appears due to a lower risk perception, as the high uncertainty associated with the global downturn fades.

This chapter was written by George Luarsabishvili of the Georgia Resident Mission, ADB, Tbilisi.

3.3.1 GDP growth



F = full year.

Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

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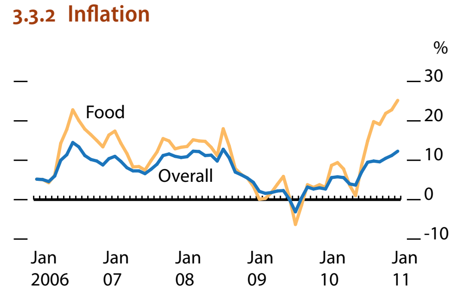
3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

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The change in the monetary policy stance is expected to have a greater impact on the economy in 2011. The upward revision in the policy rate has narrowed its gap with deposit rates, making it less attractive to use the refinancing facility. Increases in reserve requirements have reduced excess bank reserves, as apparently reflected in slowing loan volumes in early 2011, to a level that will make monetary control more effective.

The main prudential ratio in the financial system is well above the minimum requirement: the average risk-weighted capital adequacy ratio was 17.4% at end-2010. Moreover, the ratio of nonperforming loans to total loans declined to 11.6% at year-end and banks made an aggregate profit (after 2009's loss).

Recovery in economic activity along with improved tax administration brought about a revival in tax receipts and general government income (excluding grants). Total revenue increased by 11.4% year on year. On the expenditure side, the government raised social spending and salaries, adjusting largely by containing other current expenditure items such as spending on goods and services for public administration. Capital spending and net lending rose somewhat more than planned in the original program. Still, the deficit narrowed to 6.5% of GDP in 2010 from 9.2% a year earlier (Figure 3.3.5).

Foreign financing was much higher than a year earlier and provided more than 80% of the deficit financing, although Treasury bills remained important.

External public and publicly guaranteed debt increased from 31.4% of GDP in 2009 to 37.4% in 2010. The debt repayment burden will become very heavy in 2013, when a large Eurobond issue matures and significant repayment obligations to the International Monetary Fund fall due. Rapid fiscal consolidation is essential in preparing to make these payments.

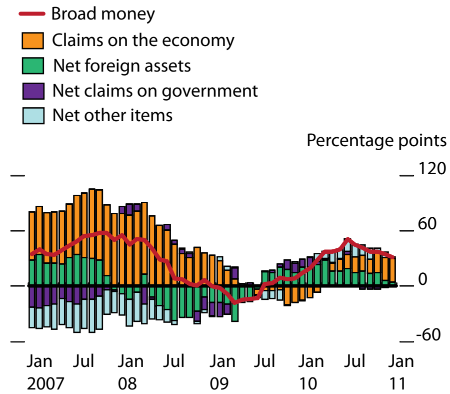
A recovery in global demand and higher prices of ferroalloys and nonferrous metals—the country's leading export commodities—helped to boost exports by 23.5%; imports grew by 15.8%. The trade deficit widened to $2.6 billion, though this was largely offset by stronger net remittances and services exports.

The current account deficit amounted to an estimated 11.4% of GDP in 2010, up from 11.2% in 2009 (Figure 3.3.6). Inflows of foreign direct investment (FDI), however, were disappointing. They had been expected to come back as the main source of growth, but missed the $600 million target.

The lari depreciated against the US dollar by about 5% in 2010. Weaker inflows in the first half of the year and banks' buildup of foreign exchange balances led to a larger depreciation in this period, but the currency subsequently strengthened (Figure 3.3.7) on improved earnings and capital inflows. Because of the steeper increase in domestic prices than in major trade partners, the real effective exchange rate appreciated by 2.8%.

Gross international reserves gained about $155 million, rising to $2.3 billion at end-2010, equivalent to about 4 months of 2011 estimated imports. Reserves were bolstered by drawing on funds from the International Monetary Fund made available under stand-by arrangements originally approved in 2008 and augmented in 2009 to a cumulative amount of about $1 billion.

3.3.3 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 17 March 2011).

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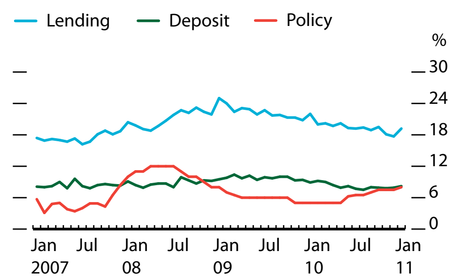
3.3.4 Interest rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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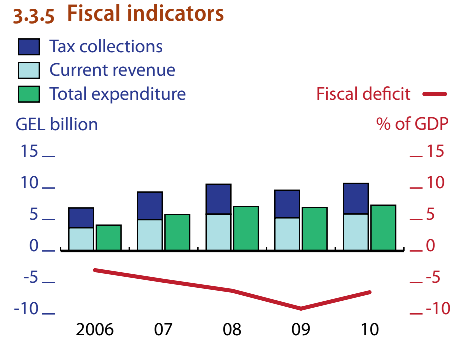
3.3.5 Fiscal indicators



Sources: International Monetary Fund. 2008. *Country Report* No. 08/328. October; 2009. *Country Report* No. 09/267. August; 2009. *Country Report* No. 09/331. December; 2011. *Country Report* No. 11/31. January. http://www.imf.org; Ministry of Finance of Georgia. http://www.mof.ge/en (accessed 17 March 2011).

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Economic prospects

Growth in 2011 will be measured because of the cyclical revival of 2010 and a phased withdrawal of fiscal stimulus in view of the need for consolidation. Hence more modest growth of 5.5% is projected. With greater reliance on the private sector as a driver, growth is forecast to be sustained at 5.0% in 2012.

Even though the growth of broad money is seen slowing to 20%–25% in 2011, the central bank's monetary program calls for a 15%–20% increase in credit to the private sector, which it perceives as appropriate for the growth target. The central bank is committed to a flexible exchange rate regime, and is moving to adopt inflation targeting.

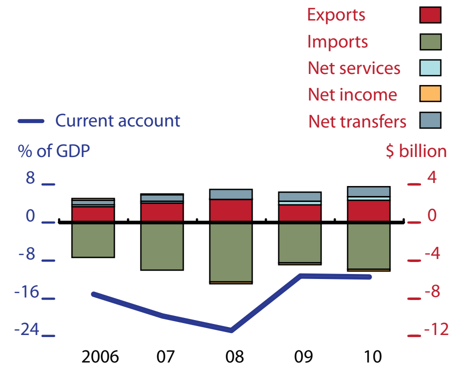
Inflation is expected to be high in 2011 at 9.5% given the ongoing surge in global food and oil prices. It should edge down in 2012 on the view that food price rises will be largely over and that oil and other import prices increase only moderately.

A new tax code that was passed in September 2010 (effective 1 January 2011) should boost government revenue. Its impact, along with the government's continued commitment to containing current spending, is seen narrowing the fiscal deficit to 4.0% of GDP in 2011 and to 3.4% in 2012. Special measures to protect low-income families from high inflation, such as electricity vouchers introduced in February 2011 and food vouchers the following month, will require cuts in budgeted expenditure to maintain the 2011 deficit target. Fiscal adjustment, unlike in 2010, will involve holding back capital spending.

The current account deficit is expected to widen slightly to 12.6% of GDP in 2011 as rising food and oil prices add to the import bill. A steady stream of remittances and services surpluses as well as growing export revenue from a sustained global recovery will help to rein in the deficit. It is projected to narrow to 11.4% of GDP in 2012, largely reflecting a further narrowing of the trade gap. External financing requirements of the current account deficit will increasingly rely on private inflows, such as FDI, as official development assistance slows.

External risks associated with this outlook include a setback in the global recovery, higher than expected global commodity prices, and weaker FDI inflows. On the domestic front, the most significant risk is slow fiscal consolidation.

3.3.6 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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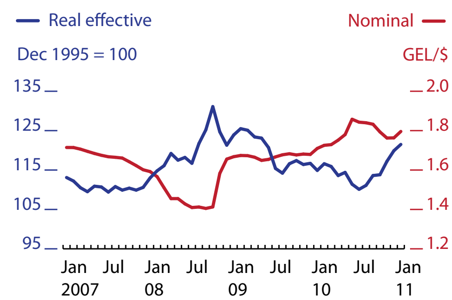
3.3.7 Exchange rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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Development challenges

A key challenge is to make growth sustainable over the medium term. The country therefore needs to diversify its production structure and exports from traditional products. The current limited physical, financial, and human capital are key bottlenecks.

Further efforts are needed to improve the fiscal deficit and to continue implementing reforms so as to prevent systemic risks from developing in the private sector.

3.3.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	5.0
Inflation	9.5	6.0
Current account balance (share of GDP)	-12.6	-11.4

Source: ADB estimates.

Kazakhstan

In 2010 the economy showed a V-shaped recovery, driven by a revival in external demand, higher oil prices, and anticrisis measures. The outlook is for steady moderate growth and a comfortable current account surplus. Nevertheless, limited credit availability from restructured but still weak banks and rising inflation are headwinds. To diversify the economy and raise productivity, the government is implementing an industrial-innovation program.

Economic performance

The recovery that started in the last quarter of 2009 continued into 2010, giving full-year growth of 7.0% (Figure 3.4.1). Improved global economic conditions, a revival in external demand for oil and minerals, and mounting oil prices all played a role, as did anticrisis measures put in place in 2009. Bank restructuring was also a positive factor, though private credit to the economy stayed weak.

This solid growth performance was driven by 9.6% growth of industry. Manufacturing expanded by 18.4% and mining by 5.3%. Construction, which slowed sharply during 2007–2009, gained some momentum and grew at 1.0% in 2010. Agriculture contracted by 11.7% in 2010 as a result of damage that severe summer droughts caused to about 10% of arable land. With overall economic activity picking up, services expanded by 6.0%.

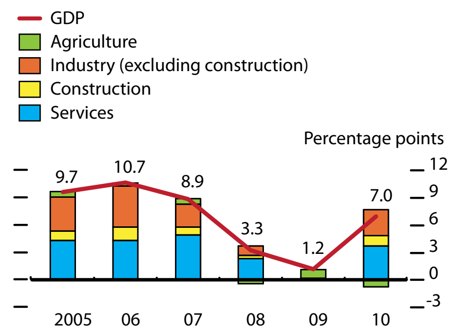
On the demand side, after a stagnant 2009 and with the recovery beginning to take hold, private consumption and gross fixed investment grew by 7.5% and 7.0%, respectively, in 2010 (Figure 3.4.2). Credit conditions stayed tight, which may have held back further increases in private consumption and investment. After the slump of 2009, export volume grew by 9.5% in 2010, as demand for oil and other key exports picked up. With rising consumption and investment, imports grew by 6.5% in 2010.

Overall average annual inflation reached 7.1% in 2010, remaining within the target band of 6%–8% of the National Bank of Kazakhstan (NBK). In January 2011, year-on-year headline inflation was, however, at 8.1%, 0.8 percentage points higher than a year earlier. This rise was largely due to the continued increase in prices of food items (Figure 3.4.3). The sharp drop in agricultural output as a result of the severe droughts that afflicted Kazakhstan and the Russian Federation in 2010 contributed to the food price surge. Inflation for nonfood items and services continued to moderate, indicating some slack in the economy.

With the economy beginning to gain traction but also showing signs of weak private sector activity, the NBK kept the refinancing rate at 7.0% during 2010, unchanged since September 2009. It also maintained the

This chapter was written by Utsav Kumar, consultant of the Central and West Asia Department, ADB, Manila; and Christopher T. Hnanguie and Manshuk Nurseitova of the Kazakhstan Resident Mission, ADB, Astana.

3.4.1 Contributions to growth (supply)



Source: Agency of Statistics of the Republic of Kazakhstan.
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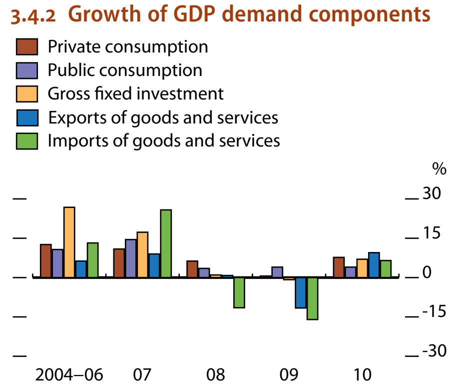
3.4.2 Growth of GDP demand components



Sources: Agency of Statistics of the Republic of Kazakhstan; Economics Intelligence Unit. 2011. *Kazakhstan Country Report*. March.
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reserve requirements, which it had lowered to a historical low in March 2009, to boost liquidity. Broad money supply increased by 14.1% in 2010, largely on account of higher net foreign assets (Figure 3.4.4). Credit to the economy grew by 6%, though that to the private sector rose by only 0.8% in 2010, reflecting both weak private sector activity and risk aversion among banks.

After the onset of the financial crisis and with falling oil prices, foreign exchange reserves came under stress. The NBK devalued the tenge in February 2009 by about 20%, following a similar adjustment in the Russian Federation, from T120/$ in 2008 to T150/$, with a 3% band. As the economic recovery gathered pace and oil prices came back from their lows, the NBK introduced in February a wide, asymmetric trading band of +10%/-15% around T150/$. Over the course of the year, the nominal exchange rate appreciated marginally.

Budget revenue increased due to the improvement in economic activity, higher oil prices, and the reintroduction in mid-August 2010 of an oil export duty of $20 per ton. Transfers from the oil fund, the National Fund of the Republic of Kazakhstan (NFRK), were also used to support the budget. As a result, current revenue climbed by 28%.

Total expenditure increased by 21%: 19% on current items, due to higher social spending and wages; 55% on capital items, due to investments in priority projects. The fiscal deficit narrowed to 2.5% of GDP in 2010 from 2.9% a year earlier. Most of the deficit was financed through domestic sources, although foreign financing increased.

After a contraction in 2009, exports jumped by 38.5% in 2010 due to the improved global economic environment and higher oil prices. Imports recovered to grow by 10.3% in 2010. The modest pickup in imports points to weak private domestic demand as well as lack of credit. The $28.9 billion trade surplus was partly offset by a persistent services deficit, as well as by a negative balance in the income and current transfers accounts combined (Figure 3.4.5).

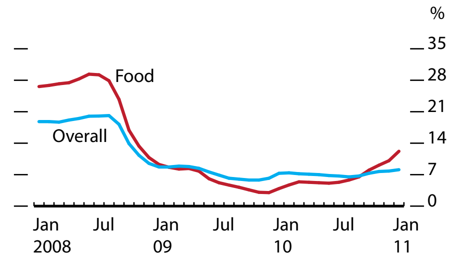
The current account balance moved back into positive territory from a deficit of $4.4 billion (3.8% of GDP) to a surplus of $4.3 billion in 2010 (3.0%). Gross international reserves at end-2010 climbed by 22.5% to $28.3 billion. Assets of the NFRK rose by 25.5% to $30.6 billion (Figure 3.4.6). An important development on the trade front was the formation of a three-country customs union (Box 3.4.1).

Total external debt grew rapidly from the early 2000s, reaching about 92% of GDP just as the global capital markets began to wobble in August 2007. The rapid increase in debt was due to external borrowing by banks to finance consumption and construction (Figure 3.4.7). The debt composition has changed significantly, with public and publicly guaranteed debt, always low, now accounting for only 4.3% of the total. Almost half the total private debt outstanding is intracompany debt, mainly reflecting liabilities for direct investment by oil companies.

The vulnerabilities of the banking system were exposed as the global crisis bit, putting pressure on foreign reserves as well as on the exchange rate. Banks' external debt came down after the crisis through September 2010.

The two largest banks had to be nationalized after the crisis, which had hit the banking system hard. The external debt obligations of these

3.4.3 Inflation



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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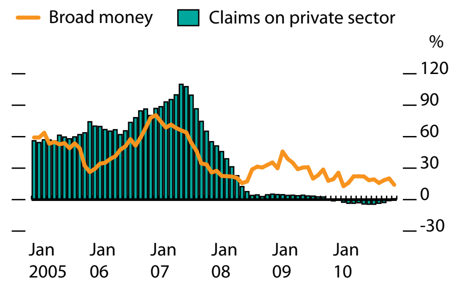
3.4.4 Growth of monetary aggregates



Note: Increase in private sector credit for February 2009–January 2010 were adjusted to exclude valuation changes on foreign currency–denominated loans stemming from the February 2009 devaluation.

Source: International Monetary Fund. International Financial Statistics online database (accessed 15 March 2011).

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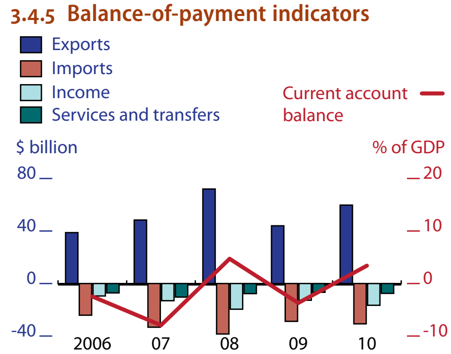
3.4.5 Balance-of-payment indicators



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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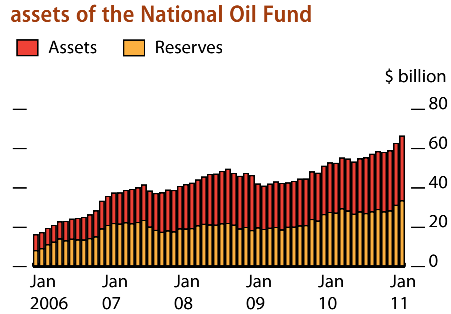
3.4.6 Official reserves and foreign exchange assets of the National Oil Fund



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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3.4.1 Customs union among Belarus, Kazakhstan, and the Russian Federation

The three countries formed a customs union in 2010. It removes duties on goods originating in member states and enforces a common external tariff for trade with third countries. It also establishes a common customs territory in which terminology, a customs code, and customs duties will be unified.

The union took effect on 1 January 2010 with a unified customs rate. At this first stage, the three countries removed most duties on trade among themselves.

On 1 July 2010, a customs code was launched between Kazakhstan and the Russian Federation, coming into force a few days later in Belarus. This second stage led to the adoption of common external tariffs.

In the third stage, customs clearance and control procedures at the Kazakh–Russian Federation border are scheduled to be abolished by 1 July 2011. (Such measures were implemented at the Belarus–Russian Federation border in July 2010.) By January 2012, a single economic space will be achieved among the three countries.

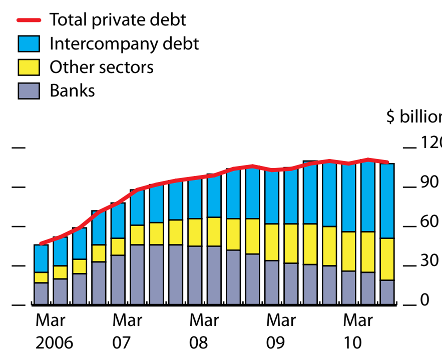
The tariff regime is based heavily on that in the Russian Federation, and Kazakhstan had to raise tariffs on around 45% of all imported items. The average common customs tariff rate is 10.6%, whereas previously Kazakhstan's simple most-favored-nation applied tariff was only 6.16%.

The value-added tax rate applied to third countries is 17%. Import customs duties from goods originating outside the union will be distributed among the three countries according to an agreed formula of 87.97% for the Russian Federation, 7.33% for Kazakhstan, and 4.70% for Belarus.

two banks and of two other smaller banks had to be restructured, resulting in debt relief of $11 billion. Overall, the share of nonperforming loans in the total loan portfolio is about 30%, and is a key factor hampering lending activity.

In addition, the restructuring of external debt has affected the private sector's access to international markets. The country's leading private bank, Kazkommertsbank, postponed its issuance of international bonds, citing unfavorable market conditions (although state-owned KazMunayGas and Kazakhstan Temir Zholy were readily able to raise money in international markets in 2010). Continued risk aversion has affected credit availability, in turn holding back private consumption and investment.

3.4.7 Private external debt



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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Economic prospects

The recovery of agriculture after the sharp contraction of 2010, capital expenditure by the government on priority projects in its program for 2010–2014, a sustained global recovery, and an increase in oil demand and prices will help run the growth momentum in 2011 and 2012. At the same time, banks' continued fragility and steep oil and food price rises may undermine the global economy and work against Kazakhstan's growth. The forecast is for GDP to grow by 6.5% in 2011 and 6.8% in 2012.

Construction will continue to face weaknesses as a result of lack of credit and the inability of the private sector to raise funds in international markets on attractive terms. Private consumption and total investment are expected to see continued growth in 2011 and 2012. Credit availability will be an important factor if higher growth rates are to be achieved. However, higher oil prices and external demand will help to boost consumption as well as investment in the oil sector.

The government is considering several programs that will help to support private consumption and investment over the projection horizon and beyond. One of them, Employment 2020, targets the self-employed, especially those in rural areas. It will provide support in the form of

3.4.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.5	6.8
Inflation	8.5	6.0
Current account balance (share of GDP)	3.5	3.5

Source: ADB estimates.

relocation from economically depressed regions, subsidized leases of property, and day care for children.

Another, the Business Roadmap 2020, for entrepreneurs and exporters in priority sectors, will provide assistance in the guise of subsidized interest rates, guarantees for bank credits, grants, cofinancing of investment projects, and rescheduling of certain tax payments.

An increase in oil exports coupled with a doubling of the oil export duty to $40/ton from 1 January this year is adding to state coffers. A concurrent shift from a personal income tax flat rate to a progressive income tax (with rates at 10%–20%) will also lift revenue, as will a decision to hold off reducing the corporate income tax rate (currently at 20%) until 2013. Both social and capital expenditure on priority projects will climb. Overall, the government is likely to achieve its target of narrowing the fiscal deficit to 2.2% in 2011 and 1.7% in 2012.

With the surge in global food prices and the region still reeling from the effects of the severe droughts, the prices of many food items are likely to rise further. In February 2011, the government introduced price ceilings for essential food items. A utility fee increase in January 2011 and a boost to consumption from wage increases in the second half of 2011 will add to inflation pressures.

Some slack still appears to be in the economy, however—as observed from moderate prices of nonfood items and services—and this will help to contain inflation this year, to 8.5%, as inflation pressures subside later in the year. Inflation in 2012 is expected to be 6.0%.

Though the trading band for the exchange rate was widened in February 2010, the NBK has intervened to prevent the tenge from appreciating sharply. On 28 February 2011, it abolished the corridor for the tenge/$ exchange rate and introduced a managed float regime. It is unlikely that the tenge will be allowed to breach T141/$, as further appreciation, combined with the inflation differential with the advanced countries, could result in a loss of competitiveness.

The current account balance is projected to remain positive in 2011 and 2012, at 3.5% of GDP. Imports will increase on the back of higher private consumption and investment as banks become more willing to lend, and of government investment in a variety of priority projects. Exports will markedly increase further due to higher oil prices and stronger demand for oil. The trade surplus will be offset by the deficit on other components of the current account.

Development challenges

Diversifying the economy's industrial base, lowering reliance on natural resources, and generating more balanced and equitable development constitute the premier development challenges. Another is to increase competitiveness (Box 3.4.2).

3.4.2 Accelerated Industrial and Innovative Development Program

The primary thrust of the government's industrialization program (released in March 2010) is diversifying the economy and reducing reliance on oil. The second is increasing national competitiveness.

The program lists the following (among others) as critical to success: developing the priority sectors of the economy (heavy machinery, information and communications, education, and health care); strengthening the "social effectiveness" of the priority sectors and investment projects; and creating a favorable industrialization environment.

The strategy identifies four sectors where the efforts of the state will be concentrated:

- Traditional industries: natural gas sector, mining and metallurgy, atomic energy, and chemical industry.
- High domestic demand: machine building, pharmaceuticals, construction, and building materials.
- Predominantly export oriented: agribusiness, light industry, and tourism.
- Sectors of the future: information and communications technology, biotechnology, alternative power engineering, nuclear energy, and space.

State support to the priority sectors includes provision of physical infrastructure (such as information and communications, energy, and transport) and social infrastructure (such as skilled human resources).

Such support also includes measures to reduce administrative barriers, guidelines on technical regulations, and providing a conducive environment for foreign direct investment.

Kyrgyz Republic

Sociopolitical protests in Bishkek in April 2010 that ousted the former president, followed by ethnic violence in the south in June, battered the economy. Disruption was then exacerbated by border closures with Kazakhstan and Uzbekistan, the main transport conduits for trade. The crisis has put public finances under severe stress, alleviated by a July 2010 $1.1 billion pledge of assistance from donors. The time taken to return to normality will depend heavily on the new government's ability to bring about and maintain political and social stability.

Economic performance

After modest growth of 2.9% in 2009, the country was recovering well from the global economic crisis as GDP growth bounded to 16.4% in the first quarter of 2010. But the closures of international borders following the April and June events stopped imports and exports at times, intensifying the impact of the internal disruptions on the economy. For all 2010, GDP dropped by 1.4% (Figure 3.5.1).

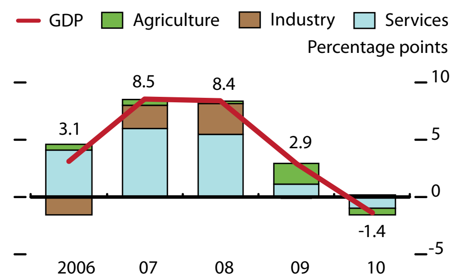
All sectors contracted in 2010, except for gold and other industrial production, which grew by 8% and 11.3%, respectively. Gold output climbed mainly because of a higher ore yield. Expansion in industrial production was largely attributable to a low 2009 base, reflecting the impact of global and regional recession. Some subsectors, however, showed strong outturns: garments were up by an estimated 50% and electricity, gas, and water services were together 11% higher.

Agricultural output fell by 2.8% largely due to delays in sowing crops (a knock-on effect of the disturbances) and an ensuing lower harvest in part caused by shortages of imported fuel. Construction output fell by 22.8%, as unrest and supply disruptions curtailed work, including that on large investment projects in the hydropower and mining subsectors.

The contraction in GDP would have been more severe without expanded gold production. Also of help was an estimated 25% increase in workers' remittances (from the Russian Federation and Kazakhstan, the country's main economic partners) that boosted a major source of income for the population, helping to ease the downward pressure on aggregate demand (Figure 3.5.2).

The imposition of duty by the Russian Federation on oil exports to the Kyrgyz Republic raised domestic oil-product prices by about 35%. This and increasing imported food prices, combined with lower domestic wheat production, have significantly added to inflation pressures. In the second half of 2010, inflation accelerated steadily and reached 19.2% at year-end, with food prices up by 27% (Figure 3.5.3). The April 2010 reversal of electricity and heating tariff increases to their 2009 levels (tariffs were

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 28 February 2011).

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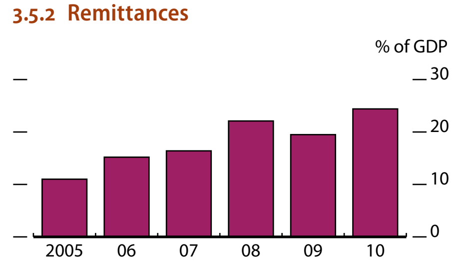
3.5.2 Remittances



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 11 March 2011).

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This chapter was written by Nurbek Jenish, consultant of the Kyrgyz Resident Mission, ADB, Bishkek.

doubled on 1 January 2010) helped to mitigate price escalation. Low inflation early in the year kept annual average inflation to 8.0%.

The April and June 2010 events have significantly increased budgetary expenditure on compensation to the families of victims; unplanned spending for the constitutional referendum and elections; outlays associated with rehabilitating damaged infrastructure and buildings; security expenditure; and subsidies for utility companies due to the tariff-hike reversal. On the revenue side, improved tax administration in the second half of the year helped to offset the negative impact of the crisis and border closure on value-added tax and customs collections.

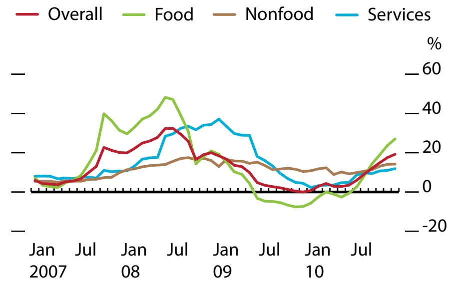
In 2010, the budget deficit widened to an estimated 6.5% of GDP (Figure 3.5.4). Assistance from both bilateral and multilateral donors as well as use of the $300 million Russian loan proceeds (received in 2009) covered financing needed for the enlarged deficit. Since some of the recent spending increases were one time (for rehabilitation and social protection, resettlement, and reconstruction), they can be unwound as the situation improves in 2011, though much rebuilding will still be needed in 2012. Reconstruction, alongside the government's plans to greatly increase salaries of teachers and other social sector workers from May 2011, will further widen the budget deficit. Government estimates of the budget deficit for 2011 are around 9%.

In July 2010, the donor community pledged $1.1 billion assistance over 30 months. External support will be critical in helping the authorities to deal with the consequences of the crisis. External—mainly concessional—borrowing increased publicly guaranteed external debt from around 53% in 2009 of GDP to an estimated 62% in 2010. The external debt ratio is forecast to reach 67% by end-2011. Although the International Monetary Fund rates the country's risk of debt distress as moderate, the government will need to follow prudent policies to ensure external debt sustainability.

In response to the crisis, the National Bank of the Kyrgyz Republic (NBKR, the central bank) eased its monetary stance by lowering the reserve requirement by 1.5 percentage points to 8.0% in May 2010, and adjusted the sale of its notes to changing monetary circumstances. Nevertheless, credit to the economy increased by only 2.7% due to weak demand and troubled banking conditions. The public's preference to increase its cash holdings at the expense of deposits surged after the April events, pressuring banking system liquidity and complicating the central bank's monetary operations. Despite the downturn in economic activity and banking sector problems, external finance of the fiscal expansion increased monetary aggregates. In 2010, money supply rose by 18.6%, primarily due to increased foreign assets (Figure 3.5.5).

The crisis shook financial stability. Loan quality has worsened dramatically—the ratio of nonperforming loans rose from 7.9% before April to an estimated 16% at year-end. The deterioration in quality has been mainly concentrated in loans for trade and commerce. The NBKR introduced temporary administration at seven banks (later reduced to four), including Asia Universal Bank—the largest bank with over 20% of bank deposits—after it experienced a large nonresident deposit outflow, allegedly linked to the previous regime. To mitigate deposit-run risks, the authorities nationalized the bank and created a new bank based on

3.5.3 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 28 February 2011).

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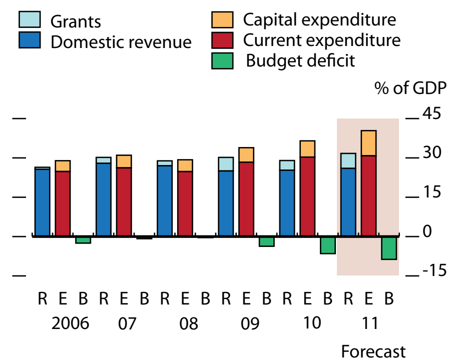
3.5.4 Budget indicators



B = Balance; E = Expenditure; R = Revenue.

Note: Domestic revenue includes capital receipts.

Sources: International Monetary Fund. 2008. *Country Report* No. 08/381. December; 2009. *Country Report* No. 09/209. July; 2010. *Country Report* No. 10/336. October. http://www.imf.org; Ministry of Finance.

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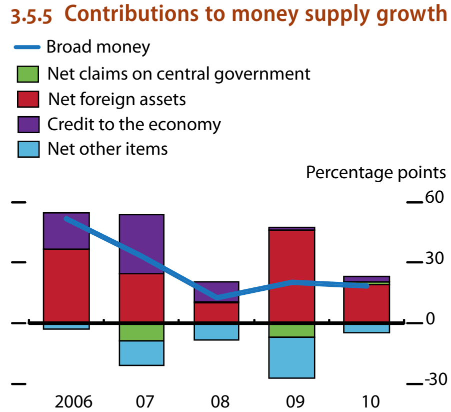
3.5.5 Contributions to money supply growth



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 11 March 2011).

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the old one. Despite difficulties, the banking system remains adequately liquid and capitalized.

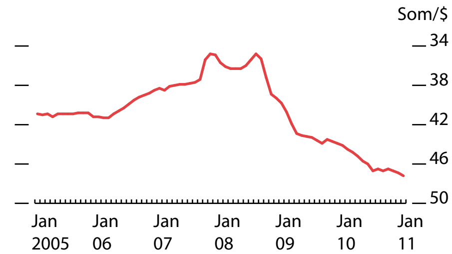
In April and May, the NBKR undertook large US dollar sales in the foreign exchange market to meet public demand and prevent an excessive depreciation of the local currency. For much of the rest of the year, it intervened to offset pressures for appreciation stemming from large donor-funded external budgetary support. Over the year, the som depreciated by around 7% against the dollar (Figure 3.5.6). In view of continued large expected inflows of external assistance in 2011, the NBKR plans to intervene to forestall an unwarranted appreciation of the exchange rate and reduce excess bank liquidity created by these operations.

Exporters did not fully benefit from the economic recovery in the Russian Federation and Kazakhstan in the wake of internal unrest and periods of closed borders. Further, the introduction of a customs union among the Russian Federation, Kazakhstan, and Belarus in July 2010 decreased the volume of Chinese goods that are reexported, as they now face higher duties into the union. Still, increased production of gold, the country's main export commodity, and rising gold prices helped to bolster export revenue that is estimated to have increased by 7.0% for the year.

Despite the border disruptions, imports are estimated to have increased by 15.0%. This expansion reflected higher import prices of food and fuel, though imports financed by donors and workers' remittances were also factors. The current account deficit is estimated at 5.0% of GDP in 2010, up from 2.4% a year earlier (Figure 3.5.7).

On the political scene, following the resignation of the former president in April, an interim government assumed power. It drafted a new constitution, which was adopted in a nationwide referendum in June, changing the country's political system into a parliamentary republic. (The country also elected an interim president, whose tenure will last until 31 December 2011. A presidential election under the new constitutional arrangement is scheduled for October 2011.) Parliamentary elections were held on 10 October 2010, with five parties winning seats. Following the creation of a majority coalition consisting of three parties in December 2010, Parliament elected a speaker and formed a government.

3.5.6 Exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 14 March 2011).

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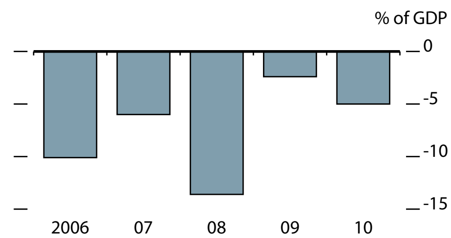
3.5.7 Current account balance



Source: National Bank of the Kyrgyz Republic. *Balance of Payments of the Kyrgyz Republic*. Various issues. http://www.nbkr.kg

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Economic prospects

The economy is expected to pick up with GDP growing at around 5% in 2011 and 2012. The forecasts rest on expectations of a normal security environment, continued reconstruction works, full resumption of trade and services flows, and improved investor confidence. They also rely heavily on construction growing by about 40%, mainly due to large-scale reconstruction works in the south. Services and industry are seen growing by 6% and 4%, respectively.

Economic expansion of the Russian Federation and Kazakhstan will also contribute to growth through increased demand for the Kyrgyz Republic's exports and higher remittances from workers in those two countries.

Considerable fiscal challenges loom over the next 2 years. Much reconstruction is still needed, and the government plans to increase

3.5.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.0
Inflation	13.0	8.0
Current account balance (share of GDP)	-9.0	-9.0

Source: ADB estimates.

salaries of teachers, as well as medical and other social sector workers in 2011, yet is reluctant to cut down on pension and social protection spending as this might affect social stability. It therefore plans to improve tax and customs administration and cut nonpriority spending. Around 73% of the budget deficit will be financed by donors.

The pickup in economic activity with higher import prices for food and higher remittance spending will exert an upward pressure on consumer prices. The NBKR's monetary and exchange rate policies will aim to keep inflation in check by neutralizing the effects of large fiscal expansion yet support the postcrisis recovery. Cancellation of export duties on petroleum products by the Russian Federation from 1 January 2011 will help to mitigate upward pressures on prices. For 2011, average inflation is expected to move higher to 13.0% and then moderate to 8.0% in 2012 as global price pressures subside.

Extensive reconstruction works and a recovery in domestic demand will raise the import bill in the forecast period. Increases in global food and oil prices will also push imports higher. Gold prices are expected to rise by 5%–10% in 2011 and remain at historically high levels. Remittances are forecast to increase moderately, after their strong growth in 2010.

The current account deficit is projected at 9.0% of GDP in 2011 and 2012. Foreign direct investment is likely to remain low in the next 2 years due to the uncertain political and security situation, though large inflows of official external assistance are expected to finance the large current account deficit.

Development challenges

The country faces huge challenges in economic recovery, reconstruction, and social reconciliation. Success will not be easy given the considerable pressure on public financial resources in a weakened economy. Achieving sustainable robust economic growth remains the major challenge facing the country.

Tajikistan

Rising remittance inflows and strong industry and construction outturns revived growth in 2010, aided by a favorable climate that supported year-round hydropower output. The economy is projected to sustain growth in 2011–2012 despite risks from rising food and fuel prices, transport bottlenecks, and a poor investment climate.

Economic performance

GDP climbed to 6.5% in 2010 from 3.4% in 2009 (Figure 3.6.1). Industry grew by about 10%, as favorable weather allowed higher hydropower production (which accounts for most of the electricity generated), in turn allowing small and medium-sized enterprises to maintain continuous operations in winter. Thus industrial growth mainly came from these enterprises, particularly in light manufacturing and food processing, unlike previous years.

Aluminum production suffered due to limited imports of alumina, caused by intermittent disruptions to rail transit through Uzbekistan. These were largely resolved in the second half of the year. Indeed, the two countries have faced several bilateral issues over the years. At present, the main one relates to differences over managing riparian resources.

Public spending on key infrastructure projects, such as roads, tunnels, and transmission lines, grew, underpinning growth in construction.

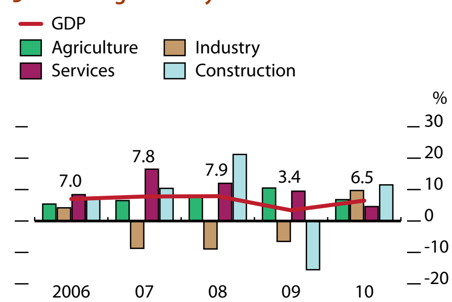
Growth in agriculture slowed to a still strong 6.8% after an unusually high 10.5% gain in 2009 (due to a reallocation of land to noncotton agriculture). Slowing activity in retail trade, as disruption in rail transit restricted imports, held services growth to about 5%.

Economic recovery in the Russian Federation lifted remittances by 29% to $2.4 billion in 2010 (Figure 3.6.2), the equivalent of 40% of GDP. They remained a key factor in economic and social stability in Tajikistan, supporting domestic demand and private consumption.

The government launched a massive public campaign to collect funds for building the Roghun hydropower plant in January 2010. It believes that, if carried out, this project could end perennial winter power deficits and allow Tajikistan to become a substantial regional electricity exporter. The campaign targeted raising $1.4 billion to construct the initial phase of Roghun by selling shares to the public. But, after the campaign had raised more than $186 million by May, the government suspended it after seeing the adverse impact on household consumption and economic activity. It remains, however, committed to the project.

End-of-period inflation nearly doubled to 9.8% in 2010 from 5.0% in 2009 (Figure 3.6.3), mainly because of rising food prices—particularly of wheat, following the drought in and subsequent suspension of exports by

3.6.1 GDP growth by sector



Sources: Tajikistan State Statistics Agency. http://www.stat.tj; International Monetary Fund.

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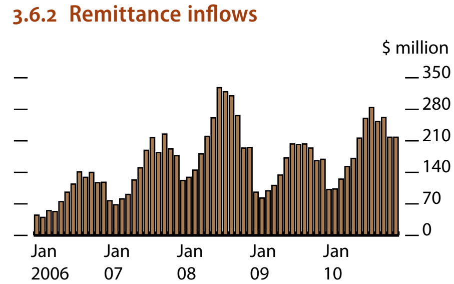
3.6.2 Remittance inflows



Sources: National Bank of Tajikistan; International Monetary Fund.

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This chapter was written by Kakhorjon Aminov of the Tajikistan Resident Mission, ADB, Dushanbe.

the Russian Federation. Higher global fuel prices and the imposition by that country (the main supplier of petroleum) of export duty on hydrocarbons added a further supply-side push. Demand-side pressures from increased remittance spending also stoked inflation, which averaged 6.4% in 2010.

Banks continued to face tight liquidity conditions and high rates of nonperforming loans. They are constrained by a low deposit base and a limited ability to attract capital inflows, while they have significant exposure to risky credits in agriculture and a shortage of sound investment opportunities.

The government wrote off about $500 million of doubtful cotton sector loans. This move cut banks' ratio of nonperforming loans from 28% at end-2009 to about 18% a year later, but as their compensation was in the form of very low yielding T-bills it contributed little to their liquidity, income, and ability to take up new lending opportunities. Trade disruption and delayed cargo deliveries hit trade finance, a sizable part of banks' normal business given that imports are over one-half of GDP.

All these factors restrained credit expansion to the private sector. To mitigate banks' difficulties, the government deposited $50 million collected during the Roghun campaign at commercial banks to strengthen their reserves and add to lending capacity.

In response to rising inflation, the central bank lifted its refinancing rate from 8.0% to 8.25% in November 2010 and to 9.0% in March 2011. In 2010, bank lending rates varied around 25% while deposit rates varied around 6.5%, the large spread reflecting both high doubtful loans and structural difficulties.

Tajikistan continued to pursue fiscal policy aimed at macroeconomic stabilization while sustaining pro-poor programs. The government's postcrisis plan, adopted in early 2010, aimed to lift social expenditure to 11.5% of GDP in 2010, but could not meet the target. This was mainly because revenue collection was under stress in the first half of last year owing to reduced collection of value-added tax on imports and of customs duties, but revenue picked up after the easing of the transit bottleneck.

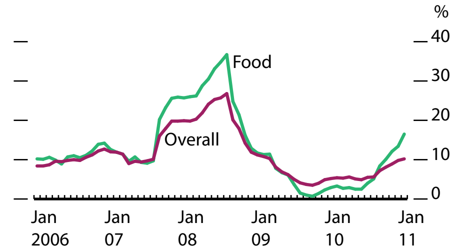
Although government revenue and expenditure did not fully reach budgeted levels, the overall deficit (excluding the public investment program and related grants) kept to the target of 1% of GDP in 2010 (Figure 3.6.4).

Recent fiscal deficits have been financed by external support, but borrowing capacity is low. The government's emphasis on completing infrastructure projects financed by external borrowing raised the debt-to-GDP ratio slightly to 34.4% of GDP in 2010 (Figure 3.6.5). The latest debt sustainability analysis from the International Monetary Fund (IMF), carried out in July 2010, puts Tajikistan at high risk of debt distress. The government is committed to controlling the debt level: its debt management strategy limits the ratio to 40% of GDP.

Higher global prices for aluminum and cotton underpinned a 40.9% surge in exports in 2010, a marked turnaround from the prior-year's 10.7% contraction. In volume terms, exports of aluminum rose moderately but cotton fell, as less land had been allocated to production. Imports grew by only 8.2%, mainly because of the rail disruptions.

The increase in export earnings outpaced the unusually small rise in imports and kept the trade deficit largely unchanged from the previous

3.6.3 Inflation



Source: Tajikistan State Statistics Agency. http://www.stat.tj
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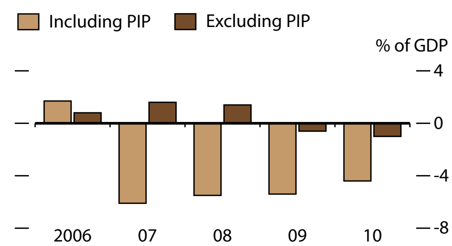
3.6.4 Fiscal balance



PIP = public investment program.
Source: International Monetary Fund. 2010. *Country Report* No. 10/374. December. http://www.imf.org
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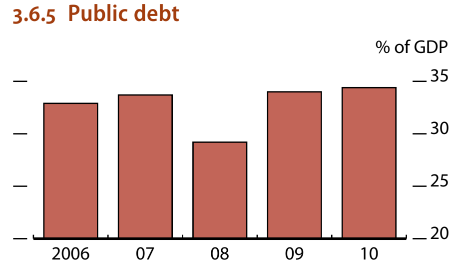
3.6.5 Public debt



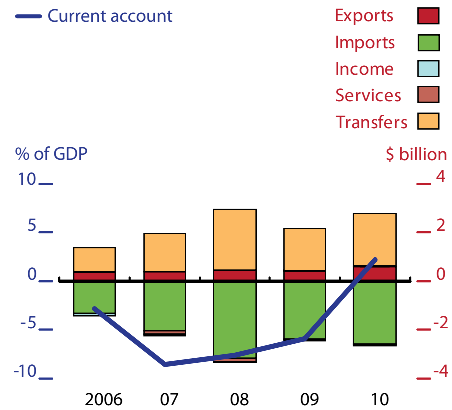
Sources: International Monetary Fund; ADB estimates.
Click here for figure data

year. With the strong recovery in remittances, the current account is estimated to have moved to a surplus of 2.2% of GDP from a deficit of 5.9% of GDP in 2009 (Figure 3.6.6).

Following the large depreciation in 2009 that mirrored those of major trade partners, the somoni was stable against the US dollar in 2010, depreciating by only 0.7% (Figure 3.6.7). This reflected market conditions—good export performance and rising remittances in the face of restrained conditions on importing.

Foreign reserves picked up from $278 million in 2009 to $640 million. This increase was due to the improvement in the current account, while capital flows and credit disbursements, including those from the IMF, came in broadly as planned. But the level of foreign reserves remained low at year-end, equal to only 2.3 months of projected 2011 imports.

3.6.6 Current account balance



Sources: National Bank of Tajikistan; International Monetary Fund.

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Economic prospects

Growth is projected to edge up to 6.8% in 2011 and 7.0% in 2012, fueled by continued remittance inflows and by increases in aluminum and cotton prices in 2011, both of which fall off but stay high in 2012.

Remittances are forecast to grow by about 7% each year, reaching their precrisis high in 2012. They will underpin rising private consumption expenditure, boosting imports and so buoying budget revenue.

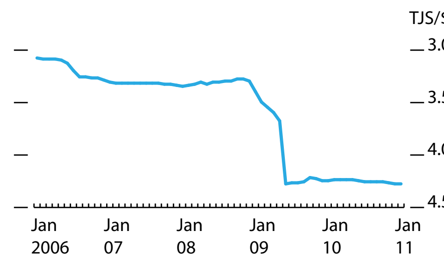
Production of aluminum and cotton is projected to rise moderately, responding to higher global prices (as well as reallocation of land back to cotton), but limited aluminum production capacity and inefficient cotton financing will hold back a stronger response. Agricultural processing, light industry, construction, and services will likely continue their strong growth.

Inflation in 2011 and 2012 is projected to increase to 10.5% and 9.5%, reflecting rising global food and fuel prices. The authorities are committed to maintaining a cautious fiscal and monetary stance under their economic program with the IMF and have averred that they would tighten policies if nonfood price pressures emerge. The central bank has already raised its refinancing rate.

Rising remittance-fueled consumption spending and expanding public investment are projected to generate much stronger import growth in 2011 and 2012 of about 28% and 10%, assuming normal regional trade and cargo transit arrangements. Exports are set to rise, by around 25% and 1%, largely reflecting global price movements. The trade deficit will deteriorate, and even with expected higher remittances the current account balance will move to a deficit of 4.3% and 6.4% of GDP.

These projections are subject to several external and internal risks, including growth in the Russian Federation's economy; the level of precipitation, essential for agriculture and water accumulation for electricity generation; and political and social stability.

3.6.7 Nominal exchange rate



Source: Tajikistan State Statistics Agency. http://www.stat.tj

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3.6.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.8	7.0
Inflation	10.5	9.5
Current account balance (share of GDP)	-4.3	-6.4

Source: ADB estimates.

Development challenges

Tajikistan faces interrelated challenges that hinder reduction of widespread poverty and a move to higher and more sustainable growth. The first is its heavy reliance on remittances, which was keenly felt in 2009's global downturn. The second is its dependence on a

few exportable commodities and very narrow production base. The government therefore needs to strengthen infrastructure and services, improve the business and investment climate, and diversify agricultural output.

Many aspects of doing business, such as business registration procedures, investment protection, and tax systems, need to be improved, as seen clearly in the World Bank's latest *Doing Business* report. The share of private activity in GDP is below half, which is very low internationally. Private investment has been stagnant at less than 5% of GDP over the last 5 years, reflecting an unfavorable business environment and lack of investor confidence.

To boost economic activity, the government needs to focus on reducing risks to private investors, through, for example, providing and enforcing property rights, reducing corruption, and enhancing necessary supporting infrastructure. Improving the security situation and maintaining stability are also important.

Stagnating tax revenue and a weak fiscal position call for reform in the public resource management system, particularly tax policy and administration. Policy makers need to focus on implementing the comprehensive 5-year Tax Administration Reform Strategy, approved in 2010, which has financial and technical support from various development partners. Complemented by more efficient and better governed state-owned enterprises, such an approach could sharply raise revenue performance and reduce the call on the state budget.

3.6.2 Central Asian rankings on the ease of doing business, 2011

Georgia	12
Kyrgyz Republic	44
Armenia	48
Azerbaijan	54
Kazakhstan	59
Tajikistan	139
Uzbekistan	150

Note: Out of 183 countries worldwide. No ranking for Turkmenistan.

Source: World Bank. *Doing Business 2011*.

Turkmenistan

Growth recovered to near double-digit levels in 2010 with resumption of gas exports and new gas pipelines, alongside large-scale public investments. The outlook is for continued strong growth and moderate inflation. But moving the economy from its heavy dependence on hydrocarbons requires a diversified base of industries and services, as well as a dynamic private sector.

Economic performance

The economy rebounded in 2010 with government sources estimating GDP growth at over 9%, close to the levels seen prior to the global recession (Figure 3.7.1). Much of the growth derived from the resumption of natural gas exports to the Russian Federation, which were suspended for much of 2009, and the opening of new gas pipelines to the People's Republic of China and the Islamic Republic of Iran. The strong growth also came from large-scale public investments, a surge in foreign direct investment, and rapid gains in construction, transport and communications, textiles, and agriculture.

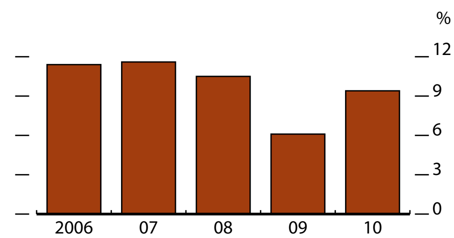
Natural gas remains the mainstay of the economy—hydrocarbon exports accounted for over 90% of exports in 2010. Moreover, hydrocarbon production is the main source of government revenue. Gas exports reportedly grew by 34% in 2010 from the previous year.

Consumer price inflation for the end of period was estimated to have risen from 0.1% in 2009 to 4.6% in 2010, giving a 2010 average of 3.9%, a switch from deflation of 2.7% in 2009 (Figure 3.7.2). The inflation partly reflects rising international food and grain prices, which went up by about 12% in 2010. Government controls over certain prices, wages, and pensions and a stable exchange rate helped to keep consumer prices in check.

The government's expansionary fiscal policy reduced the budget surplus from an estimated 7.8% of GDP in 2009 to 2.8% in 2010 (Figure 3.7.3). Much of the spending is guided by the National Program of Social and Economic Development, which was updated in mid-2010 to cover 2011–2030. The program entails large public investment in economic and social infrastructure.

The recovery in gas exports and increased earnings from higher oil export prices helped to narrow the current account deficit from an estimated 16.1% of GDP in 2009 to 4.7% in 2010 (Figure 3.7.4). The balance of trade in 2010 moved to a small surplus of $100 million, from a deficit of $1.8 billion in 2009. Estimated exports were $10.1 billion for the year, a slight increase from $9.5 billion in 2009. Imports were estimated to be $10.0 billion, down from $11.3 billion the previous year.

3.7.1 GDP growth



Sources: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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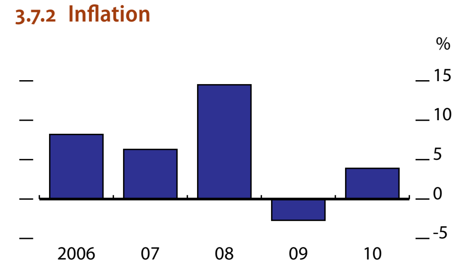
3.7.2 Inflation



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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This chapter was written by Jennet Hojanazarova of the Turkmenistan Resident Mission, ADB, Ashgabat; and David Oldfield of the Central and West Asia Department, ADB, Manila.

Economic prospects

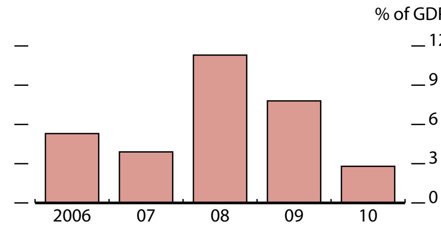
The outlook for 2011 and 2012 appears to be highly favorable, and growth is likely to be robust over the forecast period. The predicted growth rates will result from higher volumes of natural gas exports due to new pipelines with the People's Republic of China and the Islamic Republic of Iran, and continued implementation of the government's development policies. The global gas supply glut will likely peak in 2011 and gas prices will remain low, but demand by Turkmenistan's established buyers should stay strong.

Growing gas exports are necessary to finance the government's heavy spending on infrastructure and the social sector. It is expected to continue its fiscal stimulus, in line with the recently updated National Program. These measures, along with an expected rise in global food and other commodity prices, are likely to add to inflation in 2011, nudging it up to 5.0% in 2011 and 6.0% in 2012.

Trade with neighbors should receive a boost in 2012 if the construction of the new North–South railway linking Turkmenistan with Kazakhstan and the Islamic Republic of Iran is completed on schedule. Total exports are seen rising by nearly 24% in 2011, and imports by 4%. A potential trade surplus of over $2 billion in 2011 could lead to a current account surplus of 3.4% of GDP.

Long-term growth prospects are enhanced by the long-awaited agreement signed in December 2010 for the ambitious Turkmenistan–Afghanistan–Pakistan–India gas pipeline. While security challenges in two of the countries pose risks to construction and operation, the four countries have targeted a gas delivery date by 2015. On completion, the pipeline will deliver 33 billion cubic meters annually and increase Turkmenistan's total gas exports to Asia to over 90 billion cubic meters a year.

3.7.3 General government fiscal balance



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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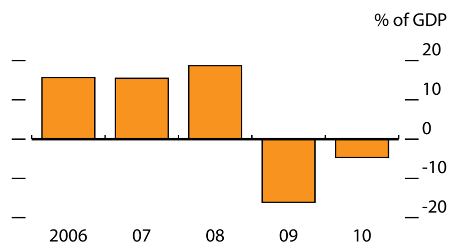
3.7.4 Current account balance



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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Development challenges

Highly dependent on exports of energy, Turkmenistan faces several challenges in diversifying the economy to high-value-added and technology-based goods and services. This requires numerous structural reforms—administrative, financial, and institutional, for example.

Successful diversification also requires efficient reallocation of resource revenue to productive sectors. The government will therefore have to make a thorough cost-benefit analysis and prioritize value-added investments, and, going beyond gas-related industries, create processing and manufacturing industries capable of generating new sources of income. Ongoing large government investment in mining, textiles, food processing, and tourism are a step in the right direction, but much more investment is required.

Turkmenistan also needs to develop a dynamic private sector. An adequate legal and regulatory framework for private business must be in place, along with an expanded banking sector that can provide financial capital. Additionally, the country needs to develop entrepreneurship and expertise in market principles in the public and private sectors.

3.7.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.0	10.0
Inflation	5.0	6.0
Current account balance (share of GDP)	3.4	7.0

Source: ADB estimates.

Uzbekistan

Strong economic growth in 2010 was driven by expanded public investment, increased net exports, and a pickup in workers' remittances. The outlook is for sustained public sector–oriented growth, and continued strong fiscal and external positions. The authorities need to keep a close eye on inflation, though it is expected to remain moderate. Diversification from the commodity and energy sectors, alongside private sector development, would help to generate broad-based and sustained growth.

Economic performance

The economy continued to perform well in 2010, supported by the effects of a fiscal stimulus, the government's medium-term investment program, and the global economic recovery. Growth was driven mainly by industry (including construction) and services (Figure 3.8.1), with estimated annual growth rates of 8.3% and 11.6%, respectively.

In industry, growth was led by the chemical, machinery, light, and food industries, which together expanded by 12.0% and accounted for almost half of total industrial output. These industries benefited from the significant public investment and commercial bank lending provided under the government's 2009–2010 anticrisis and industrial modernization programs. The chemical and machinery industries are also attracting investment from Asia and the Middle East. Construction grew at 8.1%, largely due to government support to rural infrastructure and housing development, as well as greater foreign investment in hydrocarbons.

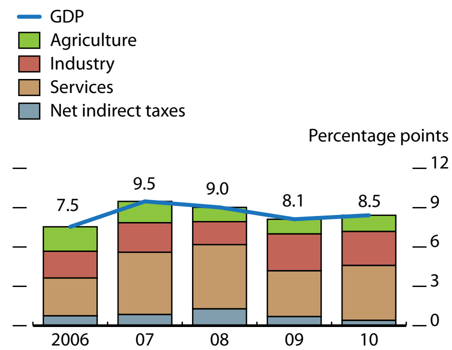
The expansion in services mainly reflected increases in government social spending for health care, especially in rural areas. Favorable weather and higher vegetable crop cultivation led to agricultural growth of 6.8%.

In 2010, the government continued implementing infrastructure programs aimed at developing rural areas and modernizing industry. The Fund for Reconstruction and Development (FRD) and state-owned banks allocated about $6.0 billion. Lending from commercial banks to the economy increased by one-third in 2010. Gross fixed capital investment rose by 9.2%, to the equivalent of around 30% of GDP (Figure 3.8.2). According to the government, about $3.9 billion, or 25.1%, was foreign.

The majority of foreign investment goes into fuel, energy, telecommunications, and automobile manufacturing. The government reported that it plans to attract up to $50 billion in foreign investment during 2011–2015. Notable projects include a joint venture with Daimler on bus assembly and expansion of production lines at GM Uzbekistan (a joint venture between General Motors and the state-owned Uzavtosanoat company). Under government initiatives to encourage use of natural gas in vehicles, a new joint venture between Uzbekistan and the Republic of Korea will construct gas compressor stations for cars.

In February and October 2010, the authorities raised utility prices

3.8.1 Contributions to growth (supply)



Sources: State Statistics Committee of Uzbekistan; ADB estimates.

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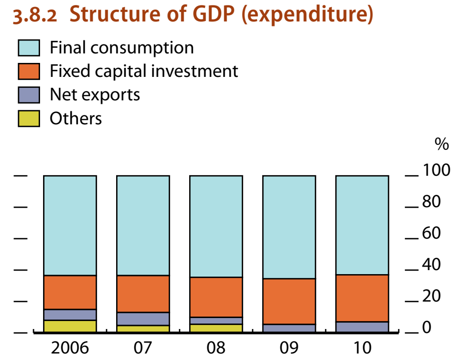
3.8.2 Structure of GDP (expenditure)



Note: Others refer to statistical discrepancy and changes in stocks.

Sources: Center for Economic Research. *Uzbekistan Almanac 2010*; ADB estimates.

Click here for figure data

This chapter was written by Iskandar Gulamov of the Uzbekistan Resident Mission, ADB, Tashkent.

for heating, hot water, and electricity by a cumulative 18%–30% in an attempt to bring them closer to cost-recovery levels. The increases, with depreciation of the local currency and a 30% annual hike in public wages and pensions, put upward pressure on inflation. The central bank sought to mitigate this pressure by slowing broad money growth to 34.6% from its peak of 43.8% in 2009. The government reported year-end inflation of 7.3%. The latest estimate from the International Monetary Fund for average inflation is 10.6% (Figure 3.8.3).

The local currency depreciated by 8.3% against the dollar in 2010. On 1 January 2011, the central bank reduced its benchmark refinancing rate from 14% to 12% to reduce the rates of loans provided under its programs for industrial modernization, rural housing construction, and small and medium-sized enterprises.

The general government budget is estimated to be in balance in 2010. Taking into account the FRD, the consolidated budget is estimated to have a surplus of 2.5% of GDP (Figure 3.8.4). The steep wage and pension hike, greater support for health care, as well as the rural development program have lifted budget spending to an estimated 34.6% of GDP. The government also provided tax exemptions for enterprises operating under investment and localization programs, but revenue gains from commodity exports and the utility price adjustments were enough to offset the increased expenditure.

In line with the policy of reducing direct taxation to encourage economic activity, in 2010 the government reduced the rates of both corporate and personal income taxes by 1 percentage point to 9% and 11%, respectively. The fiscal authorities also reduced the rate of the unified tax paid by micro and small firms from 8% to 7%. The share of direct taxes in GDP decreased from 7.1% in 2008 to an estimated 5.9% in 2010.

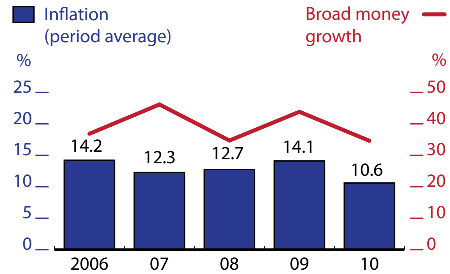
Reflecting the increased infrastructure development and subsequent rise in foreign financing, including government-guaranteed foreign debt, total external debt is estimated to have risen to 14.9% of GDP, slightly above the 2009 figure of 14.6%.

The international prices of gas, cotton, and gold, Uzbekistan's main export commodities, were historically high throughout 2010, leading to goods and services export growth of 10.8%. That growth was also aided by recovery in the Russian Federation, with the share of machinery, including passenger vehicles, in total exports more than doubling in 2010. Stronger growth in the Commonwealth of Independent States sharply boosted foodstuff exports.

The government reported that imports of goods and services fell by 6.8% in 2010. Imports of machinery and equipment, 44% of the total, dropped by 27.3%. Official import restrictions reduced imports, especially from countries in the Commonwealth of Independent States. Reflecting a pickup in global food prices as well as stronger consumption demand, the share of foodstuffs in imports climbed from 10.3% in 2009 to 10.9% in 2010.

Remittances sent to Uzbekistan from the Russian Federation rose by an estimated 22% in 2010 to $1.4 billion (to around 3.7% of GDP), given the economic pickup in that country. Due to improved exports and remittances, the current account surplus is estimated to have increased to 15.6% of GDP in 2010, from 11.0% of GDP in 2009 (Figure 3.8.5).

3.8.3 Inflation and money supply



Sources: International Monetary Fund. 2010. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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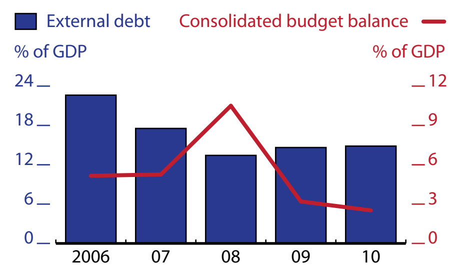
3.8.4 Fiscal and debt indicators



Sources: International Monetary Fund. 2010. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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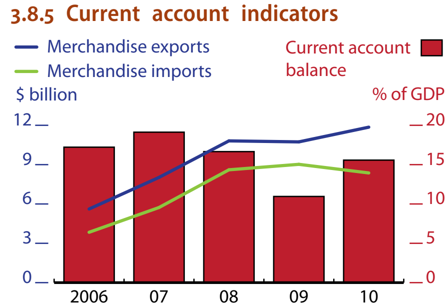
3.8.5 Current account indicators



Sources: International Monetary Fund. 2008. *Article IV Consultation*. July. http://www.imf.org; ADB estimates.

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Economic prospects

Greater investment and infrastructure development will sustain GDP growth at 8.5% in 2011 and 8.4% in 2012. Industry (particularly construction) and services are expected to be the major contributors. Industrial output will be driven by domestic lending and foreign investment, while services will expand in line with higher domestic demand. Increasing lending coupled with favorable international prices will stimulate output of energy, machinery, and metals. Agriculture is expected to be driven by higher vegetable and fruit output, while grain production will improve moderately.

The share of investment in GDP is expected to climb rapidly in the forecast period, partly because the government is seen pursuing the infrastructure development programs faster. On 15 December 2010, it adopted a presidential decree that envisages spending $30 billion on 259 industrial projects and $23.1 billion on new construction in 2011–2015. Most financing for both sets of programs is planned to come from enterprises' own resources, loans from domestic banks, and FRD resources.

The government plans to direct up to 60% of budget spending ($6.2 billion) toward social programs—outlays on which are expected to rise by 14%—at the same time as raising allocations for investment (by 37%). It is also seen further reducing the tax burden and strengthening revenue collection. The consolidated budget, including the FRD, is forecast to post a surplus of 2.4% in 2011 and 2.0% in 2012.

Higher public sector wages and social payments alongside a gradual recovery in remittance inflows will sustain domestic consumption, as will government plans to create many jobs through infrastructure. Higher import costs, a more accommodative fiscal policy, and further depreciation of the local currency will stoke price pressures in 2011–2012. To counter them, the authorities are likely to adopt a monetary policy that slows money supply growth. Inflation is forecast at 8.8% in 2011 and 8.5% in 2012.

International prices for gold and cotton are seen peaking in 2011, but staying high. Uzbekistan's export prices for natural gas, which have approached international levels, are likely to stay at these high levels. Exports are forecast to grow at 14.0% in 2011 and 3.1% in 2012, supplemented by a gradual improvement in remittance inflows. The steep rise in public investment will likely offset the slower export growth in 2012 in terms of contribution to GDP.

Growth in imports will be driven by expansion of infrastructure development and by increases in global energy and food prices. Since machinery and equipment are the main import items, the post-2011 investment surge will drive imports even higher. Import growth is therefore put at 11.9% in 2011 and 16.3% in 2012. The current account surplus is projected at 16.3% and 12.6% of GDP.

The downside external risks to the forecasts are related to the pace of economic recovery in Uzbekistan's main trading partners as well as uncertainty in global financial markets. The immediate challenge is to manage rising pressures from fiscal expansion and global food price increases. To prevent unwanted fiscal-led pressure on monetary policy, the authorities are ready to adapt the structure of budget expenditure and the pace of nominal depreciation of the currency.

3.8.1 Development challenges

With one eye on the long-term goal of diversifying the economy, the government has designated 2011 as the year of small businesses and private entrepreneurs.

According to official statements, these two groups contributed more than half of total GDP and employed more than 70% of the total labor force in 2010. The central bank reported that total lending to both groups jumped by 40% that year to $1.7 billion. As well as lowering taxes, the government's program for 2011 targets better access to capital for them and simpler reporting requirements.

Sources of export income, too, need to be broadened and natural resources prudently managed, as the current resource-based approach is susceptible to volatility in global commodity prices.

Effective banking supervision and improved prudential banking requirements will help to guard against potential risks associated with rapid credit growth and greater commercial bank lending to state-owned enterprises.

Improving access to credit for small and medium-sized enterprises will widen the range of banking assets while benefiting the broader population through job opportunities.

3.8.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	8.4
Inflation	8.8	8.5
Current account balance (share of GDP)	16.3	12.6

Source: ADB estimates.

EAST ASIA

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

People's Republic of China

Strong investment, supported by an expansion of private consumption and net exports, powered a return to double-digit growth. The authorities ended the fiscal stimulus program and, with inflation pressures building, tightened monetary policy. GDP growth is forecast to moderate both this year and next. Inflation will rise in 2011, then likely decelerate in 2012. Going beyond the next 2 years, the new 5-year plan puts more emphasis on consumption and services as drivers of growth and on reducing both income inequality and pollution.

Economic performance

Brighter than expected economic growth in the second half of 2010 lifted the full-year rate of expansion in the People's Republic of China (PRC) to 10.3% in a return to the pre–global recession double-digit pace. All sectors recorded solid growth, led by industry with a 12.2% increase that contributed about two-thirds of total GDP growth. Services expanded by 9.5% and agriculture by 4.3% (the grain harvest was good, despite harsh weather).

From the demand side, investment and consumption explained 92% of total growth, investment being the main contributor (Figure 3.9.1). Still, the winding back of the aggressive fiscal stimulus put through during the global recession slowed the growth of fixed asset investment in nominal terms from the very high 31.0% seen in 2009 to 24.4% in 2010.

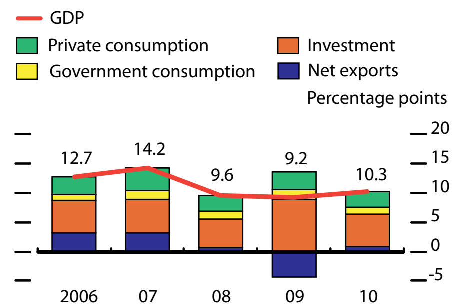
Private consumption grew by 11.0% in nominal terms (9.3% in real terms), supported by higher incomes. Sales of household appliances and furnishings benefited from heavy investment in housing, while sales of automobiles continued to surge. Despite several years of solid growth in private consumption, however, it remains low as a share of expenditure-based GDP at 34%.

Net exports contributed positively to GDP growth in 2010 (by 0.8 percentage points), unlike 2009 when net exports fell as global trade slumped.

Monetary policy supported growth, even as the authorities reined in the highly expansionary stance taken during the global recession. While broad money supply (M2) growth decelerated to 19.7% in 2010 from 27.7% in 2009, it was above the 17.0% target for 2010 of the People's Bank of China (the central bank).

Growth in bank credit at CNY8 trillion also exceeded its target, by CNY0.5 trillion, although it was well below 2009's outturn (Figure 3.9.2). This measure of credit is likely to understate the total as it excludes loans channeled through trust companies. Several

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics of China; ADB estimates.

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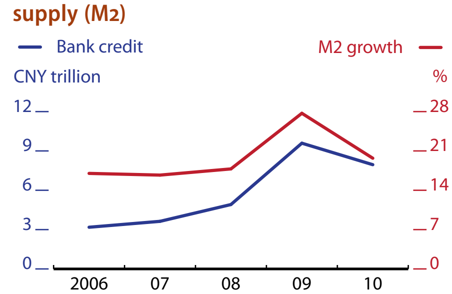
3.9.2 Growth in bank credit and money supply (M2)



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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This chapter was written by Yolanda Fernandez Lommen and Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

estimates suggest that these off-balance-sheet loans amounted to about CNY3.8 trillion in 2010.

Abundant liquidity, rising food prices, and higher costs of imported oil and commodities pushed up consumer prices during 2010 (Figure 3.9.3), when inflation averaged 3.3%.

The government changed some of the weights in the consumer price index basket in early 2011, lowering that for food and raising the one for housing. Yet despite this, the index is still seen as understating inflation because its composition and weights have not been significantly adjusted to reflect the major changes in consumption patterns in the last decade.

Moving to stem inflation, the central bank raised the reserve requirement for banks six times in 2010 and three times in the first quarter of 2011 (to 20.0% for large banks). It also lifted the benchmark interest rate twice in 2010 and once in the first quarter of 2011 (by a total of 75 basis points to 6.06%—Figure 3.9.4). The government imposed price controls on some food items and increased subsidies for low-income earners.

Prices of residential property in cities rose strongly, propelled by rising incomes, investment demand, and the abundant liquidity. Overall property prices climbed by an average of 10.0% in 70 major cities. Real estate investment surged by 33.5% in nominal terms, outpacing overall investment growth. Government actions to curb house prices included raising both mortgage interest rates and down payments as well as directing banks not to lend for purchases of third (or more) homes. These changes damped the rate of increase during the year (Figure 3.9.5).

Fiscal policy was supportive of growth in 2010, although less so than in 2009 as the massive CNY4 trillion fiscal stimulus program launched in late 2008 came to an end. Fiscal revenue and expenditure rose by 21.3% and 17.4%, respectively, well above the government's traditionally conservative targets. The strong revenue performance was a consequence of the robust economic growth and higher prices. The budget deficit narrowed to the equivalent of 2.1% of GDP from 2.9% in 2009.

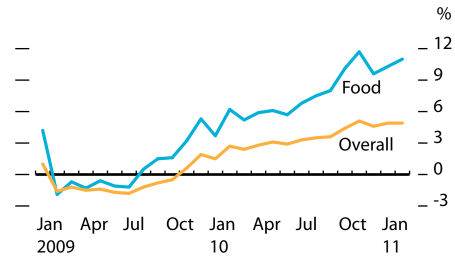
Global recovery in trade last year saw the country's trade flows soar by nearly 35% to about $3 trillion. Merchandise exports in nominal US dollar terms rebounded by 31%. Imports rose even faster (Figure 3.9.6), reflecting strong demand and higher prices for oil, other commodities, and capital goods. The trade surplus at $254 billion was little changed from 2009.

The PRC is diversifying its export markets in light of the slowdown in major industrial economies. It became Brazil's top trade partner in 2009 with bilateral trade showing a more than 12-fold increase in value since 2001. Some 85% of its exports to Brazil are manufactured products, while soybeans and minerals account for two-thirds of its imports.

Foreign direct investment (FDI) reached $105.7 billion in 2010, up by 12.4% from the previous year. By sector, manufacturing, real estate, and services attracted the most FDI. The leading sources of FDI were (in order) Hong Kong, China; Taipei,China; Singapore; Japan; the United States; the Republic of Korea; and the United Kingdom.

The PRC's direct investment abroad increased by 23.4% to $59 billion in 2010. It targeted energy, mining, and agriculture. Asia remained the top regional destination, although flows to South America and Africa

3.9.3 Monthly inflation



Source: CEIC Data Company (accessed 16 March 2011).

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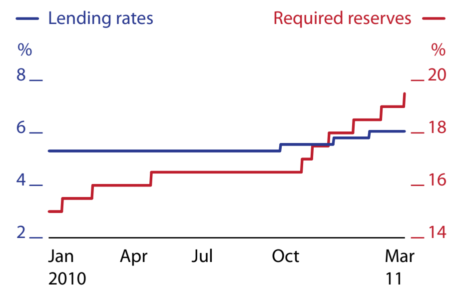
3.9.4 Monetary indicators



Source: CEIC Data Company (accessed 25 March 2011).

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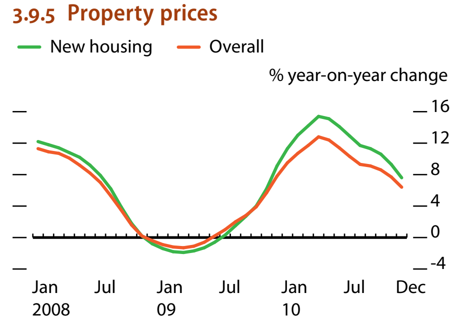
3.9.5 Property prices



Note: Overall are both residential and nonresidential.

Source: CEIC Data Company (accessed 16 March 2011).

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picked up. Large investments in energy-related projects in some Central Asian countries have turned the PRC into the second-largest investor there, after the Russian Federation.

The PRC is also gaining prominence as a lender to developing countries: its lending in the past 2 years exceeded that from the World Bank (excluding the International Development Association, which makes grants and low-interest loans). These operations included loan-for-oil deals with Brazil, the Russian Federation, and Venezuela; power-related projects in India; and infrastructure investments in Argentina and Ghana.

The current account surplus increased to $306.2 billion, but as a ratio to GDP it declined to 5.2%. This surplus, coupled with the FDI inflows and central bank purchases of foreign exchange to manage the exchange rate, pushed up foreign exchange reserves by 19% to $2.85 trillion. The yuan appreciated against the US dollar by 3% in nominal terms during the year (Figure 3.9.7), after the authorities indicated in June 2010 that they would gradually allow greater flexibility in the exchange rate. In real effective terms the yuan appreciated by 4.2% in 2010.

Efforts to internationalize the currency resulted in much higher levels of yuan-denominated trade, estimated at CNY70 billion in 2010 compared with just CNY0.5 billion in 2009.

About 11.7 million new jobs were generated in urban areas last year, above the official target but fewer than the average 24 million new job seekers who enter the labor market each year. Average minimum provincial wages rose by 24%, illustrating government efforts to raise living standards and foster consumption.

Economic prospects

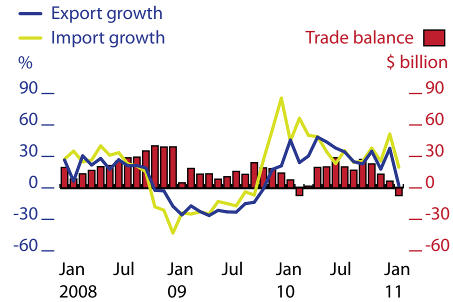
The 12th Five-Year Plan (2011–2015), approved in March 2011, seeks to rebalance the pattern of growth. Its targets indicate that the authorities are willing to forgo some speed of GDP growth to enhance its sustainability (see below).

Fixed asset investment is expected to remain the main driver of growth in 2011 and 2012, decelerating to 22% in 2011 and to 20% in 2012 (Figure 3.9.8). The expiration of the fiscal stimulus package in 2010 will reduce such investment by CNY2 trillion this year (or 7% of the total in 2010). Monetary tightening under way will also damp the high rates of investment. Further, the central government is scrutinizing local government finances and investment more closely.

Fiscal policy will be broadly expansionary, with a higher priority on education, health care, low-cost housing, and research and development. The overall budget deficit is projected to be little changed at about 2% of GDP.

Inflation pressures are prompting the authorities to tighten monetary policy, but their stance is expected to remain supportive of growth. They have trimmed the target for growth in M2 money supply to 16% for 2011; a similar rate is assumed for next year. For new lending, the central bank has opted not to provide an annual target ceiling on new bank loans for 2011. It will instead target a new measure of total credit, "total social financing," which includes loans from trust companies, corporate bonds,

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 16 March 2011).

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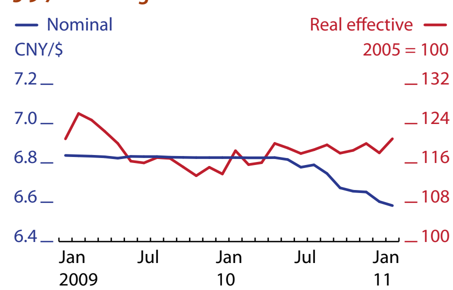
3.9.7 Exchange rates



Source: CEIC Data Company (accessed 16 March 2011).

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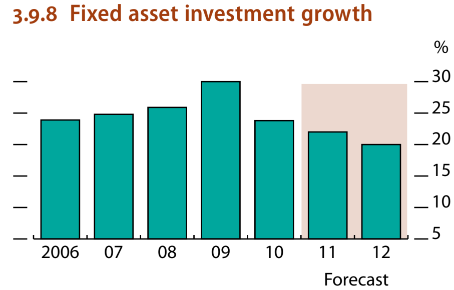
3.9.8 Fixed asset investment growth



Sources: CEIC Data Company (accessed 20 March 2011); ADB estimates.

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and equities of nonfinancial companies. It has not yet disclosed the numerical target.

Private consumption growth is expected to accelerate to 12.6% this year in nominal terms, a consequence of rising incomes and expanding state provision of education, health care, and pensions.

The contribution of net exports to GDP growth will moderate from 2010 owing to the base effect, still subdued demand from major export markets, and the expiry of tax rebates on some PRC exports. The increase in merchandise exports is forecast to slow to about 20% in nominal terms this year and 18% in 2012, below the near 30% average pace seen in the 5 years before the global recession.

Based on these projections, GDP is forecast to grow by 9.6% in 2011, easing to 9.2% in 2012 (Figure 3.9.9) on expectations that industrial production and fixed investment will continue to moderate.

Industrial production is expected to slow over the 2 years owing to relatively soft external demand, overcapacity in some manufacturing subsectors, and government efforts to reduce carbon emissions and other environmental damage. Nevertheless, in the first 2 months of this year, industrial output grew by 14.1%, slightly above the rate in December 2010.

In further signs of a solid start to 2011, fixed asset investment rose by about 25%, investment in real estate surged by 35%, and retail sales increased by 16% in the first 2 months (all in nominal terms).

Inflation is forecast to accelerate to 4.6% on average in 2011 (Figure 3.9.10), a result of higher global prices for food and oil, rising wages, and robust domestic demand. For the first 2 months of this year it averaged 4.9%, exceeding the full-year official target of 4.0%. The pace is expected to ease later in 2011 mainly because of the base effect.

In 2012, inflation is projected to ebb to 4.2% owing to the anticipated leveling off of global oil and commodity prices as well as tighter domestic monetary policy. Although the authorities are tightening to address inflation, they face difficulties in controlling bank liquidity and in managing inflation expectations without a nominal inflation anchor (Box 3.9.1).

Imports are expected to increase faster than exports during the forecast period, largely owing to high prices for imported energy and commodities. The current account surplus is projected to fall to 4.6% of GDP this year and 4.2% next, continuing a decline from a recent peak of 10.6% in 2007 (Figure 3.9.11) brought about mainly by faster growth in the value of imports than exports.

Downside risks to the economic outlook relate mainly to the fragility of external demand (exacerbated by the modest recovery in the United States), fiscal and debt concerns in the European Union (the PRC's largest trading partner), and now Japan. Although data are inadequate at present to assess the impact of the massive earthquake and tsunami on the PRC economy, they may have a short-term effect on bilateral trade, to a degree because Japanese companies in the PRC rely on spare parts and materials imported from Japan.

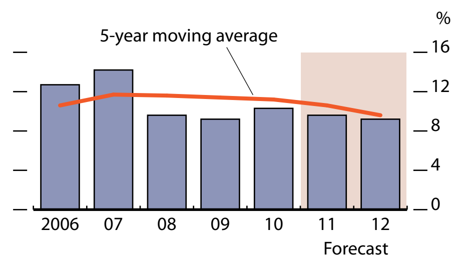
The rapid increase in local government debt to an estimated CNY7.6 trillion, stemming from the stimulus program begun in late 2008, is likely to lead to some rise in nonperforming loans at banks, given that about one-third of the debt is estimated to be at risk. This risk is, though,

3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.6	9.2
Inflation	4.6	4.2
Current account balance (share of GDP)	4.6	4.2

Source: ADB estimates.

3.9.9 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

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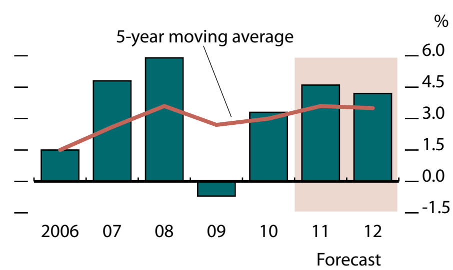
3.9.10 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

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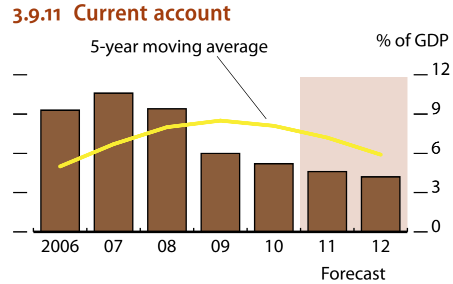
3.9.11 Current account



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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mitigated by the current moderate level of nonperforming loans (1.1% of total lending), larger provisions for bad loans, and more stringent bank capital-adequacy requirements in recent years.

Failure to decisively implement the government's agenda to rebalance the economy risks jeopardizing the sustainability of growth in the longer term. Rapid growth over three decades has allowed for transition from a low- to a middle-income country, but has also generated imbalances such as heavy reliance on investment, relatively low levels of private consumption, underdeveloped services, widespread environmental damage, and expanding income gaps.

Development challenges

Implementing the 12th Five-Year Plan will be a major challenge. Its main policy directions include the following: a better balance in the drivers of growth among investment, consumption, and exports, with services playing a more important role; a stronger emphasis on improving living standards and narrowing income inequalities; newly designated strategic industries—a modern energy industry, a comprehensive transport system, information-based industries, and biotechnology—to promote innovation; and plans to combat global warming and reduce carbon intensity, including ambitious emission-reduction targets, a carbon tax, new indicators for pollutants, and carbon-trading programs.

The plan sets quantitative targets on key economic, social, and environmental indicators. It trims the GDP growth target of 7.0% for 2011–2015 from 7.5% in the previous plan, a move aimed to signal the government's willingness to sacrifice speed of growth for the sake of sustainability (actual GDP growth in the previous plan was 11.2%).

Critical among the objectives is changing the growth pattern toward a model oriented more to services and consumption from the past emphasis on industry and capital investment. Economic rebalancing was an objective in the previous plan, and indeed some progress was made in, for example, curbing energy consumption and pollutants and expanding the coverage of urban and rural health care.

Yet there was limited progress on major rebalancing targets. Consumption, for instance, substantially lagged investment (with average contributions of 41% and 54% to annual GDP growth in the past 5 years). On the production side, services' share of GDP is relatively low at about 43% (Figure 3.9.12).

The need to transform the pattern of economic growth is stronger now than in 2006 both because the external imbalances have become more pronounced, and because the recent global recession highlighted the risks of the export-led growth paradigm. Moreover, the implications of population aging in the PRC threaten the sustainability of growth and complicate the reform agenda.

Rebalancing is, however, unlikely to occur without significant policy adjustments, including shifting the emphasis of public spending from investment to public services, liberalizing the finance sector, developing capital markets to help small and medium-sized enterprises and the self-employed to access credit, and facilitating a greater role for private players in the economy.

3.9.1 Anchoring inflation expectations

Climbing consumer and asset prices in the country risk raising inflation expectations, and so encouraging new rounds of price increases that further heighten expectations. Such spirals have occurred in the past, leading to 20% inflation in 1988.

International experience suggests that the best way to control inflation expectations is to anchor them, preferably with inflation targeting rather than monetary targeting.

Inflation targeting allows the monetary authorities to use all available information, not just monetary variables, to determine monetary policy settings.

It is also transparent and readily understood by the public, increases central bank accountability (because its performance can be measured against a clearly defined target), and can help focus the political debate on the main role of the central bank in the long run (controlling inflation instead of boosting economic growth).

A central bank's credibility is indispensable in inflation targeting, so as to keep expectations well anchored.

In the People's Republic of China at the moment, accelerating inflation and difficulties of managing the high levels of bank liquidity suggest that some anchoring of expectations might now be appropriate. And although it would be premature for the central bank to adopt formal inflation targeting—given its limited independence and government controls on interest rates—it could consider some features of an anchoring system, such as announcing an explicit inflation objective or target range, and committing to achieve it for several years.

To increase the central bank's credibility, it would need full control over managing its reserves, more leeway to liberalize interest rates, and greater exchange rate flexibility. Managing inflation expectations would also require it to more clearly flag its monetary intentions to financial markets.

As the new plan reflects these reforms to some degree, the key challenge lies in how to successfully carry them out in a period of political transition to a new generation of leaders in 2012–2013. Moreover the intended reforms, although necessary, are not risk free, and might create or exacerbate policy-making trade-offs.

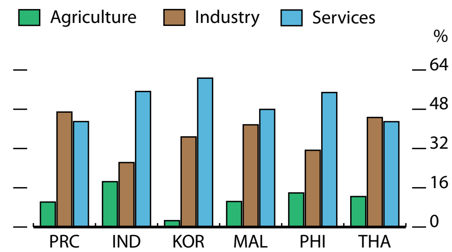
For instance, promoting services as a source of growth and employment may entail short-term side effects such as increased unemployment (until the full benefits unfold in the medium to longer term, when excess labor is absorbed through implementation of adequate supportive policy measures, including education and training).

Further, promoting consumption as a driver of growth would require larger salary increases, as supported in the plan, which could generate a wage-price spiral in the economy, trapping policy makers in a difficult choice between rebalancing and price stability.

Closing the income gaps is another major challenge. The benefits of rapid growth in the PRC have not been evenly distributed among regions, resulting in a skewed distribution of income in favor of coastal cities and urban citizens. The Gini coefficient, a measure of income inequality (zero indicates perfect equality and 1 absolute inequality) has worsened from 0.16 in 1978 to the current 0.47.

The PRC's rapid development has also come at a significant environmental cost. Heavy dependency on coal as an energy source has led to high levels of air and water pollution. The additional tens of millions of new automobiles on the roads in the past few years have taken carbon dioxide emissions to alarming levels. Against this background, government plans to accelerate urbanization—as stated in the new plan—require greater efforts to facilitate a sustainable process of urbanization in the framework of a low-carbon economy.

3.9.12 Sector shares in current GDP, 2010



PRC = People's Rep. of China; IND = India; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; THA = Thailand.

Note: Data for India are based on advance estimates. Data for the Republic of Korea refer to 2009.

Source: Asian Development Outlook database.

Click here for figure data

Hong Kong, China

Coming out of contraction the economy grew robustly in 2010, driven by recovery in goods and services trade that spurred growth in consumer spending and investment. Inflation rose from low levels, and is forecast to speed up in 2011. Economic growth will moderate this year and next. Low interest rates and abundant liquidity have contributed to a property-price spurt that the authorities are trying to damp with macroprudential measures and increased supply of land for housing.

Economic performance

This services-driven economy made a solid comeback in 2010 as it recovered from contraction in 2009. GDP picked up by 6.8%. From the demand side, consumption, investment, and net exports all contributed to growth (Figure 3.10.1).

Private consumption grew by 5.8% and was responsible for more than half the GDP growth. Consumption spending was supported by a pickup in employment and buoyant stock and property markets. Retail sales were boosted by a 22% jump in visitor arrivals to 36 million.

Government consumption made a small contribution to the expansion. Budget spending in FY2010 (ending 31 March 2011) came in below allocation, while revenue burgeoned alongside the recovery in economic activity and asset prices. The budget was in surplus to the tune of an estimated 4% of GDP.

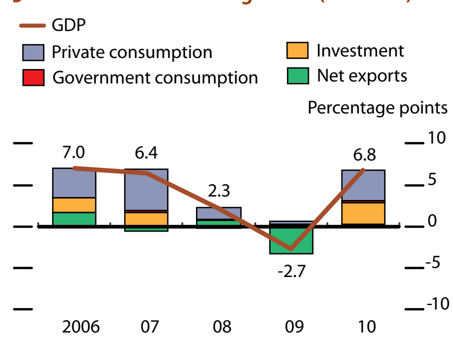
After 2 weak years, fixed investment rebounded by 8.1% in 2010, accounting for about one-quarter of GDP growth. Private investment in machinery, equipment, and computer software was strong, especially in the first half (reflecting the low base). Several large-scale projects boosted public construction, including the Guangzhou–Shenzhen–Hong Kong express rail and the Hong Kong–Zhuhai–Macao bridge.

With the revival of global trade, exports of goods bounced back to record 17.3% growth in real terms, from a double-digit contraction a year earlier. Exports to the People's Republic of China (PRC) and other major Asian markets (Japan; the Republic of Korea; Singapore; and Taipei,China) saw growth of 15%–23%. Exports to the United States and Europe also rose, but failed to scale 2008's precrisis peak. Imports of goods in real terms rose by 18.1%, reflecting growth in private consumption and the pickup in investment.

Services exports grew by 15.0% in real terms in 2010 as financial and professional services, trade services, transport, and tourism all benefited from the recovery in global trade and deepening integration with the rapidly growing PRC.

The important financial and insurance subsector grew by 7.5%

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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This chapter was written by Arief Ramayandi and Aleli Rosario of the Economics and Research Department, ADB, Manila.

in 2010. Equity capital raised through initial public offerings rose to HK$449.5 billion (US$57.9 billion), making Hong Kong, China the world's biggest center for such capital raising last year. The subsector is benefiting from wider external use of the yuan. The number of authorized financial institutions participating in yuan business increased from 61 to 115 and their total deposits increased almost fivefold.

A resumption of employment gains in 2010 (after net job losses in 2009) lowered the seasonally adjusted unemployment rate to 4.0% in the fourth quarter (Figure 3.10.2). But real earnings grew by just 0.1% during the year.

Inflation quickened over the year to 3.1% in December 2010 owing to rising domestic demand, a softer US dollar, higher prices for imported food, and rising housing costs (Figure 3.10.3). It averaged 2.4% for the year.

Very low interest rates and abundant liquidity, coupled with strong underlying demand for housing, propelled prices of all categories of property in 2010. Residential property prices rose by 20.4% in the 12 months to December 2010, following a gain of 28.5% a year earlier. A housing affordability index shows that houses became more expensive in relation to incomes (Figure 3.10.4).

Concerned that the sharp runup in prices was spilling over from the high-end property sector to the broader residential market, the authorities directed banks to lower their loan-to-value ratios and raised stamp duty on high-end housing. As prices continued to trend up, the government in November 2010 imposed a special stamp duty on residential property resold within 24 months of acquisition. To add to the supply of housing in the medium term, it increased the land available for residential construction. By year-end, these measures appeared to damp speculation, as reflected in fewer transactions.

In the external accounts, a sharply wider merchandise trade deficit and lower surplus in the income account offset a larger services trade surplus in 2010. The current account surplus declined to US$14.8 billion (6.6% of GDP).

Economic prospects

In light of projected slower global trade and moderating PRC growth, Hong Kong, China will see its expansion ease this year and next.

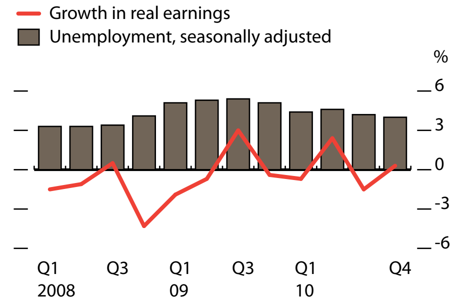
Private consumption is expected to remain healthy in 2011, based on growth in employment and incomes, and be the main contributor to growth in the economy. Retail sales in volume terms rose by 23.6% in the first month of 2011 (Figure 3.10.5) aided by inbound tourism.

Business investment will likely expand moderately this year, supported by low interest rates. Major public infrastructure projects begun in the past 2 years will continue contributing to growth in the forecast period.

Slower growth in world trade and the ending of the low-base effect on 2010's outturn are expected to bring down growth in merchandise exports to about 7.5% in nominal terms in 2011 from 22.4% in 2010. Robust growth is foreseen for services exports, particularly to the PRC.

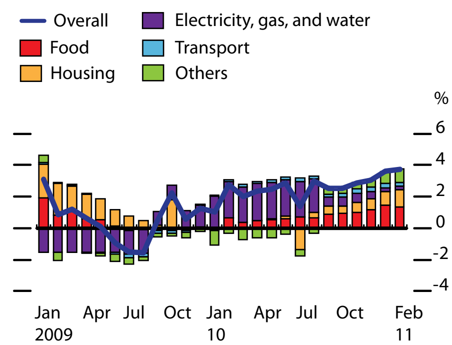
The budget for FY2011 includes an increase in spending of nearly 25%, and projects a small budget deficit. Spending on capital works is budgeted to rise to US$7.5 billion this year and will likely exceed this amount in

3.10.2 Unemployment and earnings



Source: Census and Statistics Department. http://www.censtatd.gov.hk/ (accessed 28 March 2011).
Click here for figure data

3.10.3 Sources of inflation



Source: CEIC Data Company (accessed 28 March 2011).
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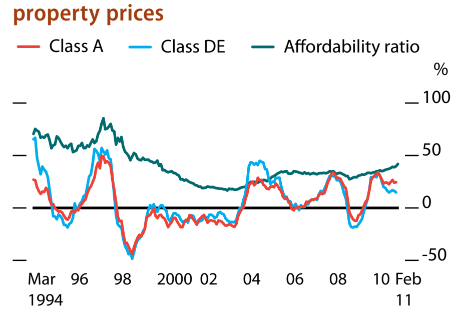
3.10.4 Affordability ratio and growth of property prices



Notes: Class A refers to residential properties less than 40 square meters in size. Class DE refers to residential properties above 100 square meters. Affordability ratio refers to the ratio of mortgage payments (for a 45 square meter apartment) to the median income of all households.
Source: CEIC Data Company (accessed 28 March 2011).
Click here for figure data

2012. Major infrastructure projects to begin in 2011 include extensions of mass transit rail lines.

On the balance of these factors, GDP growth is forecast at 5.0% in 2011, easing to 4.7% in 2012, as the economy is expected to stabilize around its longer-term growth trend. Current account surpluses equivalent to 7.2%–7.5% of GDP are projected for the forecast period.

Inflation this year will be well above the average rate of just over 2% of the past 5 years. Hong Kong, China imports most of its food from the PRC, where food prices have been rising. Further, the yuan has steadily climbed against the Hong Kong dollar (Figure 3.10.6), raising the cost of all purchases from the mainland. Higher global fuel and food prices, rising housing costs, and a likely increase in wages add to inflation pressures. Inflation was 3.7% in February 2011 and is forecast to average 4.5% for the year.

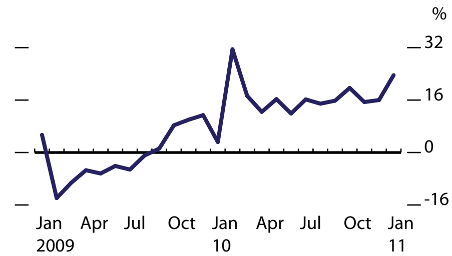
In 2012, inflation is seen easing to 3.3% as global food prices decelerate and the housing market stabilizes, the latter aided by the policies introduced in 2010.

3.10.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	4.7
Inflation	4.5	3.3
Current account balance (share of GDP)	7.2	7.5

Source: ADB estimates.

3.10.5 Retail sales volume growth



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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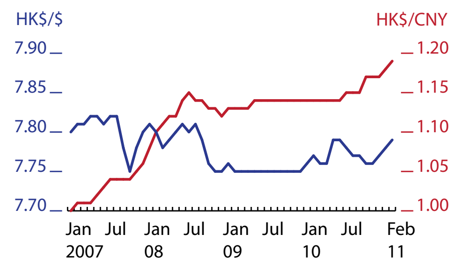
Development challenges

The Hong Kong dollar's link to the US dollar through a currency board framework constrains the authorities from using interest rates as a tool to curb property booms. Monetary policy is tied to that of the US Federal Reserve, which is not expected to tighten much during the next 2 years. The government is therefore relying on macroprudential measures to rein in speculation and to ensure prudent mortgage lending by banks, while it increases the supply of land for housing.

Acknowledging the risk of a property bubble, the financial secretary said in March 2011 that the government stands ready to take further action to calm the housing market.

As for inflation more broadly, the FY2011 budget provides several one-time measures aimed at helping the population cope with rising costs of living. They include a subsidy for each residential electricity account capped at HK$1,800, waived rates (property taxes) up to HK$6,000, and 2 months' rent exemption for public housing tenants. The government also proposes to give a HK$6,000 cash payment to permanent residents aged 18 and above, and an income tax rebate up to a maximum of HK$6,000. These two measures will, however, add to domestic demand and, potentially, inflation.

3.10.6 Exchange rates



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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Republic of Korea

Robust economic recovery continued through 2010, when a strong export performance and healthy domestic demand underpinned the steepest rise in GDP for nearly a decade. Growth is expected to moderate to a more sustainable pace in 2011. The paramount near-term challenge is to contain emerging inflation pressures. A key development challenge is to create more job opportunities for those seeking work.

Economic performance

Economic recovery gained traction in 2010 in the Republic of Korea, as GDP rose by 6.1%, the sharpest increase since 2002. The exceptional growth largely reflects a rebound from below-trend growth of 2.3% in 2008 and 0.2% in 2009. The recovery was broad-based and rested on both external and domestic drivers. Externally, exports surged in tandem with the rebound in the world economy and trade. Domestically, private demand replaced fiscal and monetary policy stimulus pushed through during the global recession. Figure 3.11.1 shows the trajectory of quarterly growth during 2008–2010.

Among the different sources of growth in 2010, robust investment played the dominant role, accounting for over two-thirds of the year's expansion (Figure 3.11.2). Surging exports of manufactured goods drove the sharp rise in investment. Private consumption accounted for the rest of GDP growth. Government consumption contributed less than a tenth, mirroring the transformation from policy-led recovery to growth based on private demand. The impact on GDP of the stronger total demand was partly offset by a surge in imports of goods and services.

As global trade volume swung from sharp contraction in 2009 to expansion in 2010, it propelled a 29.6% rise in merchandise exports in US dollar terms. Export performance was strong throughout the year (Figure 3.11.1). Information technology-related products such as semiconductors and liquid crystal displays performed particularly well. Exports of autos, auto parts, and general machinery also grew rapidly. In terms of export destinations, demand from the People's Republic of China (PRC) and Southeast Asia drove growth in the first half and held up well in the second. Demand from Japan and the United States also picked up last year from 2009.

Mirroring the strong recovery of demand, imports rose sharply by 31.9%. The merchandise trade surplus rose to about $42 billion, but the deficit in services trade nearly doubled to $11 billion. The current account surplus fell to 2.8% of GDP, from 3.9% in 2009.

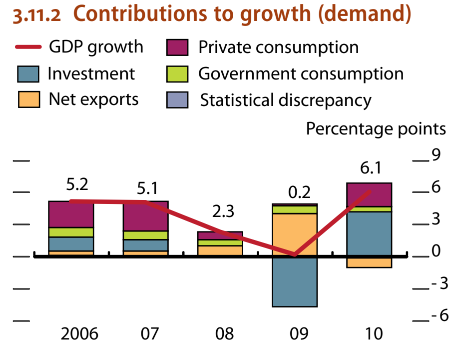
An outstanding feature of growth in 2010 was the acceleration of equipment investment, which soared by 24.5%, though it partly reflects a base effect from 2009, when such investment fell by 9.1%. Companies

3.11.1 GDP and merchandise export growth

Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

Click here for figure data

3.11.2 Contributions to growth (demand)



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

in export-oriented industries regained their appetite for investment as global demand for their products recovered. Companies were also spurred to expand facilities by a rise in manufacturing capacity utilization from an average of 74.6% in 2009 to 81.8% in 2010 (Figure 3.11.3). Further, an appreciating won against the US dollar in the second half of the year lowered the cost of imported capital goods. Imports of machinery rose sharply, although those of transport equipment grew much less quickly.

Construction investment contracted by 2.3% in 2010, after growing by 4.4% in 2009 on the back of public works. The weakness in construction reflected a sluggish housing market, where the inventory of unsold housing continued to build.

Private consumption bounced back (Figure 3.11.4) to grow by 4.1% in 2010, after feeble growth in 2009, supported by a stronger labor market. Employment rose by 323,000, even as the government scaled back job creation programs. Real wages increased by more than 3%, after contracting by 6% in 2009. Gross domestic income rose by 5.8%, the fastest pace in 8 years. An upturn in the stock market and appreciation of the won contributed to stronger consumer sentiment.

The unemployment rate nudged up to 3.7% from 3.6% in 2009, mainly a result of more Koreans looking for work in light of the improved outlook.

In terms of economic sectors, manufacturing stood out with a 14.6% increase in production last year, fueled by surging export demand. Services expanded by a healthy 3.5%.

Despite the strong economic growth, average inflation rose only slightly in 2010, to average 2.9%, within the Bank of Korea's target band of 2.0%–4.0%. As economic recovery gained traction, the central bank started to edge up its policy interest rate from the record low 2.0% set during the global recession. From July 2010 to March 2011, the Bank of Korea raised the rate in four steps to 3.0%.

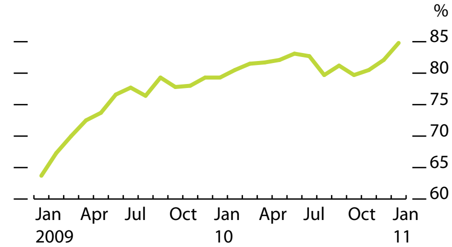
Economic prospects

Exceptionally strong growth in 2010 was based to a large extent on a one-time base effect due to weak performance of 2009. Consequently, the economy is expected to decelerate this year to more sustainable levels around the potential growth rate, estimated at 4.3%–4.9%. A generally benign global outlook will support exports and healthy private investment, and consumption will underpin growth. The consolidation of growth and the emergence of inflation pressures mean that inflation is set to replace growth as the priority of policy makers.

Merchandise exports are projected to grow by more than 10% in 2011. Demand from industrial economies will likely be subdued, but developing countries are forecast to grow rapidly and provide a more certain source of demand. The country has diversified its export markets in recent years, with the PRC in particular providing an important export market during the global recession (Figure 3.11.5).

Exports to the PRC have traditionally been dominated by high-tech parts and components for assembly and reexport to industrialized countries. Increasingly, however, the PRC is becoming a direct consumer of final goods, which helps to explain why the the Republic of Korea's exports to that market held up so well in 2009–2010.

3.11.3 Manufacturing capacity utilization



Source: CEIC Data Company (accessed 11 March 2011).

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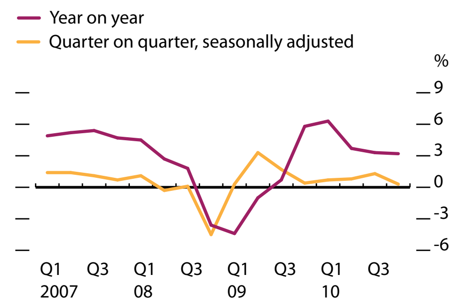
3.11.4 Private consumption growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

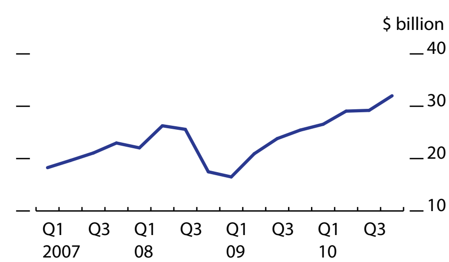
Click here for figure data

3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.6	4.6
Inflation	3.5	3.0
Current account balance (share of GDP)	1.8	1.7

Source: ADB estimates.

3.11.5 Exports to the People's Republic of China



Source: CEIC Data Company (accessed 11 March 2011).

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Still, several factors will damp growth in exports in 2011. First, the country's exports, especially durables and capital goods, are sensitive to the global business cycle, so the expected easing in world trade growth will act as a drag on exports. After past global downturns, exports initially responded elastically to the recovery of global growth, but lost some momentum as recovery moderated.

Other constraining factors for growth are an expected appreciation of the won and likely weakness in unit prices of exports. (Foreign competitors have expanded production capacity for semiconductors, liquid crystal displays, and other key items, which sets an upper bound to their prices.)

On the domestic front, strong consumer and business confidence will buttress growth in private consumption and investment (Figure 3.11.6). High corporate profits in 2010 and prospective foreign capital inflows have enabled firms to invest. However, as pent-up demand for investment postponed during the global slump was largely satisfied in 2010, equipment investment is likely to moderate to a more sustainable level of about 8% this year.

Construction investment will likely grow at the sluggish pace of about 3%. A significant inventory of unsold housing in the Seoul area will constrain construction, as will large debts of private housing companies and the government's Land & Housing Corporation. The corporation's debts are an example of a more general problem of high and growing debt burdens of state-owned firms (Box 3.11.1).

Private consumption is projected to expand by 4.0%–4.5% in 2011, bolstered by growth in incomes. The labor market looks set to remain strong (up to 250,000 jobs will likely be generated, down a bit from last year owing to the expected moderation in growth of exports industries). Softness in export unit prices will weigh on terms of trade and gross domestic income. But gains in corporate profitability in 2010 will pave the way for more robust wage growth. A decline in housing prices that bottomed out in the second half of 2010 should support consumer confidence.

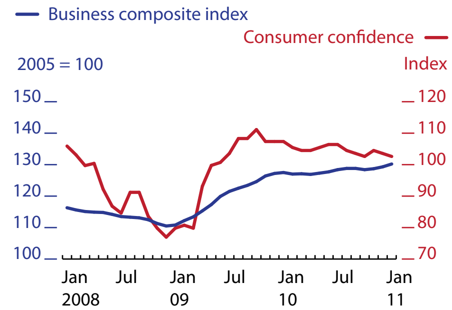
Inflation pressures surfaced toward end-2010 and are expected to intensify this year. Major price indicators are on the rise (Figure 3.11.7), with inflation breaching the central bank's target band in January and February this year. Inflation in 2011 is forecast at 3.5%. It is expected to ease a little in 2012, when monetary policy will be tighter and global prices for oil and food are expected to decelerate.

Cost-push factors such as higher global oil and food prices have contributed to the rise in inflation, though aggregate demand is also putting upward pressure on prices. Additionally, as actual output has surpassed potential output since the first quarter of 2010 (Figure 3.11.8), it is likely that monetary policy will be tightened further to contain inflation.

The authorities are also using administrative measures to control prices of specific items, especially food. Further, in February 2011 the government advised that it would minimize increases in public utility charges.

The fiscal stimulus has been withdrawn as the economic recovery gathered pace. The overall fiscal deficit was reined in last year to 2.3%

3.11.6 Confidence indicators



Note: Data for January 2008–August 2008 refer to the Consumer Expectations Index; values after that were derived from the Composite Consumer Sentiment Index.

Sources: CEIC Data Company; Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (both accessed 11 March 2011).

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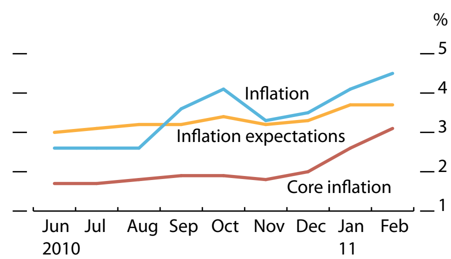
3.11.7 Inflation indicators



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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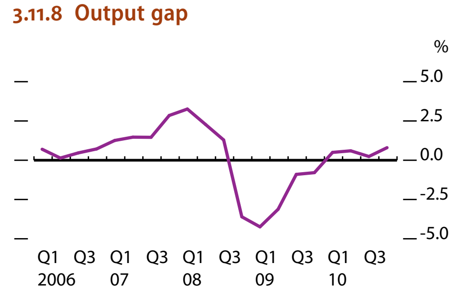
3.11.8 Output gap



Source: ADB estimates.

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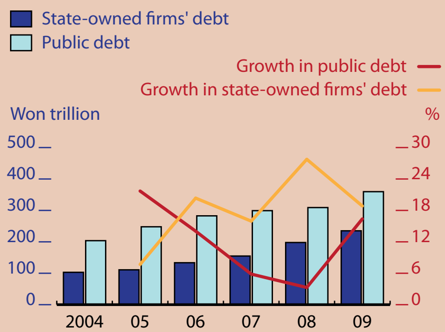
3.11.1 The rising debts of state-owned firms

The rapid increase in debt of state-owned firms may have damaging implications for future fiscal health. Public debt levels are low relative to Europe, Japan, and the United States, and public finances are generally in good shape.

This benign picture ignores, however, large and growing debts of 21 firms owned by the central government. Such debts are not part of the International Monetary Fund's definition of public debts, but still represent contingent liabilities for the government.

As at end-2009, these firms' total debt reached 235.1 trillion won ($201.4 billion), equivalent to 65.4% of public debt. Further, their debt grew by an average of 17.9% a year between 2004 and 2009, significantly faster than the growth in public debt (12.0%) (Box figure 1).

1 State-owned firms' debts and public debt



Source: Korea Development Institute.

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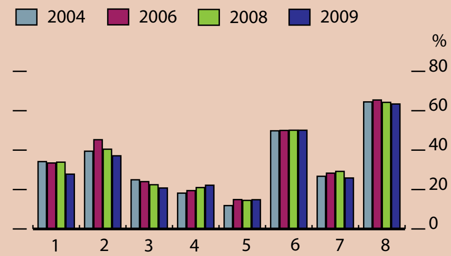
A study by the Korea Development Institute assessed the extent to which the debts of state-owned firms pose a risk to financial sustainability. The study was based on an analysis of six of the larger firms—in land and housing, gas, electricity, railways, highways, and petroleum—which together account for 87.5% of state-owned firms' total assets and 92.9% of their total debts. As much of their growth has been financed by borrowing, the weighted debt-to-capital ratio of the six rose from 106.3% in 2004 to 196.8% in 2009.

A high debt burden is not necessarily a concern, however, if there is enough liquidity to deal with short-term financial difficulties. Also, if profitability is high enough to allow for a gradual reduction of the debt burden, the risk that burden poses to fiscal sustainability is limited.

Critically, the ratio of short-term debt to total debt among state-owned firms is relatively low (Box figure 2) and the duration of borrowing is relatively long. They tend to have higher credit rating than private firms, facilitating their access to long-term credit, but few have "quick" assets that can be converted to cash at short notice. Their average ratio of current assets to short-term debt stood at 61.1% at end-2009, comparing unfavorably with the overall corporate average of 99.1%.

2 Short- to long-term debt ratio



1 = Land and housing; 2 = Gas; 3 = Electricity; 4 = Railways; 5 = Highways; 6 = Petroleum; 7 = Average of six state-owned firms; 8 = Average of private and 21 state-owned firms.

Source: Korea Development Institute.

Click here for figure data

State-owned firms generally have low profit rates, although with wide variations. Of the six, the highways and petroleum firms have low debt and high profits. Profitability of the other four has declined in recent years due to excessive business expansion and restrictions on public utility tariff increases.

Without a severe shock, the risk of liquidity problems or bankruptcy among the 21 firms owned by the government appears limited in the short run.

In the long run, however, they should strive to improve profitability so as to gradually reduce their debt burdens. While they are somewhat constrained from raising prices by public interest considerations, they should nevertheless operate along more commercial lines. (For political reasons the government is unlikely to be able to privatize them.)

It would therefore be helpful if the government allowed a gradual liberalization of public utility tariffs. Such firms should also become much more transparent about their financial health.

of GDP, from 5.1% in 2009. The government aims to further narrow the deficit in 2011 and it targets a balanced budget by 2014.

On the basis of the above factors, GDP growth for 2011 is projected to moderate to 4.6% (Figure 3.11.9), slightly exceeding the average of 4.3% during 2003–2007. Both exports and domestic demand will increase healthily, and contribute to broad-based growth. Year on year, the second

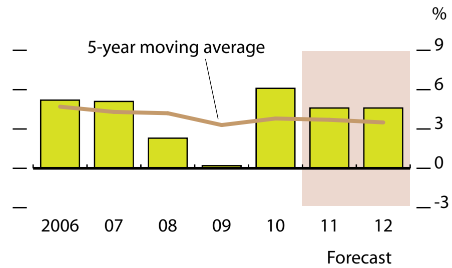
half will outperform the first, largely owing to the base effect. The outlook for 2012 is expected to be broadly similar to 2011's.

The primary source of uncertainty involves monetary policy. The cost of keeping interest rates low, in terms of the impact on inflation, is likely to be significantly higher than in 2010. The GDP outcome will therefore partly depend on how the central bank resolves the trade-off between growth and inflation.

The large size and volatility of capital inflows remain a risk, although macroprudential measures adopted by the authorities are mitigating it. For example, tax exemptions for foreign investors that were introduced in May 2009 to promote bond market development are being rolled back, and the government has set a ceiling on foreign exchange–related derivatives to limit banks' short-term foreign borrowing. External risks center on the trajectory of global commodity prices and recovery of industrialized countries.

The impact of the Japanese disaster will be limited and temporary. While exports that compete with Japan, such as autos and electronics, may benefit, disruptions to imports of capital goods will hurt manufacturers.

3.11.9 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011); ADB estimates.

Click here for figure data

Development challenges

A key driver of private consumption growth in 2010 was the strong labor market. Growth of employment and wages is also expected to be a major positive factor in 2011, but paradoxically many job seekers cannot find work. A broad definition of work seekers includes the unemployed, those who work fewer than 36 hours a week and want to work more, and people who have never been employed or been out of the workforce for a long time but want to work. Their number shot up by 19.1% in 2009 to 1.8 million people, and rose by a further 5.4% in 2010, despite the economic recovery (Figure 3.11.10).

Several policy options can be considered. First, specialized skill training programs at small and medium-sized enterprises could be promoted for youths, especially high-school graduates, along with retraining for older individuals. This is important because youths and older people together accounted for around one fourth of work seekers in 2010, according to a study by Hyundai Research Institute.

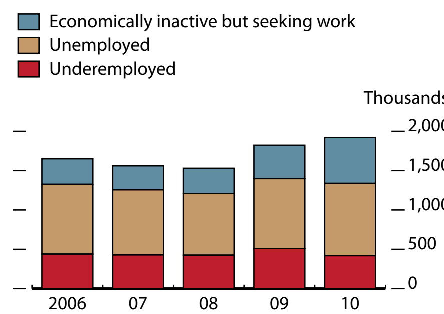
Second, an expansion of public child care facilities would enable more women with children to stay in work (the share of females in work seekers rose from 39% in 2009 to 43% in 2010).

Third, given that unemployment became more prevalent among those, especially females, with junior college or higher education, education must become better aligned with the needs of employers. Employment information, too, should be made more widely available at universities and colleges.

Fourth, efforts should be made to facilitate the employment of those work seekers formerly employed by public job-creation programs.

Fifth, internship programs in both public and private sectors should be expanded as they give valuable work experience to those who have never worked before (individuals unemployed for less than a year accounted for the largest share of work seekers).

3.11.10 Work seekers



Source: Hyundai Research Institute.

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Mongolia

Rising global prices of minerals and strong investment in mining contributed to a return of economic growth in 2010. These factors, coupled with a surge in fiscal spending, will spur higher GDP growth this year, too. Inflation accelerated to double-digit-levels in 2010 and is expected to be even higher this year. Rapidly rising prices and fiscal discipline are near-term challenges for policy makers.

Economic performance

A 6.1% recovery in GDP in 2010 was driven by growth in the minerals sector, high prices for mineral exports (Figure 3.12.1), and support from development partners. The outcome was a turnaround from a 1.3% contraction in the economy in 2009.

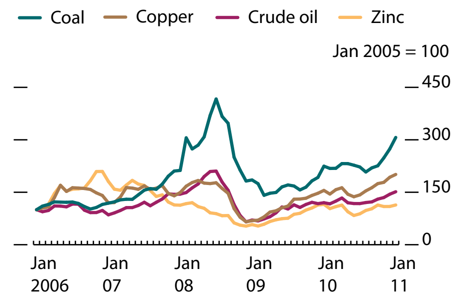
Mining benefited from a rebound in copper prices, strong external demand for coal and iron ore, and construction at Oyu Tolgoi, which will be one of the world's biggest copper and gold mines. Copper prices returned to 2008 levels early last year and rose to over $9,000 a ton in December 2010. Copper export volumes in 2010 were little changed from 2009, but their value jumped by more than 50%; export volumes of coal and iron ore more than doubled in 2010. Strong economic growth in the People's Republic of China (PRC), Mongolia's major trading partner, underpinned the increase in mineral exports.

Industry as a whole contributed nearly half the growth in GDP in 2010 (Figure 3.12.2) as construction and manufacturing expanded, along with mining. Services accounted for the rest of GDP growth: wholesale and retail trade recovered strongly as the economy bounced back.

Agriculture, however, which directly supports about one-third of the population of 2.8 million, was hit by severe winter conditions (a *dzud*) that reduced livestock numbers by about a quarter to 32.7 million. The sector's overall output contracted by nearly 17%. An estimated 10,000 households headed by livestock herders lost their livelihood and migrated to urban areas. The livestock losses also hurt the cashmere industry, reducing production of raw cashmere by 13.2% and output of cashmere sweaters by 20%.

Economic recovery was supported by an SDR 153.3 million (about $229 million) 18-month stand-by arrangement with the International Monetary Fund, completed in September 2010. Under this arrangement, Mongolia borrowed $185.4 million from the Fund and received commitments for $184 million for budget support from development partners. This financing, and associated policy actions taken by the government, bolstered both the budget and external positions and restored confidence in the currency (the togrog).

3.12.1 Global prices of main exports



Source: International Monetary Fund. International Financial Statistics online database (accessed 12 March 2011).

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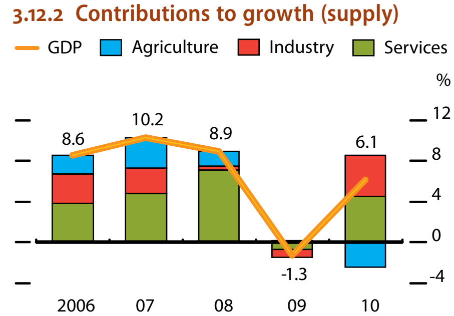
3.12.2 Contributions to growth (supply)



Source: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn.

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This chapter was written by Bayasgalan Rentsendorj of the Mongolia Resident Mission, ADB, Ulaanbaatar.

External trade rebounded last year from a sharp slump in 2009. Merchandise exports and imports in US dollar terms both jumped by about 53%, exports propelled by higher copper prices and increased coal and iron ore volumes and prices. Higher imports stemmed from the need for equipment in the mining industry, as well as rising prices of oil and food.

Deficits in trade in goods and services caused the current account gap to widen to 15.3% of GDP in 2010 (Figure 3.12.3). A surge in foreign direct investment to $1.6 billion, largely into mining, and in portfolio investment boosted gross international reserves to $2.2 billion at end-2010, equivalent to about 8 months of imports. (Reserves were just $637 million at end-2008.)

Inflation accelerated to nearly 13% by end-2010 (Figure 3.12.4), and averaged 10.1%. The loss of livestock during the *dzud*, coupled with an outbreak of hoof-and-mouth disease, caused a sharp runup in food prices. Strengthening domestic demand was reinforced in October when the government raised public sector wages by 30%. M2 money supply surged by nearly 63% over the year.

Inflation would have been higher had it not been for a 13% appreciation in the togrog against the US dollar in 2010 (the country has a managed floating exchange rate). As the economy recovered and inflation quickened, the Bank of Mongolia in May 2010 raised its policy interest rate from 10.0% to 11.0%.

Higher commodity prices and cash prepayments from the Oyu Tolgoi mine contributed to a 54.5% surge in government revenue in 2010. Government spending went up by 31.7%, largely the result of cash transfers and increases in public sector wages and pensions. The budget was roughly in balance (Figure 3.12.5).

Economic recovery generated jobs and lowered the unemployment rate, though it was still high at 8.6% at end-2010. Poverty remains widespread, with about one-third of the population living below the national poverty line. There has been progress on the Millennium Development Goals related to education and health, but achievements on the poverty, malnutrition, and environmental goals are trailing.

Improvements in business optimism and in public trust in banks encouraged a recovery in lending and strong gains in togrog deposits. Nonperforming loans and loans in arrears fell to about 15% of total loans. New banking and central bank laws were approved in February 2010 to improve bank regulation and supervision. A bank-restructuring strategy, drafted by the central bank, awaits approval by Parliament.

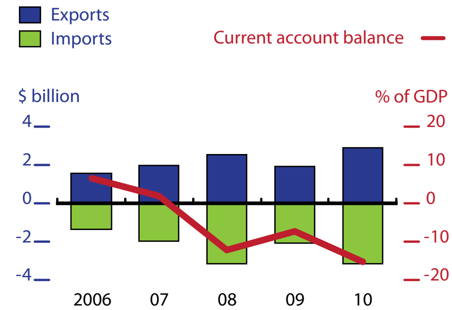
Economic prospects

Growth is expected to accelerate in 2011 and 2012, supported by high global mineral prices, development of new mines, and fiscal spending.

Mining is the key driver. Investment in the Oyu Tolgoi copper and gold mine is projected to total more than $4 billion over the next 2 years. The mine is scheduled to start production in 2013.

Preparations are being made to develop the coal deposits of one of the largest undeveloped coalfields in the world, Tavan Tolgoi. Like Oyu Tolgoi, these deposits are near the border with the PRC, a potential

3.12.3 Current account and trade indicators



Sources: Bank of Mongolia. 2011. *Balance of Payments Report*. January. http://www.mongolbank.mn; ADB estimates.

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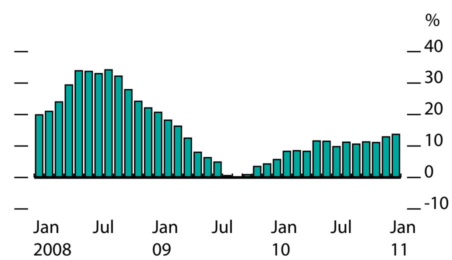
3.12.4 Monthly inflation



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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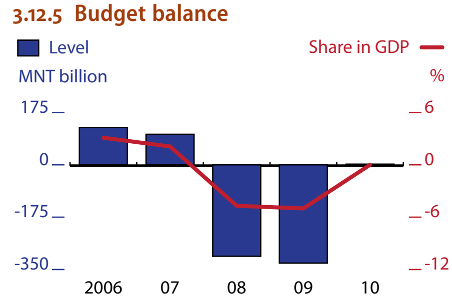
3.12.5 Budget balance



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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market for the minerals. At full capacity, Tavan Tolgoi could produce 15 million tons of coal a year. A state-owned company is expected to mine in one part of Tavan Tolgoi from this year, and international mining companies are bidding to develop another part.

The government has ambitious plans for a new rail line linking into the Russian Federation's rail network and so through to its Pacific ports. It also plans to build an industrial complex, including a copper smelter, oil refinery, and facilities to process metals and produce construction materials. The aim is to reduce the country's dependence on exports of raw materials. The rail line and industrial complex would, however, require investment of more than $10 billion, and their economic viability and financing are uncertain.

Fiscal policy is highly expansionary this year. The 2011 budget, with a deficit equivalent to almost 10% of GDP, includes a 35% boost in spending. Cash allowances through the government's Human Development Fund are budgeted to almost double from 2010. Disbursements include a monthly cash allowance of MNT21,000 (about $16) for every citizen and partial tuition support for each college student. Government expenditure overall is projected to rise from 37.3% of GDP in 2010 to 52.0% in 2011, while revenue is set to climb from 37.3% to 42.0%.

Agriculture is expected to recover from the impact of last year's severe weather. The government is providing support for farm-based livestock husbandry, attempting to mitigate weather-related risks.

Taking these factors into account, GDP growth is forecast to grow by a rapid 10% in 2011. High rates of inflation and an increasingly negative real policy interest rate suggest that the central bank will tighten monetary policy. It raised the reserve requirement for banks from 5.0% to 9.0% in February 2011. Further tightening is likely to contribute to a moderation in GDP growth in 2012, projected at about 8.0%.

High food prices, hikes in government spending (notably the cash payments), and the increasing cost of imported fuel are likely to result in very high inflation in 2011, averaging 17%. On the assumption of further monetary tightening this year, inflation should decelerate in 2012, but is projected to remain elevated at 14.0% (Figure 3.12.6).

Robust mineral exports projected for 2011 will be offset by an increase in imports of supplies and equipment for mining, as well as the rising cost of imported food and fuel. The current account deficit is seen at about 15% through the forecast period. Its main sources of financing will be foreign direct investment and public and private sector borrowing from abroad.

The togrog could come under further upward pressure, undermining nonmineral industries, including cashmere and textiles.

Parliament last year enacted a fiscal stability law to improve the management of volatile revenue inflows from minerals and to help avoid the boom–bust instability that is common in mineral-based economies.

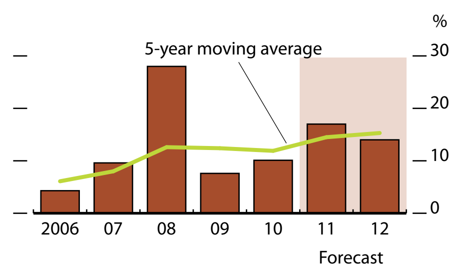
The law should foster budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. It also requires cost estimates for spending proposals to ensure consistency with the medium-term fiscal framework. A fiscal stability fund will be established to accumulate revenue saving, to be tapped during economic downturns. Most of the fiscal stability law's measures do not apply until 2013, however.

3.12.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	8.0
Inflation	17.0	14.0
Current account balance (share of GDP)	-15.0	-14.0

Source: ADB estimates.

3.12.6 Average inflation



Sources: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

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As for monetary policy, the new central bank law mandates the Bank of Mongolia to focus solely on price stability. Inflation targeting, coupled with a flexible exchange rate, should provide an appropriate monetary framework, which will take some time to establish. The monetary authorities have a tentative timetable to introduce inflation targeting in 2012.

Development challenges

The direction of fiscal policy is of increasing concern. Very high levels of government expenditure planned for 2011 are procyclical and may become a source of macroeconomic instability by fueling inflation, demand for imports, and exchange rate volatility.

Policies to develop minerals and promote economic diversification need to be balanced with sound macroeconomic management and prevention of boom–bust cycles. It is important to bring fiscal policy into line with the fiscal stability law and establish a sound medium-term budget framework.

Protecting the poor from the impact of rising prices and enabling their full inclusion in economic growth through greater employment are other objectives. Proposed measures to better target entitlement payments would mitigate the impact of high inflation.

Putting the banking system on a stronger foundation will require follow-through on the structural reforms proposed for the sector.

The "Dutch disease" risk common to mineral-based economies is likely to remain on the horizon. In this scenario, rapid increases in exports of minerals put upward pressure on the exchange rate and inflation, draw resources away from nonmineral sectors, and generate a stream of government revenue available for subsidies and handouts. The outcome can be uncompetitive nonmineral industries and overextended government budgets (particularly when global mineral prices turn down).

Taipei,China

A powerful recovery last year reflected a rebound in domestic demand and a surge in exports. Growth will moderate this year, owing to the high base set in 2010. Inflation has picked up, but is forecast at relatively modest levels. The outlook is improved by tariff reductions on exports to the People's Republic of China (PRC) and the opening of more industries to investment from there.

Economic performance

This trade-dependent economy rebounded vigorously from recession in 2009. Surging demand for its manufactured exports in 2010 drove a burst of investment and supported increased private consumption. The 10.8% rise in GDP—the fastest in almost a quarter century—was partly a result of the low-base effect from the contraction in the previous year.

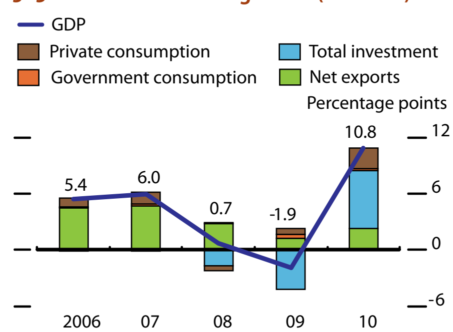
Private investment soared by nearly 33% in 2010, after contracting in 2009, with substantial increases in manufacturing, information and communications, and construction. Public investment also rose, albeit modestly, as the authorities continued with infrastructure spending, including reconstruction in areas hit by the severe Typhoon Morakot of August 2009. Overall, higher gross fixed capital formation contributed most of the boost to GDP in 2010 (6.1 percentage points of the total) (Figure 3.13.1).

Rebounding exports and manufacturing spurred employment and income growth, in turn buttressing private consumption. Unemployment declined to 4.7% by end-year, from 5.7% the previous year. Real average monthly earnings in manufacturing rose by 7.5% in 2010, after declines in the 2 previous years. The stronger labor market buoyed consumer confidence (Figure 3.13.2). Private consumption grew by 3.7% in 2010 and added 2.1 percentage points to GDP growth.

Sectorally, growth was dominated by manufacturing (constituting about 84% of industry), which surged by 26.8% and contributed 7.2 percentage points to GDP growth. Construction increased by 10.9%, though its contribution to GDP was slight, as it is a much smaller industry. Services grew by 4.8%, with wholesale and retail trading the major contributors to growth in this sector.

Strong global demand for manufactured goods drove growth of nearly 40% in exports of electronic products and chemicals, and increases of over 30% in metal products and plastics. Total exports shot up by nearly 35% in United States (US) dollar terms. The major markets were the PRC; Hong Kong, China; and the US, which collectively took 53% of total exports (Figure 3.13.3). Merchandise imports bounced back even more,

3.13.1 Contributions to growth (demand)



Source: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011).

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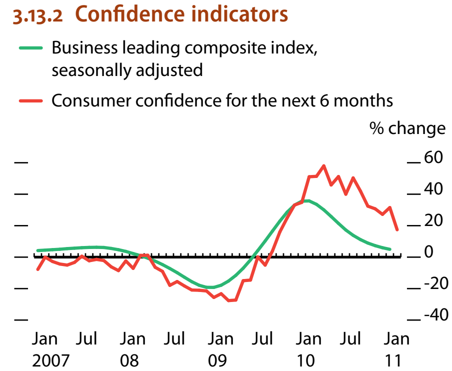
3.13.2 Confidence indicators



Source: CEIC Data Company (accessed 16 March 2011).

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This chapter was written by Akiko Terada-Hagiwara and Shiela Camingue of the Economics and Research Department, ADB, Manila.

by 43.2%, fueled by imported materials for manufacturing industries and capital goods required by the investment boom.

The merchandise trade surplus therefore fell by 12% to US$26.9 billion. After accounting for small surpluses in services and income, the current account surplus declined, to a still significant 9.4% of GDP. The overall balance of payments was in surplus and international reserves rose to US$382 billion by end-2010.

On the back of tighter economic links with the PRC through the Economic Cooperation Framework Agreement signed last year and abundant global liquidity, short-term portfolio inflows picked up and reached US$10 billion in the fourth quarter of 2010. A rapid increase in purchases of government bonds by foreign institutional investors, speculating on an appreciation of the NT dollar, prompted the monetary authorities in November 2010 to put limits on short-term debt that foreigners can hold. The local currency appreciated against the US dollar from NT$35.2 in March 2009 to NT$29.1 by end-2010.

After cutting interest rates in 2008 and 2009, the monetary authorities started to normalize rates as the economy rebounded. From June 2010, they raised the discount rate in three steps to 1.625% by year-end. Bank credit grew by 7.8% in 2010, after it had declined by 1.4% in 2009 (Figure 3.13.4). M2 money supply growth averaged 5.3% for the year, within the 2.5%–6.5% target range set by the central bank.

Consumer prices also turned up last year, although average inflation was just 1.0%. Of greater concern was a surge in residential property prices (Figure 3.13.5) caused mainly by speculative buying. The authorities moved to curb bank lending for second homes and directed banks to reduce loan-to-valuation ratios for such properties, which helped to damp speculation.

Government expenditure fell by 0.8% in 2010 from 2009, as the authorities gradually withdrew 2009's fiscal stimulus measures. Revenue also declined, by 0.4%, and the budget deficit narrowed only slightly in terms of the ratio to GDP, to 3.2% from 3.5% in 2009. Outstanding government debt rose to 33.6% of GDP, though still below a 40% limit set by law.

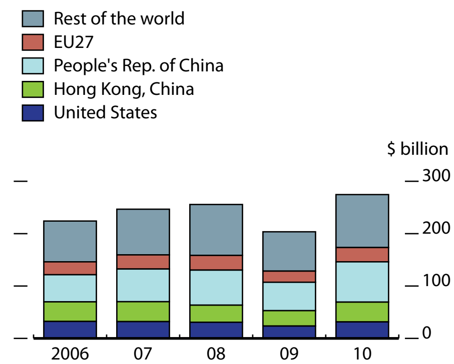
Economic prospects

Further growth in world trade in 2011 (though moderating from 2010's sharp rebound) and continuing expansion of the PRC economy will underpin growth in 2011. The pace will be around trend, however, as the base effect from the 2009 recession that propelled the 2010 outturn dissipates. Growth is expected to be broad-based, with contributions from both domestic and external demand.

The Economic Cooperation Framework Agreement with the PRC will support growth. (The PRC and Hong Kong, China together account for about 40% of Taipei,China's exports.) The first set of tariff reductions under the agreement came into effect in January 2011. Nearly 2,000 certificates of origin valued at over US$400 million, about 5% of merchandise exports to the PRC, were issued in January–February 2011 for Taipei,China products that receive preferential duties from the PRC.

The number of visitors from across the strait surged by 68% in 2010,

3.13.3 Total exports, by major trading partners



Source: Department of Statistics, Ministry of Economic Affairs. http://2k3dmz2.moea.gov.tw/gnweb/English (accessed 1 March 2011).

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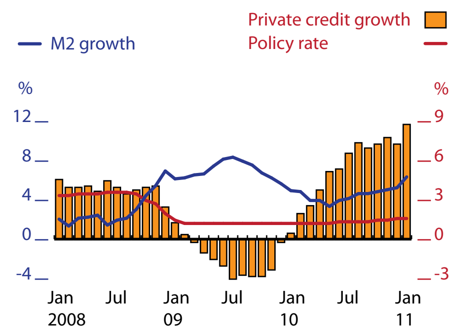
3.13.4 Credit indicators



Source: CEIC Data Company (accessed 16 March 2011).

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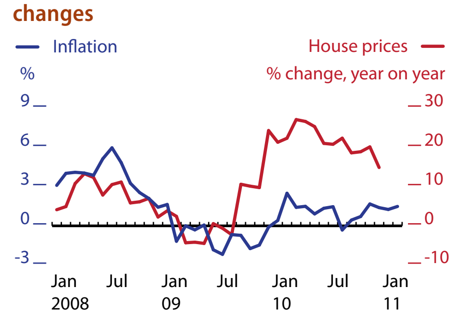
3.13.5 Monthly inflation and house price changes



Source: CEIC Data Company (accessed 16 March 2011).

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3.13.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.8	5.0
Inflation	2.8	2.9
Current account balance (share of GDP)	6.9	7.0

Source: ADB estimates.

and further growth in inbound travel is expected as more tourist groups from the PRC are allowed to visit this year.

Further, the authorities in March 2011 opened up more industries to PRC investors, including the semiconductor and flat-panel subsectors, which were excluded in the first round of investment liberalization last year. PRC investment in these subsectors is expected to lead to increases in exports to the mainland.

Growth in export orders for manufactured goods (such as mobile telephones and tablet computers) moderated to about 5% in the first 2 months of 2011 compared with the prior-year period (Figure 3.13.6). Merchandise exports increased by about 21% in January–February 2011, year on year.

Private consumption is expected to grow by 1.2% in 2011, against the background of a firm labor market. Businesses in sectors with strong external demand—semiconductors and telecommunications equipment for example—are likely to increase investment, but private investment overall is projected to contract by 2.3% this year from the high base set in 2010.

On the balance of these influences, GDP is forecast to grow by 4.8% in 2011 and about 5.0% in 2012 (Figure 3.13.7). Downside risks to this outlook come from higher than expected global oil and commodity prices, any significant slowdown in the PRC, and a prolonged supply disruption to manufactured components from plants in Japan affected by the earthquake and tsunami.

Global price increases for commodities, food, and oil will likely mean that the value of imports rises faster than exports in 2011. (The import bill rose by 25.0% year on year in the first 2 months.) The trade surplus is forecast to fall and the current account surplus decline to 6.9% of GDP.

The higher costs of imports will put upward pressure on inflation, which is projected at around 2.8% in the forecast period (Figure 3.13.8). The NT dollar appreciated by 2.7% against the US dollar from the start of 2011 to mid-March, and is expected to remain firm. Given that forecast GDP growth is broadly in line with trend potential, the monetary authorities are expected to edge up interest rates to contain inflation.

Public investment will play a smaller role in the next 2 years. About US$3.6 billion is allocated for public infrastructure this year, compared with US$5.1 billion in 2010. General government revenue is expected to outpace expenditure, narrowing the fiscal deficit.

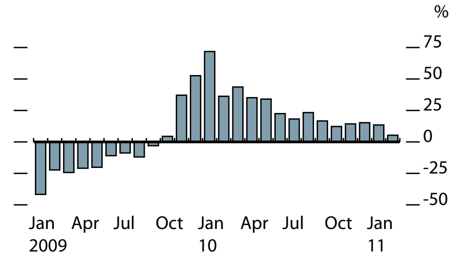
Development challenges

Longer-term growth potential is constrained by an aging, and shrinking, labor force.

The ranking of sources of GDP growth, in terms of production factors, in the decades of fast growth in the 1980s and 1990s put growth of the capital stock first, followed by total factor productivity, labor, and education. In 2000–2007, the capital stock was still the largest growth contributor; labor and education were equal second.

The labor force is projected to decline to below 10 million workers by 2030, from 11.1 million in 2010, and the age-dependency ratio could triple in that period.

3.13.6 Growth in export orders



Source: CEIC Data Company (accessed 16 March 2011).

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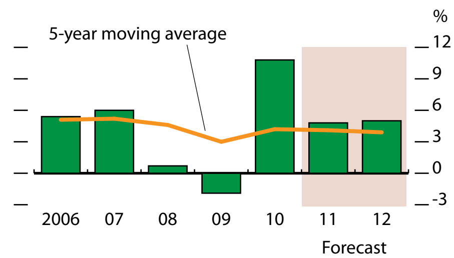
3.13.7 GDP growth



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.

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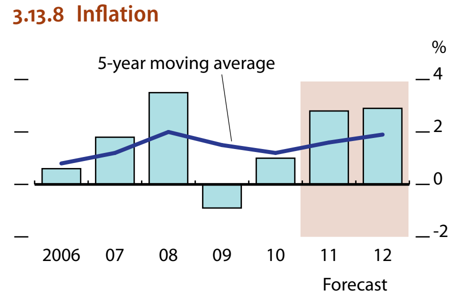
3.13.8 Inflation



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.

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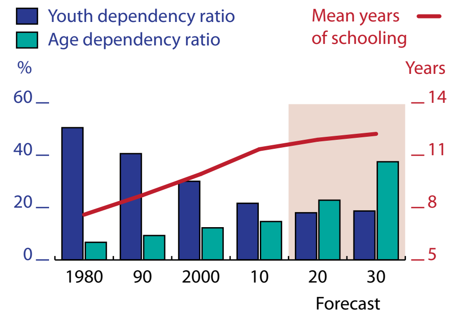
Taipei,China's labor force participation rate, at 58% of the working-age population, is the lowest among newly industrialized economies and almost 10 percentage points lower than Singapore's. The population in Singapore is aging faster, but an active immigration policy there means that labor is projected to add to its growth in the long term, while the reduction in the Taipei,China labor force will lower its growth.

To address this issue, some local authorities, such as Taipei city, are providing conditional cash transfers to households with pre-school-age children to encourage women, in particular, not to quit work when they have children. Such measures could be rolled out more widely to raise labor force participation.

With regard to education, the average number of years of schooling in Taipei,China is expected to reach developed-country levels of 12 years by 2030 (Figure 3.13.9). Hence, there is probably greater room to enhance growth potential by focusing on policies that raise the labor force participation rate, stimulate investment, and foster advanced technology.

The reductions in tariffs on exports to the PRC may well encourage some of the manufacturers that relocated factories to the PRC to bring back some production to the island. Further, the eased tariffs, proximity to the PRC, and a cut in the corporate tax rate to 17% last year all improve the odds of broadening the investor base by attracting firms from rapidly developing countries, such as India, that aim to produce for the large PRC market.

3.13.9 Dependency ratios and years of schooling



Sources: J.-W. Lee and R. Francisco. 2010. Human Capital Accumulation in Emerging Asia 1970–2030. *ADB Economics Working Paper Series* No. 216. Asian Development Bank, Manila; Population Division of the Department of Economics and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2008 Revision*. http://esa.un.org/unpp (accessed 28 April 2010).

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SOUTH ASIA

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Afghanistan

Despite deteriorating security, the economy grew steadily in 2010. Inflation increased (toward fiscal year-end), driven largely by import prices. The fiscal position continued to improve but a run on deposits at the leading private bank revealed a significant macroeconomic risk. The government presented an Afghan-led plan for development at the Kabul Conference of donors, but low implementation capacity, weak public sector governance, and perceptions of widespread corruption raise concerns over implementation. Sustainable, self-reliant growth requires significant improvements in security, progress in the Afghan-led reconciliation process, and a better private sector environment.

Economic performance

GDP continued to grow strongly, at 8.2% estimated for FY2010 (ending 20 March 2011), following high growth of 20.4% in FY2009 (Figure 3.14.1). Private consumption remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction. The wheat harvest was above average, but agricultural growth was below FY2009's record.

The size of the opium economy (not included in the official figures for economic activity) had been declining since 2007 because of crop-substitution policies, but in 2010 its farm gate price more than doubled, owing to plant disease–related lower production levels. This boosted farmers' opium-sourced income, likely complicating the already slow pace of poppy eradication.

In the early months of FY2010 the price deflation of the previous fiscal year continued. Prices began to rise from about May 2010, heavily influenced by food and then by fuel, reflecting rising import prices. Although inflation is projected to average 8.2% in FY2010, in February 2011 prices were 17.9% higher than a year earlier (20.9% food and 13.7% nonfood—Figure 3.14.2).

Afghanistan maintains a managed floating exchange rate regime. The afghani appreciated by around 10% against the US dollar over the period January 2010–February 2011, on high inflows of foreign exchange in the form of donor grants and remittances and on increased demand for domestic currency (Figure 3.14.3). This appreciation, alongside inflation now higher than among trade partners, is causing the real effective exchange rate to appreciate as well, potentially undermining exports.

To achieve stability both in domestic prices and the exchange rate, Da Afghanistan Bank, the central bank, targets reserve money (bank reserves and currency in circulation) as its key monetary tool, relying on the issue of its capital notes and foreign currency auctions to control the

3.14.1 GDP growth

Source: Ministry of Finance.

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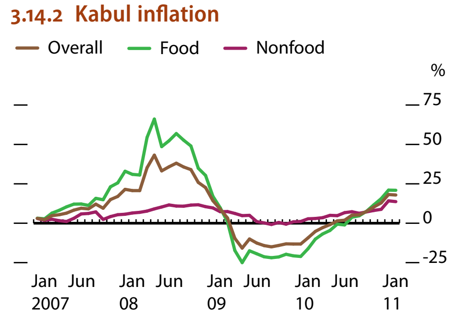
3.14.2 Kabul inflation



Sources: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. http://mail.gov.af; Central Statistical Office of Afghanistan; Da Afghanistan Bank.

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This chapter was written by Rehman Rahmani and Tia Raappana of the Afghanistan Resident Mission, ADB, Kabul; and Nina Clare Fenton of the Central and West Asia Department, ADB, Manila.

money supply. The absence of price pressures at the start of the fiscal year allowed it to adopt a relatively expansionary monetary stance for FY2010, in order to accommodate an increase in demand for money stemming from expected economic growth. It targeted reserve money growth in FY2010 at 18.9%, 1.8 percentage points higher than in FY2009.

In view of inflation pressures, however, the central bank is expected to increase interventions in the market. Gross international reserves climbed to $5.0 billion at end-March 2011 (a rise of 19% from 12 months earlier), reflecting higher donor inflows. Reserves are sufficient to finance 14.3 months of imports and can facilitate market intervention to stabilize the economy and currency.

A run on deposits at Kabul Bank, the largest private bank, in the second half of 2010 raised concerns about financial stability, highlighting the need to strengthen central bank supervision (Box 3.14.1). Although the government took steps to stabilize the crisis, the bank's losses (stemming from serious weaknesses in its corporate governance and management) could constitute a heavy fiscal burden.

Following a surge in domestic revenue collection in FY2009, the government continued to improve in this area, and collection is expected to reach 9.8% of GDP in FY2010 (Figure 3.14.4). The good performance was driven by improved tax administration, including a levying of business receipts tax at borders and other structural reforms. Still, the fiscal position (excluding grants) remains among the world's weakest. Development expenditure is almost fully funded by external assistance while fiscal sustainability—domestic revenue as a share of recurrent spending—is expected to decline to around 65% in FY2010 from 72% a year earlier.

This decline is due to upward pressures on recurrent spending, mainly from the higher wage bill owing to the expansion of the Afghan security forces and the rollout of pay and grading reforms for civil servants. Steps toward fiscal sustainability are particularly important given plans to transit to Afghan-led security, since most International Security Assistance Force nations are setting dates for withdrawing their troops.

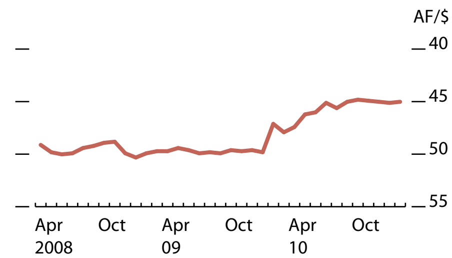
At conferences in London and Kabul in January and July 2010, the government presented refinements to its Afghan-led medium-term plan for development and announced results-based national priority programs to meet its objectives. It also set out public financial-management reforms.

Only an estimated 20% of donor funds are channeled, however, through the government budget, and to increase this share (as committed at the Kabul Conference), the government needs to greatly improve its implementation capacity. It also needs to address broader issues of transparency and accountability in the public sector, including strengthening audits on the use of domestic funds.

The current account deficit (excluding grants) is estimated to have narrowed from 43.6% to 37.6% of GDP in FY2010 (Figure 3.14.5). The narrowing trend reflects the fact that grant-related imports (and grant financing), though increasing in US dollars, are falling relative to nominal GDP. Including grants, the current account balance varies only slightly: it is expected to run a small surplus of 1.9% of GDP in FY2010, switching from a deficit of 1.4%.

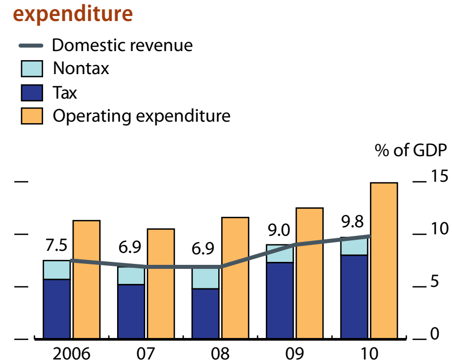
During the fiscal year imports increased by 3.7%. The rise was

3.14.3 Nominal exchange rate



Source: Da Afghanistan Bank. http://www.centralbank.gov.af
Click here for figure data

3.14.4 Domestic revenue and operating expenditure



Sources: International Monetary Fund. 2008. *Country Report No.* 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.
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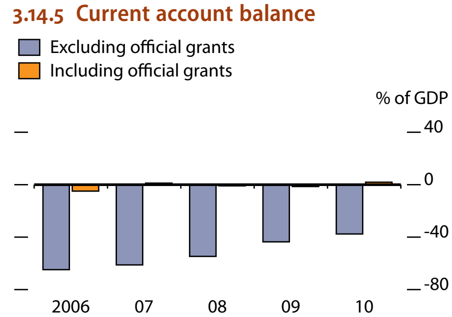
3.14.5 Current account balance



Sources: International Monetary Fund. 2008. *Country Report* No. 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.
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attributed to continued high demand from donor-funded projects, particularly for fuel, capital equipment, and food, which together make up almost 80% of imports. Exports (much smaller than imports) rose by 6.9%; the main items remained dried fruits, carpets, and furs.

Economic prospects

GDP growth rates for FY2011 and FY2012 are projected at 8.0% and 8.5%, respectively. These estimates assume that substantial development-partner funding continues; agriculture and services perform well; the resolution of the Kabul Bank crisis is not disruptive; and industry improves, aided by mining-related construction.

If managed effectively, mining has the potential to grow robustly, although its contribution to the budget over the next few years is likely to be modest. The World Bank estimates that even in a low-impact scenario the first significant investment, the Aynak copper mine, could generate budget revenue of around $155 million a year in the construction phase (2011–2015), increasing to $365 million from royalties once the mine is operating. The Hajigak iron ore mine, too, may bring in revenue of $89 million a year after it starts construction in 2013. In the early years of development, combined receipts from these two mines could therefore be over 1% of GDP, but that amount is contingent on strong management.

The government expects in the next few years to make progress on revenue collection, particularly by the possible introduction of a value-added tax, and to increase its fiscal sustainability ratio to above 70%. The tax take should also benefit from increased mining activity, largely through indirect tax revenue in the construction phase. Meeting the 70% target will, though, be challenging under continued pressure on recurrent expenditure. Although external assistance is set to gradually decline, it is likely to be needed to cover at least part of such spending for several years.

Foreign aid will continue to plug the balance-of-payments gap. The current account surplus is expected to fall slightly in FY2011, to 1.4% of GDP (including official transfers), driven by increased imports as international commodity prices rise. Excluding official transfers, the balance should continue its gradual improvement to a deficit of 34.4% of GDP as development assistance falls relative to the size of the economy (though nominally it expands).

Inflation is projected to average 9.8% and 9.1% in FY2011 and FY2012, assuming that prudent monetary policy is adopted as planned and that it can mitigate the impact of rising international commodity prices.

The previous program of the International Monetary Fund ended in September 2010; the government has therefore requested a new Extended Credit Facility, though the Kabul Bank crisis has delayed a board decision.

The government's economic program is likely to set out key actions on resolving Kabul Bank's position and strengthening broader financial supervision measures, while keeping a focus on macroeconomic stability objectives and measures toward fiscal sustainability.

This outlook is subject to several risks, such as worsening security conditions, political instability, weak governance, loss of export

3.14.1 Kabul Bank crisis

Fraudulent loans came to light at Kabul Bank in September 2010, triggering a run on deposits. Despite this huge change to its financial position, the bank still has the largest deposits and branch network in the country, and performs crucial functions such as paying civil service salaries.

The central bank initially placed Kabul Bank under a conservatorship until the bank could be sold to a qualified buyer, or, in the worst case, liquidated.

The government has so far guaranteed $400 million of the bank's deposits but it will probably also need to finance any remaining unfunded liabilities at the time of a sale.

An alternative option, proposed by the International Monetary Fund, would be to place the bank in receivership, which could be expected to ensure more transparent, legally secure, and potentially faster resolution.

Importantly, any improper financial and legal interests would be unquestionably resolved and any further losses prevented. The government's financial exposure could also be limited to a predetermined level. In March 2011, the option of receivership was being considered by the Afghan authorities.

3.14.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.5
Inflation	9.8	9.1
Current account balance (share of GDP)	1.4	-0.8

Source: ADB estimates.

competitiveness, and new barriers to trade with neighboring countries. The debt relief granted to Afghanistan under the extended heavily indebted poor countries initiative in 2010 has relieved the debt burden by $1.6 billion, taking it to a sustainable level (around 8% of GDP). Still, Afghanistan will stay at high risk of debt distress, particularly if foreign grants (expected to decrease gradually in the medium term) fall heavily.

Development challenges

It is important that the government continues to undertake a strong reform agenda and implement the commitments made at the Kabul Conference. A particular focus should be on strengthening governance, implementation capacity, and accountability of public institutions. The government's development plan should help to ensure that the budget is clearly focused on key policy objectives. Capacity should be strengthened to increase development budget implementation by at least 10%–20% annually, as committed to at the Kabul Conference. At the same time, the national budget process should build on existing systems to better monitor spending effectiveness.

If significant progress were made on all these fronts, development partners would channel more funds through the government budget, helping to align development priorities and increase aid effectiveness.

External assistance is expected to decline over the long term, hence the government needs to focus on the transition to fiscal sustainability. It is expected to continue improving its position by increasing domestic revenue and controlling public expenditure through a robust budget-formulation process.

The government will also want to improve the overall investment climate, so as to encourage private sector growth, promote exports, and reduce dependence on external assistance. The country still ranks the lowest in the region for ease of doing business, according to the World Bank's *Doing Business 2011* report, and this needs to change. Managing the potential mineral wealth well will also be critical.

3.14.2 South Asian rankings on the ease of doing business, 2011

Pakistan	83
Maldives	85
Sri Lanka	102
Bangladesh	107
Nepal	116
India	134
Bhutan	142
Afghanistan	167

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.

Bangladesh

A strong export rebound will push up growth in FY2011, but a slowing remittance expansion will damp domestic demand. Next year could see better prospects with higher external demand. A major challenge for policy makers will be to balance the needs for taming inflation and for ensuring that credit to the private sector is not stifled. To harness the country's medium-term growth potential, removing infrastructure gaps will be essential, as will enhancing the supply of skilled human resources.

Economic performance

At 5.8% in FY2010 (ended June 2010), GDP growth was marginally higher than the 5.7% of FY2009 (Figure 3.15.1). Helped by favorable weather and continued government support, strong performance by the crop and horticulture subsector boosted agriculture's expansion. This offset a decline in industrial growth due to a fall in external demand and continued shortages of power, gas, and transport facilities. Services also grew only marginally.

On the demand side, growth was again driven by private consumption aided by higher credit flows to the private sector (supporting job creation) and by a boost to public sector wages. Total fixed investment, after remaining stagnant over the past half a decade, rose from 24.4% of GDP in FY2009 to 25.0% in FY2010. The rise in private investment provided the main impetus to performance.

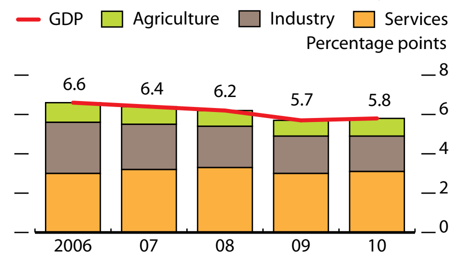
Foreign direct investment is stagnant at less than $1 billion a year. It could see a notable rise, however, if the government makes progress in awarding contracts for gas exploration and in setting up a floating liquefied natural gas terminal, as called for in its plans to address growing power and gas shortages. Foreign as well as local investment could also be lifted by the Special Economic Zone Act that Parliament passed in 2010, which aims to attract more private capital.

Annual average inflation edged up to 7.3% in FY2010 from 6.7% in FY2009 owing to a rapid rise in food prices in the first part of the year; nonfood inflation moderated. In FY2011, year-on-year inflation fell to 7.3% in July (Figure 3.15.2), from 8.7% in June but subsequently trended upward (with some volatility) to reach 9.0% in January 2011. The rise in global food and commodity prices, a continued rapid expansion in private credit, and depreciation of the taka pushed up prices.

To help the poor and vulnerable cope with higher food prices, the government stepped up food distribution operations, strengthened open-market sales of its inventories, and introduced a food-ration system for the ultra-poor.

FY2010's rapid growth in broad money continued into FY2011, reaching 21.7% in December 2010 (Figure 3.15.3), significantly above the

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November.

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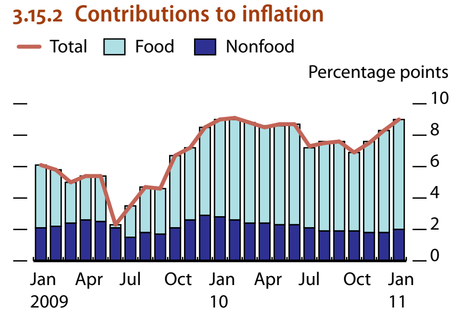
3.15.2 Contributions to inflation



Sources: Bangladesh Bureau of Statistics. *Consumer Price Index (CPI) and Inflation*. Various issues. http://www.bbs.gov.bd

Click here for figure data

This chapter was written by Mohammad Zahid Hossain, Shamsur Rahman, and Md. Golam Mortaza of the Bangladesh Resident Mission, ADB, Dhaka.

central bank's annual program target of 15.2%. Private credit, up by 27.6% year on year in December 2010 (against the target of 16.0%) was the main contributing factor. The central bank's tightening of policy rates had little effect on credit expansion. The average lending and deposit rates also remained largely unchanged at 11.2% and 6.0%, respectively, in June–December 2010.

Revenue collection rose briskly with the revenue-to-GDP ratio climbing to 11.5% in FY2010—meeting the budget target—as domestic economic activity picked up a little and tax administration improved. Total spending jumped from 14.3% of GDP in FY2009 to 16.0% in FY2010 as the government adopted an expansionary fiscal stance to offset the impact of the global recession. Spending fell short, however, of the budget target as the annual development program remained underspent because of the lingering weak capacity in key implementing agencies. The fiscal deficit of 4.5% of GDP was well within the target of 5.0%.

After declining in the first half of FY2010, exports grew consistently year on year during the second half, posting growth of 4.2% for the full year (but still much lower than the previous year's 10.1%). Readymade garment exports moved up by only 1.2%, shaving their dominant share of total exports by 2 percentage points to 77.1% in FY2010. Exports of jute goods, petroleum by-products, and engineering products rose briskly.

Imports contracted during the first 3 quarters but reversed this trend in the fourth to show full-year growth of 5.4%, as imports of capital machinery picked up. Import bills for rice and for consumer and intermediate goods fell from their year-earlier levels. Remittance growth, robust at 22.8% in the first half of the fiscal year, decelerated sharply later, posting only 13.4% full-year growth, down from 22.4% the previous year.

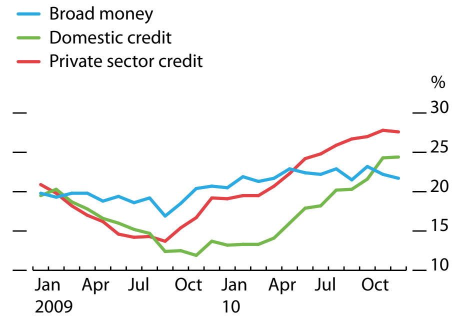
Still, the small expansion in the trade deficit was more than offset by remittance inflows, boosting the current account surplus to $3.7 billion (3.7% of GDP) from $2.4 billion (2.7%) in FY2009 (Figure 3.15.4). The improved position, alongside the lower deficit in the combined capital and financial account, pushed the overall balance-of-payments surplus to $2.9 billion and foreign exchange reserves to $10.7 billion (Figure 3.15.5) at end-June 2010, raising import cover to about 5 months. In the first half of FY2011 foreign exchange reserves showed little increase as the current account surplus largely fell away.

The nominal taka–dollar exchange rate remained stable in FY2010, but depreciated by 2.6% in the first 8 months of FY2011. Nonetheless, with domestic inflation higher than in major trading partners, the real effective exchange rate appreciated by 1.8% year on year in January 2011, implying some erosion in export competitiveness.

The Dhaka Stock Exchange general index more than doubled during FY2010 (Figure 3.15.6). The price–earnings ratio climbed from 18.4 to 24.1 and market capitalization doubled, reaching $38.6 billion (about 39% of GDP). The bullish trend in stock prices continued into the first half of FY2011 as the general index peaked on 5 December—44.0% higher than its end-June 2010 level. Then, a price correction set in, and the index fell by 41.7% by end-February as commercial and merchant banks moved to heavy selling, booking large profits. Nervous retail investors followed suit.

To stabilize the market and shore up investor confidence, the government announced measures including advising commercial and

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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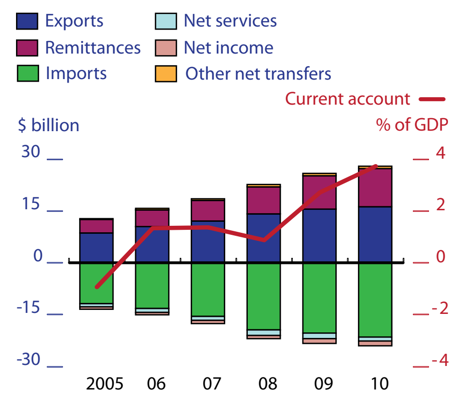
3.15.4 Components of the current account balance



Source: Bangladesh Bank. *Annual Report 2009–2010*. http://www.bangladesh-bank.org
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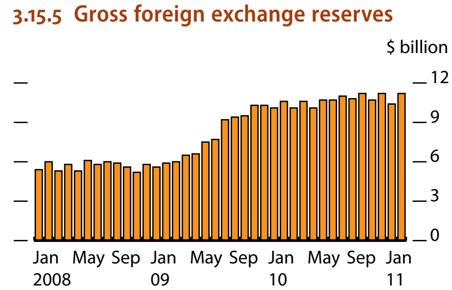
3.15.5 Gross foreign exchange reserves



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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merchant banks to reinvest their profits, instructing merchant banks to stop the practice of forcing margin clients to sell shares, and removing the index's circuit breaker. The state-owned Investment Corporation of Bangladesh, with seven other state-owned financial institutions, are creating a Tk50 billion (about $715 million) open-ended mutual fund (the Bangladesh Fund) to prop up the market. The government also formed a committee to investigate the causes of market instability.

Economic prospects

Economic forecasts for FY2011 and FY2012 rest on several assumptions. The policy focus on accelerating growth while strengthening efforts to tame inflation will continue, the momentum of budget revenue growth will be maintained, and it will be possible to mobilize more external financing. The government will step up initiatives to boost power generation (including commissioning rental power plants), thereby easing power supply shortages, and will take action to address gas shortfalls. A stable political environment and normal weather conditions are assumed.

GDP growth in FY2011 is projected to climb to 6.3% from 5.8% the previous year. The strong rebound in exports under way will support higher growth, offsetting the effects on domestic demand of the sharp slowdown in remittance growth. The pickup in export-linked domestic industries and tax incentives for domestic industries provided in the FY2011 budget are also expected to bolster economic activity. GDP growth in FY2012 is seen rising further, to 6.7% (Figure 3.15.7), with a continued policy focus on growth and a pickup in external demand.

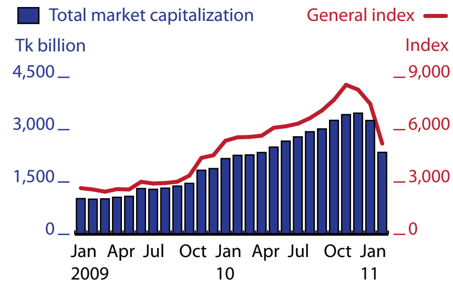
Agricultural growth in FY2011 is expected to ease to 4.1% because of lower acreage sown for the *aus* (summer crop), shrinkage in acreage and inadequate rainfall for the *aman* (monsoon crop), and the high base following the previous year's growth of 4.7%. In FY2012, the sector's growth is expected to strengthen to 4.3%, responding to higher prices following a tighter supply situation in FY2011 and continued policy support.

Industrial growth is expected to rise to 7.5% in FY2011, reflecting higher production for exports and domestic capacity expansion after the previous year's higher investment. Export performance was buoyant in the first 8 months of the fiscal year, recording 40.3% growth (Figure 3.15.8), with all major items growing strongly. Rapid growth in imports of raw materials and capital machinery also point to a better industrial performance. An improvement in the power supply and a rise in business confidence, too, are likely to boost activity. In FY2012, industry is expected to grow strongly at 7.8%, reflecting a rise in external demand and higher domestic capacity.

In FY2011, services growth is forecast to rise slightly to 6.7% from 6.4%, mainly on the strength of industrial and trade and transport activity, as the pulse of trade quickens. Sector growth will rise further to 7.2% in FY2012, reflecting industrial and agricultural strengthening.

The rise in year-on-year inflation is pushing up the 12-month average. Although the central bank's January 2011 monetary policy statement forecast 7.0% inflation for FY2011, it may well come in at 8.0%, rising

3.15.6 Dhaka stock exchange indicators



Source: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February. http://www.bangladesh-bank.org

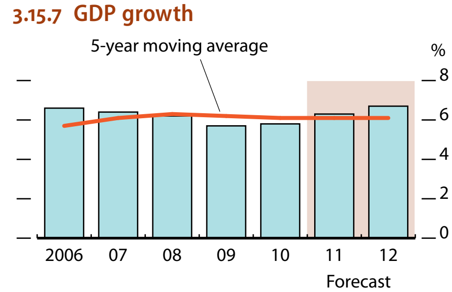
Click here for figure data

3.15.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.3	6.7
Inflation	8.0	8.5
Current account balance (share of GDP)	0.2	-0.3

Source: ADB estimates.

3.15.7 GDP growth



Sources: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November; ADB estimates.

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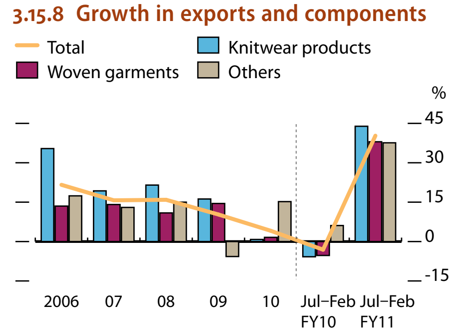
3.15.8 Growth in exports and components



Sources: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February; *Annual Report 2009–2010*. http://www.bangladesh-bank.org

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further to 8.5% in FY2012 (Figure 3.15.9). The central bank instructed commercial banks to rein in credit growth and set a deadline for cutting the credit-to-deposit ratio. The marked rise in global commodity prices, the likely further depreciation in the taka, a power tariff increase in February 2011, and expected hikes in fuel and compressed natural gas prices are all seen exerting upward supply-side pressures. Monetary policies are unlikely to fully counter them.

The slower growth in remittance inflows that began around February 2010 intensified in FY2011. Overseas workers remitted $7.5 billion during the first 8 months of FY2011, for growth of only 2.5%—a startling drop from a 19.0% gain in the year-earlier period. The decline is a concern as healthy remittance growth helps to underpin consumer spending and is a key source of domestic demand. Job placements for Bangladeshi workers, who are mostly low-skilled, declined by 10.9% in the first 8 months of FY2011 (Figure 3.15.10), continuing the declines of the previous 2 years. Remittances are likely to grow at very modest rates of 3.0% in FY2011 and 4.0% in FY2012. The latest developments in the Middle East could also affect remittances.

The continued robust performance in export earnings that started in March 2010 raised the prospect of exceeding the FY2011 annual export target of $18.5 billion. In the first 8 months of FY2011, rapid growth in readymade garment exports (woven by 38.0% and knitwear by 43.9%), representing over three-fourths of total exports, was partly due to importing countries replenishing their inventories, though it also reflected a sharp rise in wages in some other garment-exporting countries. Although industry's agreement to raise monthly wages—to about $43–$133 for garment workers—has by and large been pushed through following frequent worker unrest over the past couple of years, it hardly dented wage differentials with competitors.

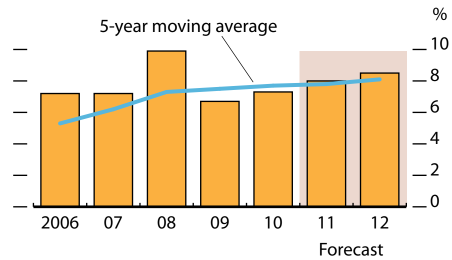
Exports of other items such as frozen foods and jute also grew strongly. Very high export growth in the first part of FY2011 is expected to moderate as inventory rebuilding comes to an end, pointing to a 21.0% expansion in exports for all FY2011. In FY2012, exports are projected to grow by 22.0%.

Exports to the European Union will benefit from relaxed rules of origin (introduced 1 January 2011) under the Generalized System of Preferences. Bangladesh readymade garments are also diversifying their export destinations to countries such as Japan, the Republic of Korea, South Africa, and Turkey.

In tandem with the rise in exports—a large part of which was based on imported raw materials—import payments rose by 40.7% in the first 7 months of FY2011. Imports of food items, industrial raw materials, and capital machinery grew rapidly. Growth in overall imports is set to moderate over the rest of the fiscal year as imports of raw materials for the readymade garment industries slow. The import bill for fuel will rise, however, reflecting volume and price increases. Imports are forecast to grow by 23.0% in FY2011 and 24.0% in FY2012.

The external current account is seen showing a smaller surplus of 0.2% of GDP in FY2011, and then turning into a deficit of 0.3% of GDP in FY2012 (Figure 3.15.11), reflecting slow remittance growth and a widening trade gap.

3.15.9 Inflation



Sources: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; ADB estimates.

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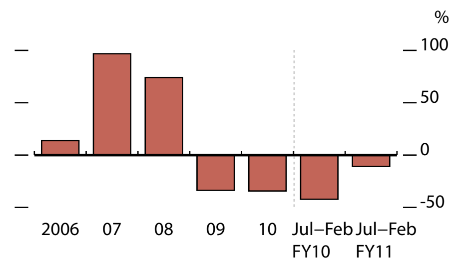
3.15.10 Growth in out-of-country employment



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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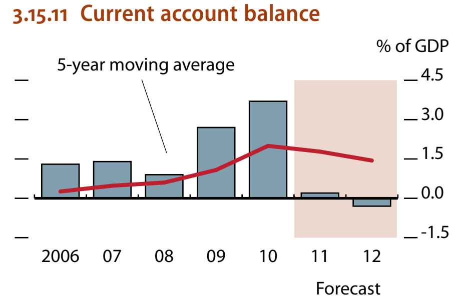
3.15.11 Current account balance



Sources: Bangladesh Bank. 2011. *Annual Report 2009–2010*. http://www.bangladesh-bank.org; ADB estimates.

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A 3-year program arrangement is expected to be finalized with the International Monetary Fund under its Extended Credit Facility, which will help Bangladesh tackle its growing balance-of-payments needs. The program is expected to catalyze financing and support policy adjustments and reforms conducive to boosting growth, while strengthening the external position (Box 3.15.1).

3.15.1 The Extended Credit Facility

Under a proposed program for a SDR640 million (about $1 billion) loan from the Extended Credit Facility of the International Monetary Fund, the government plans to undertake major reforms to put Bangladesh on a higher growth trajectory.

For raising tax revenue by around 3 percentage points as a share of GDP, it is expected to deepen tax administration reforms, including enacting value-added and income-tax laws. It aims to improve public financial management and operationalize the public–private partnership program for boosting public and private investment.

Reforms under the program are expected to improve monetary and foreign exchange operations, strengthen the finance sector and its oversight (focusing on financial conditions of state-owned commercial banks and the compliance by all banks with new capital-adequacy requirements), and promote the country's integration into the regional and global economy through a more open trade and investment regime.

For containing inflation pressure, the central bank is seen tightening monetary policy, aided by greater interest- and exchange-rate flexibility. It is also likely to work closely with the Securities and Exchange Commission to ensure appropriate actions by commercial banks and their subsidiaries to limit risks from stock market volatility.

The operating losses of the larger power and energy utilities are expected to be brought on the government budget.

Tax collection grew robustly by 28.4% during the first 7 months of FY2011 over the year-earlier period—direct taxes and domestic indirect taxes contributed most to the rise in revenue, although import-based indirect taxes also improved well. The expansion in domestic economic activity and better tax compliance, aided by reforms, are the main factors.

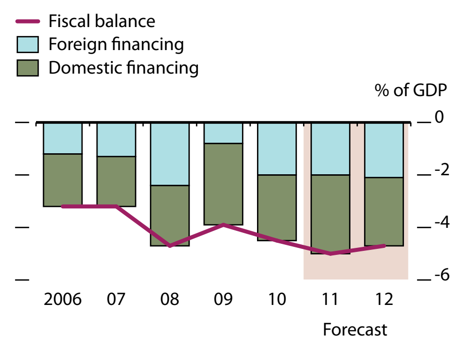
The annual development program's utilization rate in the first 8 months of FY2011 did not improve relative to the previous year, and its annual allocation is unlikely to be fully spent, despite recent government measures such as forming a task force to beef up implementation and progress monitoring.

Nor have any of the sizable resources earmarked for the Bangladesh Infrastructure Finance Fund, set up in the FY2011 budget to finance projects under the public–private partnership mechanism, been drawn on. Although budgetary allocations for food, fuel, fertilizer, and other agricultural inputs will be larger than in FY2010, the chronic underspending of investment allocations is expected to keep the fiscal deficit within its budgeted level of 5.0% of GDP (Figure 3.15.12).

The 11.0% increase in bulk power tariffs in February 2011 will help to cut Bangladesh Power Development Board's losses. The 5.0% hike in retail tariffs will improve the financial performance of power distribution companies.

The Bangladesh Petroleum Corporation (BPC) is nursing sizable losses as the government made no adjustment in domestic administered prices for fuels, even though global oil prices climbed sharply. BPC's losses will rise further as its imports are expected to soar to meet the needs of new power plants using diesel and fuel oil. BPC has arranged additional financing (of about $1.4 billion) from the Islamic Development Bank and

3.15.12 Fiscal balance



Source: Asian Development Outlook database.
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has requested assistance of $500 million from the central bank. It is also looking into additional financing from foreign commercial banks.

For the meantime, the government in the FY2011 budget made initial allocations of Tk25 billion (about $357 million) and Tk15 billion (about $214 million), as loans, to BPC and the Bangladesh Power Development Board.

Several downside risks could derail the projections. A slackening of the global recovery would likely slow export growth and heavily curtail remittances. Higher than projected domestic inflation could affect macroeconomic stability and discourage investment. Finally, inability to bring the planned short-term addition to power supply, such as the commissioning of small, private diesel and fuel-oil generators, and slippage in addressing gas shortages would also slow growth, mainly through their impact on industry.

Development challenges

Two critical challenges to exploit Bangladesh's growth potential are to upgrade infrastructure and to ensure a large, skilled workforce.

A major step in upgrading infrastructure was taken recently: three independent power producer contracts were awarded for generation. Once completed, they will add over 1 gigawatt to the grid, helping to relieve a bottleneck for industrial and employment expansion. Efforts are still needed to take advantage of the public–private partnership mechanism to create projects in infrastructure and to make the Bangladesh Infrastructure Finance Fund operational.

Bangladesh could reap a rich demographic dividend by transforming its large young population into a productive human resource through better education and health care. A balanced combination of public and private sector initiatives in delivering these services is needed.

Another issue is ensuring the availability of land for public and private sector projects. The rapidly declining land available per capita, exacerbated by poorly maintained land records, is making it increasingly difficult to buy land for infrastructure or industrial and commercial use.

A linked emerging challenge is urban congestion, in Dhaka and Chittagong especially, but also in other urban areas. Rapid urbanization is stretching too thin cities' capacity to provide urban services. For easing traffic gridlock in cities, one option is to develop mass rapid transit systems and satellite townships near the major urban areas. Rural and semi-urban areas need to be made more livable with expanded opportunities for better livelihoods.

Bhutan

The economy, which has vast hydropower potential, is driven by the cycle of hydropower building and output. Two hydropower stations are being built and two other projects started preconstruction work in May 2010, ensuring strong growth for the medium term. The main challenges for the government are to try and diversify the economy and create job opportunities.

Economic performance

Growth is estimated to have accelerated to 7.0% in FY2010 (ended 30 June 2010) from 5.7% in FY2009 (Figure 3.16.1). Construction revived with work on the Punatsangchhu I (1,200 megawatts [MW]) and Dagachhu (114 MW) hydropower stations. Services, accounting for nearly two-fifths of GDP, contributed the bulk of the GDP gain, mainly construction related. Agriculture's growth was solid. Despite generating only about 16% of GDP, it engages over 65% of the labor force.

The electricity and water sector—nearly a quarter of GDP—did not contribute to the expansion, as no additional generation capacity has been added since Tala hydropower station came online in FY2007. Tourism was also a drag on growth due to the global downturn: visitor arrivals dropped by 9.3% and foreign exchange earnings by 12.4%.

As Bhutan is linked with India through trade (93.5% of exports and 77.7% of imports) and a currency peg, rising consumer prices in India tend to spill over. Year-on-year inflation rose to 6.1% in the fourth quarter of FY2010 from 3.0% a year earlier (Figure 3.16.2).

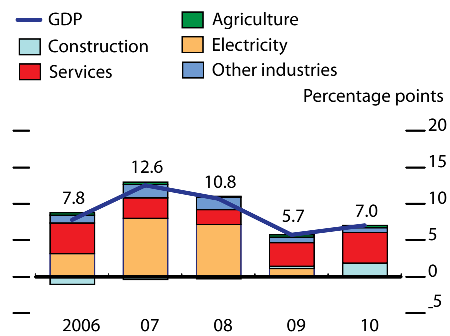
With a pickup in economic activity, growth in broad money accelerated to 30.1% from 24.6%, as domestic assets expanded. Domestic credit, primarily to the private sector, grew by 38.6% in FY2010 from 31.1% in the previous year, reflecting surging personal loans and credit to manufacturing. The sectorwide distribution of credit remained mostly to housing (about one-quarter of the loan portfolio), followed by manufacturing, personal loans, and services (including tourism).

Credit quality improved as nonperforming loans as a share of the total narrowed to 10.1% in June 2010 from 18.3% the previous year, reflecting a fall in such loans in manufacturing, where several export-oriented firms saw an upswing in sales. Banks are well capitalized with a capital-adequacy ratio of 17.1% at end-FY2010.

The budget deficit in FY2010 is estimated at around 6% of GDP, reflecting revisions that sharply raised capital expenditure despite a fall in nontax revenue (Figure 3.16.3). These adjustments stemmed from additional construction spending, including a monastery and other public buildings.

Nontax revenue declined because of a 1-year gap in dividend receipts. (Druk Holding and Investments was set up to own all major state-owned

3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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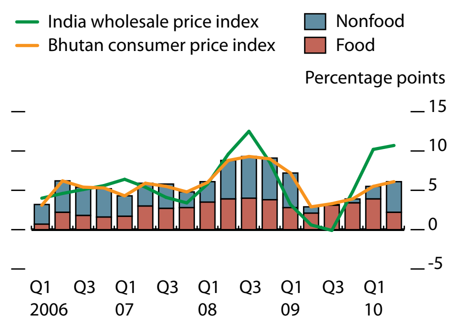
3.16.2 Contributions to inflation



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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3.16.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.5	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-20.0	-20.0

Source: ADB estimates.

This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

enterprises, including Tala Hydroelectric Project Authority, such that dividends were not immediately passed through to the budget.) The final figure of the fiscal deficit in FY2010, may, however, be substantially lower due to underimplementation of capital investment projects. The fiscal deficit in FY2011 is estimated at 4.4% of GDP. A civil service wage hike effective January 2011 will increase current spending in FY2011 and FY2012.

The government has announced tax incentives to stimulate private investment. Foreign direct investment (FDI) projects in FY2010 with an estimated investment of Nu1.1 billion (equivalent to $23.6 million) included an IT park and an agro-industry project.

The trade deficit is estimated to have worsened to 21.5% of GDP in FY2010 from 7.5%, as growth in merchandise imports accelerated markedly (Figure 3.16.4). Imports climbed by 39.0%, mainly because of heavy needs for machinery, transport vehicles, and base metals for the hydropower projects and housing.

Exports rose by only 5.5% as sales of hydropower to India (about two-fifths of total exports) were pretty flat as capacity production has been reached. A jump in budgetary grants, mainly from India, held the current account deficit to 13.5% of GDP in FY2010 from 1.6% the previous year.

The capital and financial account surplus—about half in capital grants and half in borrowing and FDI—nearly offset the current account deficit. The overall balance of payments was in surplus by $94 million, giving an unusually large positive errors and omissions item. Gross international reserves rose to the equivalent of $868.1 million at end-FY2010, equivalent to about 12 months of merchandise imports.

Economic prospects

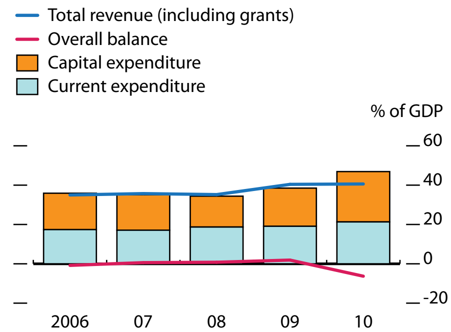
In addition to the construction of two hydropower stations, preconstruction works for Punatsangchhu II (990 MW) and Mangdechhu (720 MW) projects started in May 2010. Hydropower construction will therefore fuel GDP growth for the next 5 years, even as additional power production capacity and exports come online. Indeed, the government plans by 2020 to see new power stations increase generation capacity to 10,000 MW, about seven times the present level. Accordingly, GDP is estimated to grow by 7.5% in FY2011 and 8.0% in FY2012.

High inflation in India, especially of food, is a concern. Projected higher global commodity price hikes will indirectly affect Bhutan, where inflation is expected to reach 8.0% in FY2011 and moderate to 7.5% in FY2012.

The current account deficit will deteriorate, mainly owing to imports of construction materials for power stations, as well as higher import prices of fuel. Export growth will likely be limited in the next couple of years. Expansion will need to come mainly from manufactured and commodity exports, as no additional power generation capacity will come online.

Although tourism revenue will grow, soaring imports are expected to push the current deficit out to around 20% of GDP in both years. As with past projects, capital inflows from India to finance power plant construction, combined with development assistance, FDI, and some other borrowing, will likely suffice to finance the current account deficit.

3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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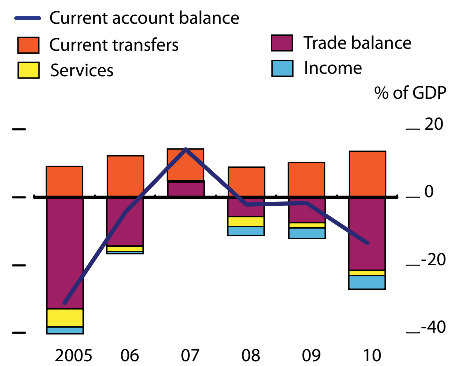
3.16.4 Current account indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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3.16.1 Development challenges

The slowdown in economic growth in FY2009, when neither new construction or new production in the power sector were strong, indicates that growth is not being led by productivity improvements or new business ventures. The government's decision to undertake the Thimphu Technology Park and Education City projects are attempts to foster economic diversification by moving toward a knowledge-driven economy.

Generating jobs is hard, as hydropower has small backward linkages and is capital intensive. Speeding up private sector development is therefore crucial to expand job opportunities and diversify the economy.

The government has announced Fiscal Incentives 2010—a broad array of general and sector-specific tax incentives—as well as Foreign Direct Investment Policy 2010, to promote private sector investment.

India

The Indian economy experienced high and broad-based growth over the past fiscal year. Inflation has been the main challenge for policy makers, with the observed pattern of price increases highlighting the need to tackle decisively weaknesses along the domestic agricultural supply chain. Weaker global trade growth and a necessary further tightening of fiscal and monetary policies will slow economic growth marginally in the new fiscal year. However, progress on fiscal consolidation and success in easing supply-side constraints will pay off the following year.

Economic performance

The economy grew by 8.6% in FY2010 (ending March 2011) according to the government's advance estimates. Growth has been broad-based and driven by a solid recovery in agriculture and continued good performance of industry and services (Figure 3.17.1).

Helped by a good monsoon that boosted the *kharif* (summer) crop, agriculture is estimated to grow by 5.4% in FY2010, after 0.4% in FY2009, when a deep and widespread drought (and subsequent flooding) held back farming. Foodgrain production, estimated at 232 million tonnes in FY2010, is 6.4% higher than FY2009's output (though still lower than the record 234 million tonnes in FY2008).

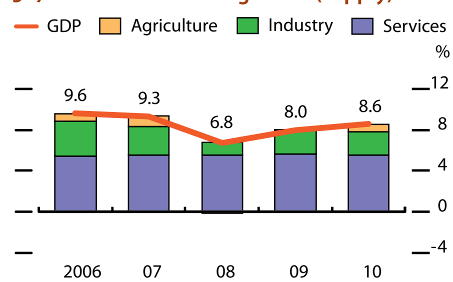
While industry is estimated to record healthy growth of 8.1% in FY2010, the second half saw a moderation of growth. In particular, after growth of 10.1% in the first half, industrial output growth slowed to single-digits in the second.

The main contributors to strong growth in the first half of FY2010 were consumer durables and capital goods. Important infrastructure sectors, such as crude oil, petroleum refining, electricity, and steel, also performed well. Apart from the base effect, the deceleration in the second half has been driven by a slowdown in capital goods production owing to a slowdown in investment. While it is difficult to pin down the exact cause of the investment slowdown, delays in obtaining environmental clearances, difficulties with land acquisition, and the lack of progress on some expected policy reforms may have played a role.

Services are estimated to grow by 9.6% in FY2010, a little lower than the 10.1% growth registered in FY2009. Key drivers included the trade; hotels; transport and communications; and finance, insurance, real estate, and business subsectors. Given the dominance of services, their healthy performance is crucial for high overall growth. This sector accounted for 64% of overall GDP growth in FY2010, down from 71% in FY2009.

The drivers of growth from the expenditure side have also been broad-based (Figure 3.17.2), with healthy contributions from private

3.17.1 Contributions to growth (supply)



Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011).

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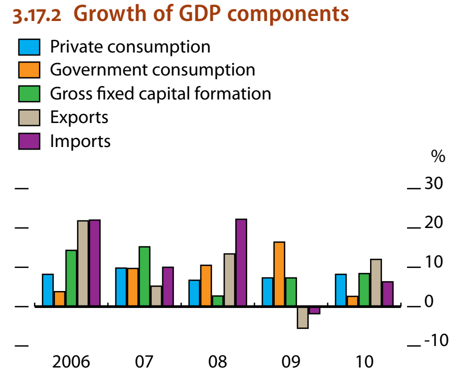
3.17.2 Growth of GDP components



Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011); ADB estimates.

Click here for figure data

This chapter was written by Rana Hasan of the India Resident Mission, ADB, New Delhi.

consumption, investment, and exports. While total consumption growth slowed from 8.7% in FY2009 to 7.3% in FY2010, this stemmed from a concurrent sharp decline in growth of government consumption from 16.4% to 2.6%; growth in private consumption—which accounts for more than four-fifths of total consumption—rose from 7.3% to 8.2%.

Similarly, although growth in gross capital formation slowed from 13.8% to 8.8% over the same period, fixed capital formation edged up from 7.3% to 8.4%. Nevertheless, the full figure for FY2010 masks a slowdown in the second half when fixed capital formation growth dropped from double digits in the first half to 6% in the third quarter. In contrast, exports picked up significantly in the second half, leading net exports to contribute positively to growth for the first time in many years.

With the onset of global recovery, investment registered a marked increase from 34.5% of GDP in FY2008 to 36.5% in FY2009, driven by a rise in corporate sector investment of 1.7 percentage points of GDP. The investment rate is estimated by the Economic Advisory Council of the Prime Minister to have increased to 37%. The saving rate recovered somewhat in FY2009 to 33.7% of GDP and appears to have risen marginally to 34% in FY 2010. Both saving and investment remain, however, below their precrisis highs (Figure 3.17.3).

Inflation has been a major concern in FY2010. While monthly year-on-year rates moderated from the double-digits reached in mid-2010, they are estimated to have been 9.2% for the fiscal year. Food inflation has been an important driver, accounting for between a quarter and a third of monthly wholesale price inflation in FY2010.

Much of the initial surge in food inflation in FY2010 (Figure 3.17.4) came from the weak FY2009 monsoon's impact on output and prices of cereals, pulses, and sugar. It has later been driven by subcontinent-specific weather shocks and demand–supply mismatches, as rising incomes and shifting dietary patterns increased demand for vegetables, fruits, and high-protein items. These factors have highlighted the need for dramatically improving production and distribution systems in agriculture.

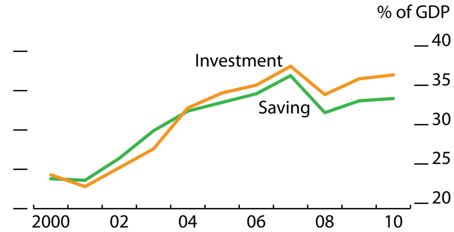
Finally, as the product-based breakdown of the figure shows, price increases in manufactured products have been important and have contributed to worries that inflation expectations are becoming entrenched.

Tackling the problem of high inflation has turned out to be complex. In response to rising inflation and a recovering economy, the Reserve Bank of India (RBI) reversed its accommodative policy stance in March 2010. The RBI has raised the repo rate (the rate at which banks borrow from it) eight times by 200 basis points in FY2010, which now stands at 6.75%; it has also raised the reverse repo rate (the rate at which it borrows money from banks) over the same period, and that now stands at 5.75% (Figure 3.17.5). The central bank also raised the cash-reserve ratio from 5.5% to 6.0% in April 2010.

The RBI recognizes that monetary policy may not be the most effective instrument to deal with supply-side pressures on inflation. But its concern is that the repeated supply shocks that have affected the economy, along with recent petroleum price increases, have generated expectations of high inflation and may contribute to future inflation. The increase in key policy rates has been partly carried out to contain such expectations.

Liquidity tightened considerably owing to an increase in credit growth

3.17.3 Saving and investment ratio



Source: Asian Development Outlook database.

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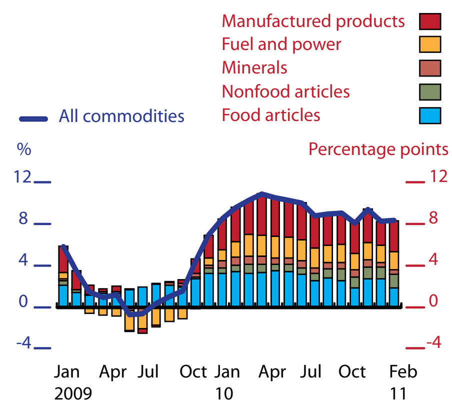
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 March 2011).

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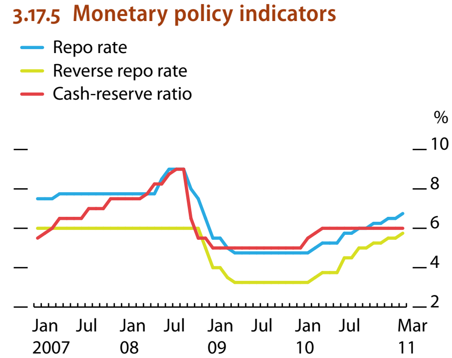
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 18 March 2011).

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and a fall in the deposit growth rate. The latter was driven by depressed real interest rates, withdrawal of deposits by telecoms companies to pay third-generation license fees, and purchases related to initial public offerings. To bolster deposits, banks have begun revising deposit rates upward by 50–75 basis points.

Merchandise exports are expected to climb from $175 billion in FY2009 to $230.3 billion in FY2010, but rising oil prices and resurgent domestic demand have taken imports from $295.5 billion to $362.3 billion (Figure 3.17.6), pushing out the trade deficit from $120.5 billion to $132 billion in FY2010. The first half of FY2010 also recorded sluggish performance of invisibles, largely due to the nonsoftware component of services.

As a result of these trends, the current account deficit is estimated to increase from $38.4 billion in FY2009 to $50.3 billion in FY2010. But a stronger currency and high nominal GDP growth in FY2010 means that, as a share of GDP, the current account deficit is estimated to be around 3.0%, a little higher than FY2009's 2.8%.

The capital account surplus is estimated to have improved from $47.8 billion in FY2009 to $64.6 billion in FY2010. Much of this gain is based on higher portfolio and debt flows, with the former increasing from $32.3 billion during FY009 to $38.8 billion in FY2010. These flows tend to be volatile, however, as seen by a net outflow of portfolio investment of $19.8 billion in November 2010 (Figure 3.17.7).

The upsurge in portfolio inflows was largely due to a global risk rally, leading to higher capital flows to emerging markets and interest shown in some public offerings. These flows helped the stock market to put on 30% in May–October 2010, though it has since declined by about 12.7% (Figure 3.17.8). In contrast, foreign direct investment (FDI) inflows slowed notably, from $35.6 billion in FY2009 to $27.6 billion in FY2010. The deceleration can only partly be explained by a still weak global recovery. Difficulties in land acquisition and environmental issues and slow progress of liberalization of certain sectors such as retail and insurance are likely also to have played a role.

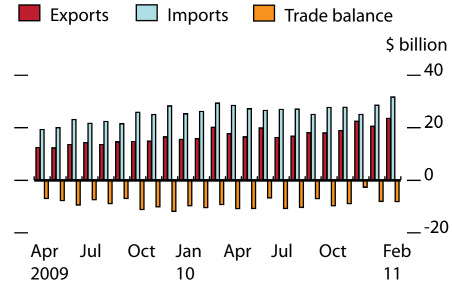
The excess of capital flows over the current account deficit resulted in accretion to foreign exchange reserves, which rose by $17.8 billion to exceed $300 billion in March 2011 (Figure 3.17.9). A part of this rise was due to valuation change as some of the major currencies appreciated against the US dollar during the year.

The rupee has remained quite stable in FY2010. It rose marginally against the US dollar. Inflation higher than in trading partners has led to a modest rise in the real effective exchange rate (Figure 3.17.10).

Better than expected revenue from the sale of third-generation spectrum for high-speed telephony and broadband services, as well as robust GDP growth, helped to reduce the central government's fiscal deficit from 6.4% of GDP in FY2009 to 5.1% in FY2010, thereby restricting the combined deficit of the center and states to around 8.1% (Figure 3.17.11). The ratio of central government gross tax revenue (including states' share) to GDP increased to 10% in FY2010, improving from 9.5% in FY2009, but it remains much lower than the 11.9% achieved in FY2007.

Despite India's strong resilience to the crisis and its ability to post robust growth rates, it has made little progress in some reforms. Moves to increase

3.17.6 Merchandise trade



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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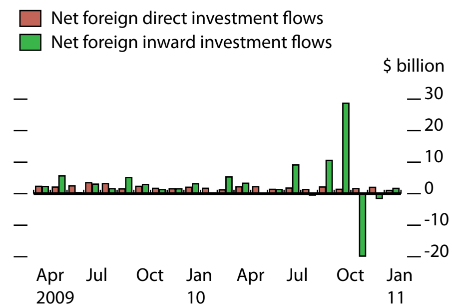
3.17.7 Investment



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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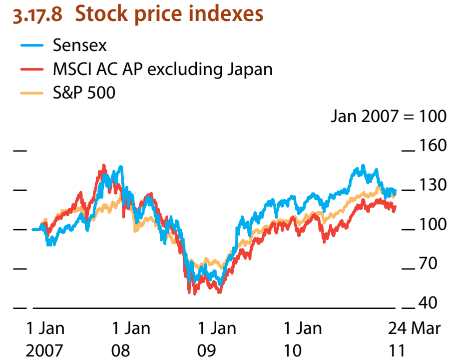
3.17.8 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 24 March 2011).

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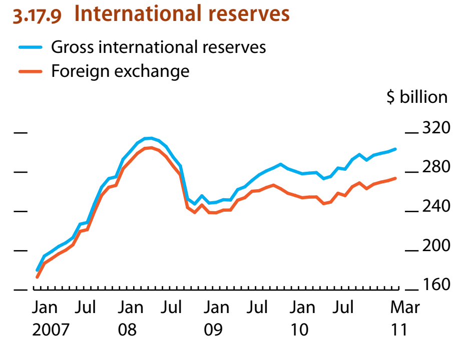
3.17.9 International reserves



Note: Gross international reserves includes gold and SDRs.

Sources: CEIC Data Company; Reserve Bank of India. http://www.rbi.org.in (both accessed 26 March 2011).

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the limit of foreign investment in sectors such as retail and insurance stalled in FY2010. Also, some major industrial projects faced difficulties in getting the required clearances from the environment ministry.

Finally and critically, the move toward a unified goods and services tax (GST), which is an important step for fiscal consolidation, slowed, with the center and states gridlocked in negotiations. The states have been concerned about losing their fiscal autonomy, which would follow from a loss of power to change tax rates. They also have anxieties that a GST would raise their dependence on central government transfers. The center and states are also discussing GST rates, as some states view the proposed revenue-neutral rates as too low. Moreover, they disagree over the taxes to be subsumed under the GST system.

Recent months have, however, seen positive steps on some of these issues. A renewed effort is under way to allow greater FDI in retail and insurance in a phased manner. The environment ministry has allowed through (with conditions) some of the projects initially denied environmental clearance but has asked promoters for some of the others to apply afresh.

On the fiscal front, there is an attempt to move toward direct cash transfers for subsidized fertilizer, liquefied petroleum gas, and kerosene, which are expected to contain the waste and misdirection of these commodities. Last, the government on 21 March introduced to Parliament a constitution amendment bill to facilitate implementation of the GST.

Economic prospects

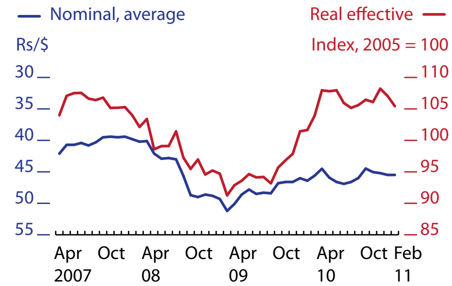
The following forecasts for FY2011 and FY2012 make several assumptions, in addition to those given in the baseline table 1.1.1 in part 1: the monsoons in both 2011 and 2012 will be normal; monetary tightening will continue in FY2011; and the government will broadly adhere to the rigorous fiscal consolidation road map suggested by the 13th Finance Commission.

While domestic pressures on inflation are expected to ease on account of normal monsoons and payoffs from the government's efforts at improving the agricultural supply chain, elevated international oil prices will exert upward pressure on prices. On balance, average inflation for FY2011 and FY2012 is expected to decline to 7.8% and 6.5%, respectively (Figure 3.17.12) on account of a high-base effect and further tightening of monetary policy by the RBI to anchor expectations.

Along with higher input prices due to rising oil prices, monetary tightening will tend to further damp private investment, which was slowing toward the end of FY2010. The government's efforts at fiscal consolidation will, however, help to provide some relief. Especially if consolidation proceeds largely as spelled out in the government's budget for FY2011—spending on subsidies is kept in check and planned infrastructure investment is not compromised—private investment may experience some "crowding in," even as the government reins in its overall spending.

Of course, elevated oil prices suggest that the government may not be able to hit its target for reducing subsidies by 12.5% in FY2011. Even with the move in 2010 to deregulate gasoline (petrol) prices, other fuel prices and natural gas remain under administrative control and the government

3.17.10 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org; (both accessed 26 March 2011).

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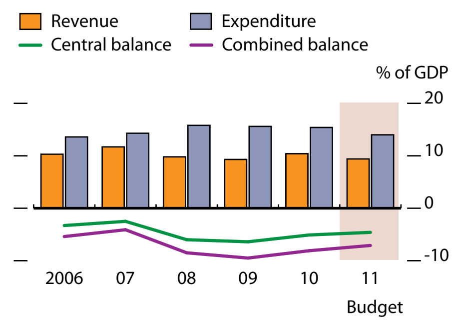
3.17.11 Fiscal indicators



Note: FY2010 is a revised, estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 21 March 2011).

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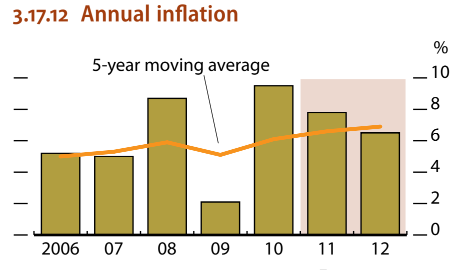
3.17.12 Annual inflation



Source: Asian Development Outlook database.

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is unlikely to raise their prices one-on-one with market conditions. Nevertheless, some reduction in subsidies should be possible and the government's intended move toward direct cash transfers of fuel-related subsidies could have far-reaching consequences in the medium term.

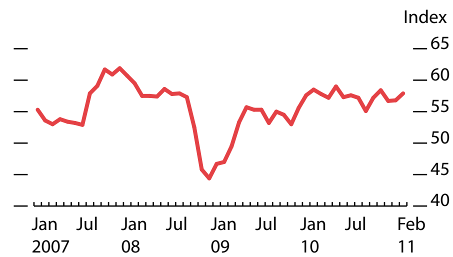
Based on the assumption of normal rainfall and with higher base, agriculture is expected to expand by 3%–4% in FY2011 and FY2012. In addition, proposed increases in public investment in the sector should provide it with a boost. But industry and services will remain the key drivers of growth.

At the same time, some large greenfield manufacturing projects have faced hurdles in terms of acquiring land and obtaining environmental clearance. Although these cases involve complex trade-offs between development, traditional livelihoods, and the environment, policy and regulatory clarity on these issues is crucial.

Yet the government's intention of streamlining the regulatory burden on Indian firms, and the expectation that current restrictions on FDI in multi-brand retail will be relaxed, augur well for both industry and services, especially by FY2012.

Sustaining growth also depends on external demand, which is assumed to moderate marginally following a rise in global economic risks. A survey by the HSBC Markit Purchasing Managers' Index for both manufacturing and services released in March 2011 shows some improvement, largely due to increase in orders and expansion in new business activity (Figure 3.17.13).

3.17.13 HSBC India manufacturing purchasing managers index



Source: Bloomberg (accessed 21 March 2011).

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But there are strong downside risks, notably inflation pressure from rising oil prices. In view of the *Asian Development Outlook 2011*'s assumptions for oil prices, as well as monetary and fiscal tightening, GDP growth is expected be a little lower in FY2011 than in FY2010 at 8.2%. It should rise to 8.8% in FY2012 as reform efforts and regulatory clarity boost investment and economic activity more generally.

The current account deficit is very likely to widen over the next 2 years—fairly sharply to 3.5% of GDP in FY2011—driven by a deteriorating trade deficit and moderate growth in invisibles. While foreign capital inflows have covered this deficit relatively comfortably in recent years, trends in FY2010 flag a cause for concern.

3.17.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.2	8.8
Inflation	7.8	6.5
Current account balance (share of GDP)	-3.5	-3.3

Source: ADB estimates.

As is well known, international flows of portfolio capital can exhibit considerable volatility and thus the slowdown in inflows of FDI to India—in contrast to the pickup observed in other emerging economies—is troubling. The recent budget has relaxed norms for foreign institutional investors in order to attract more foreign capital, especially in infrastructure. But these also need to be backed by an improvement in the regulatory environment in which firms—domestic and foreign—operate.

Development challenges

Sustaining high growth and ensuring that it is inclusive remains India's foremost development challenge. Even with the tremendous dynamism exhibited by services—a sector that has contributed almost two-thirds of GDP growth in recent years and now accounts for 55% of GDP and 25% of total employment—it is difficult to see how India will be able to sustain

inclusive growth without boosting agricultural productivity and further strengthening manufacturing. The latter is crucial for employing a young and growing workforce—including those released from farm work—with productive and well-paying jobs.

Agriculture has suffered a secular decline in public investment since the mid-1990s, as well as a steady increase in input subsidies such as those for power and fertilizer. The country is behind comparable countries in investing in new technology, research and development, and infrastructure. For example, it invests only 0.5 % of its agricultural GDP in agricultural research, compared with 0.7 % in developing countries as a whole and as much as 2–3 % in developed countries.

A silver lining to the high food inflation over the past year is the urgency it has generated among policy makers to engineer a second green revolution in India (Box 3.17.1).

The task of transforming manufacturing also deserves the attention of policy makers. A defining feature of India's manufacturing is the overwhelming importance of small firms and the informal sector in jobs (also known as the unorganized sector). Thus 84% of India's manufacturing employment is estimated to be in firms with fewer than 50 workers (Figure 3.17.14), whereas the corresponding shares are 25%–47% for economies such as the PRC; the Republic of Korea; Malaysia; Taipei,China; and Thailand. At small scales of operation, firms can often get caught in a vicious circle of reliance on traditional, low-productivity technologies with limited earnings and few growth prospects.

At the same time, larger enterprises—those operating in the formal (or organized) sector where both productivity and wages tend to be relatively high—have often been stymied by infrastructure and regulatory bottlenecks from expanding. As a result, although employment in the subsector grew robustly in 2004–2008, it still stood at only some 11 million (around 2.5% of the labor force).

From a policy perspective, there are two broad challenges for transforming manufacturing. For the formal subsector, much policy reform has already taken place—such as industrial delicensing in the 1990s and large-scale cutbacks in small-scale sector reservations in the early to mid-2000s.

What remains to be tackled are infrastructure bottlenecks, features of India's labor regulation that impinge on the adjustment of labor use within and across plants and sectors, and difficulties in the acquisition of land and environmental clearances for industrial activity. The government's recent announcement on a manufacturing policy that will tackle various regulatory issues is an opportunity to make headway on difficult institutional and politically sensitive issues.

For the informal subsector, and small and medium-sized enterprises in the formal sector, imperfections in credit markets and lack of awareness and access to markets and technologies add to the infrastructure-related difficulties that these firms face. While the government has in place a variety of interventions for assisting such firms in these areas, the key challenge lies in effectively delivering program services to target enterprises. To make sure that public financing is not wasted, clear benchmarks for success and failure must be adopted, and rigorous monitoring and evaluation systems must be built into the government's programs.

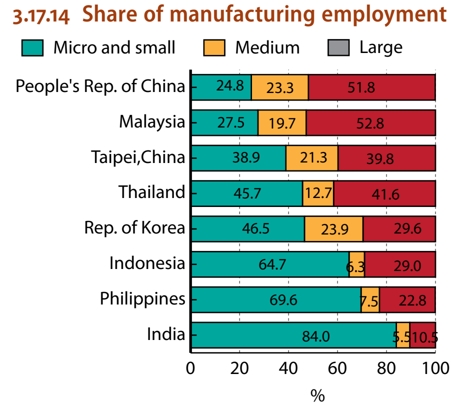
3.17.1 Transforming agriculture

The government has announced higher funding for a slew of programs aimed at dealing with production and distribution bottlenecks for fruits, vegetables, milk, meat, poultry, and fish—items that have been particularly susceptible to large price increases.

Efforts for developing "mega food parks" (for reducing wastage of fruit and vegetables for lack of storage facilities) and augmenting storage capacity and cold chains through public–private approaches are also being promoted. The government will recognize cold chains and postharvest storage facilities as an infrastructure subsector in its own right, making it eligible for any special benefits that apply.

Careful monitoring and evaluation of these efforts is needed to ensure that they have the intended effects. At the same time, state governments must review the operation of the Agricultural Produce Market Committee Act. Revamping this act would allow, for example, agro-processors, private markets, corporations, and exporters to directly deal with farmers and ease restrictions that apply to contract farming and the movement of agricultural produce from one location to another.

3.17.14 Share of manufacturing employment



Notes: Micro and small: 1–49 in all countries except Thailand (1–50 workers); Medium: 50–199 in all countries except Thailand (51–200 workers); Large: 200 or more workers in all countries except Thailand (more than 200 workers)

Source: Rana Hasan and Karl Robert Jandoc. 2010. The distribution of firm size in India: What can survey data tell us? *ADB Economics Working Paper Series* No. 213. Asian Development Bank, Manila.

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Maldives

The Maldives is attempting to push through major fiscal reform, but government efforts to implement deficit-reduction measures have been impeded by political sensitivities. The passage of new tax bills in 2010, although it took longer than scheduled, will generate revenue gains in the near term. Nevertheless, the government will need to formulate a strong medium-term adjustment strategy in order to get its economic program supported by international financial institutions.

Economic performance

The government struggled to implement fiscal reforms in 2010. Since the president's party is in the minority in the *Majlis*, it faced difficulties in pushing reforms through Parliament. The agenda included a Tourist General Service Tax (T-GST) and Business Profit Tax (BPT). As the political situation worsened from midyear—the cabinet resigned en masse—progress in fiscal reforms has slowed, especially in the area of expenditure reduction.

The T-GST was, however, passed in August, becoming effective in January this year; the BPT was passed in December and takes effect in July this year. The fiscal gap would have been larger had it not been for a temporary cut in civil servants' wages. An improvement in revenue on the back of a rebound in tourist arrivals also helped to narrow the budget deficit for the year.

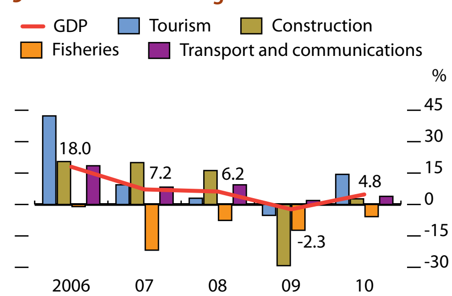
Against this backdrop, GDP growth recovered to 4.8% in 2010 after contracting by 2.3% in 2009 (Figure 3.18.1). A key driver was a better than expected upswing in tourism, which accounts for almost a third of GDP. Tourist arrivals registered a rebound of 20.7% in 2010. An influx of visitors from the People's Republic of China, the Republic of Korea, India, and other Asian countries outpaced a slower renaissance in European arrivals, a market usually accounting for around two-thirds of total visitors (Figure 3.18.2). As tourism gathered momentum, its linked sectors—transport and communications, and wholesale and retail—saw growth of 3.9% and 4.8%.

Fisheries have been performing poorly since 2006, reflecting a decline in the fish catch, and, contracting by 5.8%, were a drag on growth. Despite constituting only 3.2% of GDP, the industry is a major source of employment in many of the outer atolls.

Due to the country's import-dependent nature, rising international prices for fuel and food exerted upward pressure on domestic prices in the second half of 2010 (Figure 3.18.3). Inflation was 5.1% in December 2010, 1.1 percentage points higher than a year earlier.

While credit to the private sector continued to fall (by 2.4% year on

3.18.1 Selected GDP growth indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv
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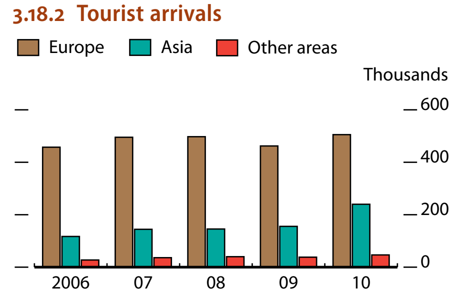
3.18.2 Tourist arrivals



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv
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This chapter was written by Eleanor Bacani and Tadateru Hayashi of the South Asia Department, ADB, Manila.

year in December 2010), Treasury bills held by banks rose by 28.4% as part of a 32.9% expansion in net credit to the government. Broad money increased by 16.5%. The interest rate on T-bills declined in the first half of 2010, but partly came back during the second (Figure 3.18.4).

The fiscal deficit is estimated to have narrowed to 16.4% of GDP in 2010 from 30.9% in 2009 (Figure 3.18.5). Although total revenue (excluding grants) is expected to have picked up by 14.6%, reflecting a rebound in tourism-related earnings and profits received from the airport concession, it was 11% below the original projection after the T-GST and BPT did not materialize in time to boost 2010 revenue as planned. Expenditure dropped by 10.2% as the government put through temporary fiscal austerity measures, such as wage cuts for public servants.

The Rf12.37 billion ($962.6 million) budget for 2011, passed in December 2010, sets only a slight reduction in the deficit to 15.3% of the GDP. Upfront payments by resort islands for lease extensions, from 25 to 50 years, as well as new tax measures, will increase fiscal revenue. But there is so far no clear road map for long-term expenditure saving.

On the external front, the current account deficit is estimated to have slightly narrowed to 31.3% of GDP in 2010 from 31.8% in 2009, as the gain in tourism receipts was outweighed by higher imports (Figure 3.18.6). While reserves declined through most of the year they spiked in November, on a $74 million upfront payment by the airport concession. This transaction helped to push the overall balance of payments into surplus, lifting gross international reserves by about one-third to $349.9 million in 2010, yielding 3.3 months of import cover. The Maldives Monetary Authority continued its currency peg to US dollar at a rate of Rf12.8, though foreign exchange shortages and a parallel market premium persisted during the year.

Economic prospects

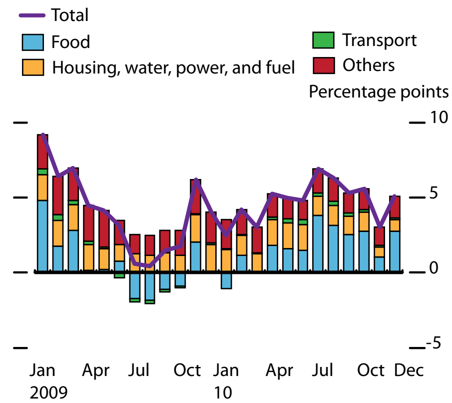
Tourism is likely to lead economic growth. Tourist arrivals from Europe should continue recovering, and the number of Asian tourists will continue growing, as their disposable incomes improve.

The 2011 budget plans about a 25% increase in total expenditure, and the medium-term fiscal framework projects the same level of expenditure in 2012, a marked turnaround from the near 12% decline a year earlier. At nearly three-fifths of GDP if fully carried out, these plans represent a marked expansion in domestic demand. On the basis that planned expenditure is scaled down and tourism makes further gains, GDP is expected to grow by 5.0% in each of the next 2 years.

On the assumption that the global oil and food prices rise substantially in 2011 and moderate in 2012, and budget expenditure pressures on domestic inflation. It is projected that inflation will rise to 8.0% or more in 2011, and moderate to 7.0% in 2012.

Steady economic growth, primarily due to the tourism rebound, and higher international commodity prices will buttress merchandise import growth. Assuming that the currency peg to the US dollar continues, growth in imports will continue to outpace tourism receipts, the current account deficit is expected to widen to 35% of GDP in 2011 and will remain at this level in 2012.

3.18.3 Contributions to inflation



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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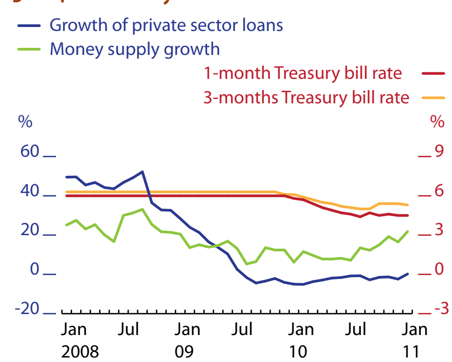
3.18.4 Monetary indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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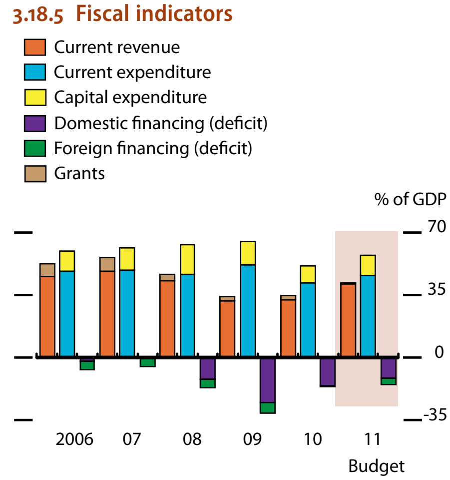
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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Development challenges

Persistent fiscal and external imbalances have rendered the country vulnerable to external shocks. International financial institutions have therefore been supporting the government's reform initiatives, including a stand-by arrangement with the IMF. The lack of a political consensus has prevented agreement on the next steps in the country's medium-term adjustment strategy, though these are expected to be resolved in due course.

Reducing income disparities between Malé and the atolls is important. Private sector development, especially promotion of micro-, small- and medium-sized enterprises outside Malé, is therefore critical. Such promotion is also an important mandate of the government through its decentralization policy.

Weak institutions and human resources are major constraints. Public sector institutions face capacity constraints, since pay in the civil service lags far behind the private sector, and second jobs among public employees are common. While heavy reliance on expatriate labor has allowed the Maldives to grow strongly for many years, the downside is that existing institutions do not have adequate capabilities.

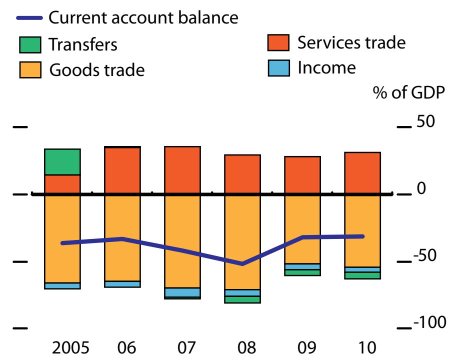
As one of the world's most vulnerable nations to sea-level rise, the government has announced plans to become the first carbon-neutral country in the world within a decade. It is preparing an investment plan along these lines, and hopes that it will not only serve as a blueprint for other nations but also draw world attention to climate change.

3.18.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.0
Inflation	8.0	7.0
Current account balance (share of GDP)	-35.0	-35.0

Source: ADB estimates.

3.18.6 Current account indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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Nepal

Political uncertainties, unfavorable weather, and weakening remittances from workers abroad restrained economic growth in FY2010. Fiscal prudence continued. Growth will fall below the 5-year average of 4.0% in FY2011, primarily reflecting the protracted postconflict transition process, but a modest pickup is foreseen in FY2012, supported by tourism and more vibrant construction activity. Key risks to growth are further delay to completing the transition, high food and oil prices, and potential impact of unrest in the Middle East.

Economic performance

GDP growth inched up to 4.0% in FY2010 (ended 15 July 2010) from 3.8% in FY2009 (Figure 3.19.1). The marginal improvement was made possible by a turnaround in growth in the relatively small industry sector (helped by fewer political strikes), and sustained expansion of services. A deceleration in remittance inflows due to the lagged impact of the global financial crisis weighed on economic activity, as did slowing agricultural output (for a second year) due to a sparse monsoon.

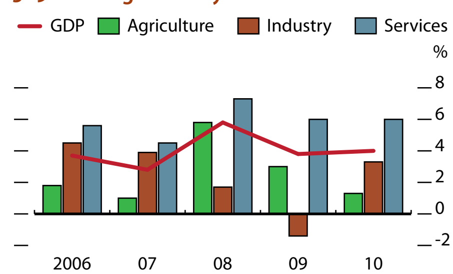
The deceleration in remittance growth, alongside commercial banks' excessive lending to real estate and reduced liquidity in banking, drove interbank borrowing rates to a record high. Inflation stayed close to double digits owing to high food prices in the first half of FY2010 (Figure 3.19.2), which in turn originated in a low domestic crop and India's high food-inflation.

Exports as a share of GDP have been dwindling in the last few years, because low productivity and infrastructure bottlenecks have undermined competitiveness. Conversely, imports as a share of GDP have been showing a trend increase over several years, with growth more pronounced in FY2010, as gold imports swelled. (Gold was the investment of choice, given paucity of attractive alternatives in a correcting real estate market.)

The widening trade deficit, coupled with slowing remittances, took the current account deficit to 2.7% of GDP in FY2010 from a surplus of 4.2% of GDP the year before. This led to a $113 million decline in official reserves. The authorities accessed $42 million from the International Monetary Fund through its Rapid Credit Facility, which provides concessional assistance to low-income countries to tide them over external shocks.

Previous years' fiscal stability was maintained, with the deficit narrowing from 3.3% of GDP in FY2009 to 2.0% of GDP, though this apparent improvement stems from delayed approval of the FY2010 budget and from a continued difficult environment for implementing projects, which kept capital spending to only 70% of target. Revenue collection

3.19.1 GDP growth by sector



Source: Central Bureau of Statistics.

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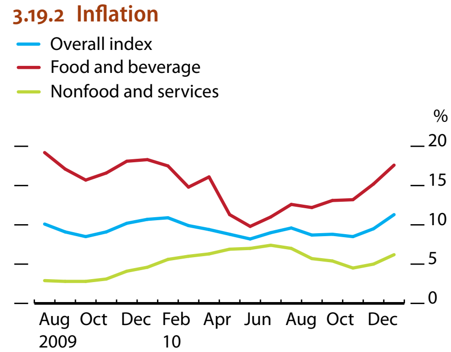
3.19.2 Inflation



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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This chapter was written by Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

preserved its recent positive momentum, helping to offset the continued surge in recurrent spending, notably on civil servants' and teachers' salaries. Small fiscal deficits and large grants by multilateral agencies have helped to improve the public debt position in recent years (Figure 3.19.3).

Despite a challenging political environment, the share of the population living below the national poverty line of about $160 a year is estimated to have declined to 25% in 2010 from 31% in 2004, largely owing to robust remittance inflows, rapid urban growth, a decline in fertility, and rising agricultural wages.

Strides have also been made in other Millennium Development Goals, such as child and maternal mortality, although greater efforts are needed to achieve similar progress in areas such as productive employment and child malnutrition. Efforts are also needed to reduce inequality—currently the highest in South Asia, with a Gini coefficient of 0.47.

Economic prospects

Economic performance in FY2011 and FY2012 will rest primarily on progress in the postconflict transition process—currently slow as seen in the 1-year extension, to May 2011, of the tenure of the Constituent Assembly that was elected to draft a new constitution. The political vacuum and drift created following the Government's resignation in June 2010 ended only in February this year. The FY2011 budget was promulgated only by ordinance 4 months into the fiscal year.

All these delays reflect the difficult transition that Nepal is suffering. With little time left for writing the constitution, many of the contentious issues, such as army integration and state restructuring, have yet to be resolved.

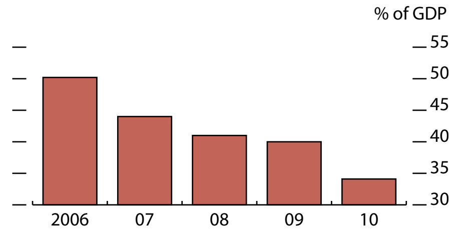
The protracted transition and the associated political disruptions have hit the economy. The delay in announcing the FY2011 budget, for example, has undermined solid progress made recently in revenue mobilization, which achieved 25% average annual growth in the last 4 years (Figure 3.19.4). More important, it has deprived the population of a much hoped-for peace dividend, including greater capital spending (Figure 3.19.5) and development benefits.

GDP growth is forecast to weaken slightly to 3.8% in FY2011. Agriculture is expected to grow by 4.0% in FY2011 (up from 1.3% in FY2010), largely due to a weather-induced recovery in the output of key summer crops (Figure 3.19.6). This improvement will not, however, be enough to offset the deceleration in nonfarm activities.

Political uncertainty, as well as power cuts (lasting as much as 14 hours a day since mid-February this year) will continue to take a toll on nonfarm activities. The tightening FY2011 monetary policy of Nepal Rastra Bank (NRB, the central bank), aimed at stabilizing the real estate market, will further curtail services expansion, to 4.5% growth in FY2011, down from 6.0% in FY2010. A slowdown in construction activity and higher fuel costs will limit industry's growth to 1.0% in FY2011, compared with 3.3% a year earlier.

GDP growth is expected to improve modestly to 4.0% in FY2012 (assuming continued normal weather conditions). A pickup in tourism-related activities driven by the Nepal Tourism Year 2011 campaign should

3.19.3 National debt



Sources: Ministry of Finance. Financial Comptroller General Office; ADB estimates.

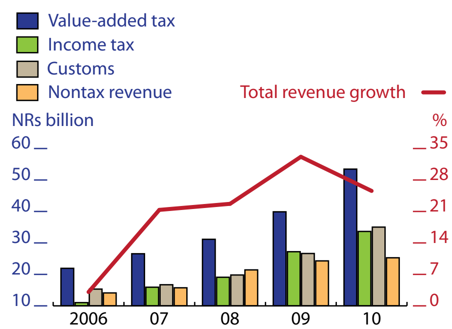
Click here for figure data

3.19.1 Selected economic indicators (%)

	2011	2012
GDP growth	3.8	4.0
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	-0.5

Source: ADB estimates.

3.19.4 Revenue indicators



Source: Ministry of Finance. 2010. *Economic Survey Fiscal Year 2009/10.* July. http://www.mof.gov.np

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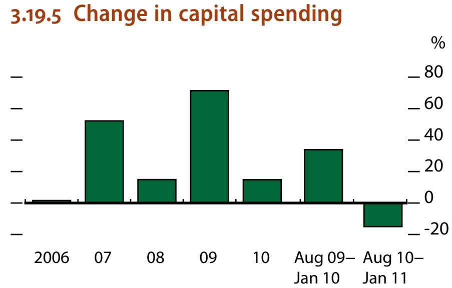
3.19.5 Change in capital spending



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation.* January. http://www.nrb.org.np

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raise services growth to 5.5%. A modest uptick in construction activity, as NRB's policy is absorbed, should lift industry's growth to 1.5%.

Year-on-year inflation reached 11.3% in January, largely reflecting food and fuel price increases. A revision of the consumer price index—lowering the weight for food in line with the Fourth Household Budget Survey, 2005/06—has pulled calculated inflation down by about 1 percentage point relative to the previous method.

Average inflation for FY2011 is expected to be 10.0%. High food and oil prices and the domestic distortions such as power cuts will continue to exert upward pressure, only part of which will be offset by the good harvest. With likely moderation in Indian prices (see the chapter on India) and the government's measures to prohibit transport syndicates' restrictive practices (which have contributed to higher prices), 8.0% average inflation is expected in FY2012.

It is assumed that NRB will not tighten monetary policy further in the rest of FY2011 and FY2012 for two main reasons. First, the current policy stance has already considerably slowed real estate activity. A further tightening could trigger a disruptive correction in house and land prices, worsening the quality of commercial banks' loan portfolios and potentially posing a threat to macroeconomic stability.

Second, the expected moderation of Indian inflation will probably obviate any need for monetary tightening. NRB's attention is likely to be focused on establishing confidence in the banking system and enhancing its supervision capacity. The vulnerability of the commercial banking system has increased significantly in recent years due to a rapid emergence of other financial institutions (Figure 3.19.7). Recurring bank liquidity crunches are manifestations of this vulnerability, as deposits have reportedly been shifted from major commercial banks toward smaller financial entities that offer higher deposit rates, are difficult to supervise, and appear to take on riskier lending.

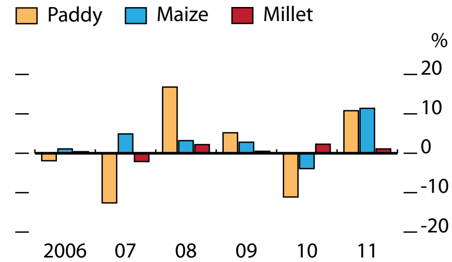
After sharply deteriorating in FY2010, the external position has since recovered significantly (Figure 3.19.8). Although the oil import bill is soaring because of higher prices, overall import growth has slackened, mirroring remittance inflows.

Exports have picked up, partly in response to the tax incentives for exporters announced in the FY2011 budget. As a result, the merchandise trade deficit has been limited to $2.0 billion in the first half of FY2011. Remittances and tourism receipts have offset 90% of this deficit. After an approximate 4% fall in FY2010, external reserves recovered this loss in the first half of FY2011, to reach $2.8 billion in January 2011, worth about 6 months of imports (Figure 3.19.9).

Both domestic and external factors will challenge any further strengthening of the balance of payments in FY2011. Domestic manufacturing is plagued by low productivity and poor infrastructure. Import growth will likely accelerate on higher oil prices, although it will be somewhat offset by remittance inflows, which were growing at about 18% in the first half (Figure 3.19.10). A current account deficit of 0.5% of GDP is expected in FY2011 and FY2012, reflecting little change in trends.

An escalation in political disruptions, if the peace process bogs down, is the key downside risk to growth prospects. A further risk is an abrupt downward correction in the real estate market, which would

3.19.6 Change in summer crop output



Source: Ministry of Agriculture and Cooperatives.

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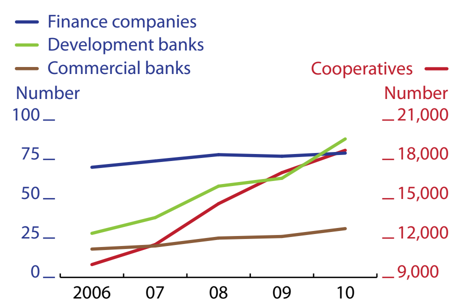
3.19.7 Financial institutions



Source: Nepal Rastra Bank. 2011. *Banking and Financial Statistics*. January.

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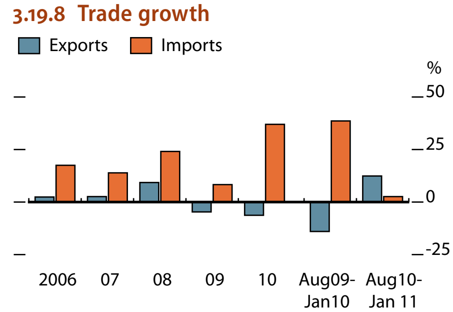
3.19.8 Trade growth



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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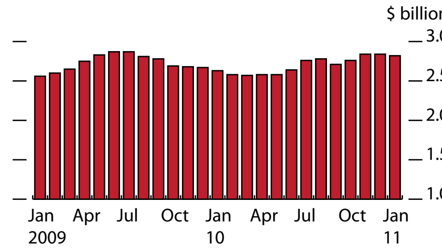
no doubt severely undermine revenue mobilization efforts and put many construction-related jobs in jeopardy. Given the high volume of commercial bank lending for real estate, surging loan defaults would repress normal financial activity.

Externally, the unrest in the Middle East is an emerging risk to the steady remittance inflows as the region is a key destination for Nepalese migrant workers. The recent earthquake in Japan could also hit Japanese tourist arrivals and aid flows to Nepal. An additional external risk is the surge in oil prices which could severely strain Nepal's external position and cause a supply shock if domestic prices are not adjusted accordingly. Nepal also remains vulnerable to high global food prices.

3.19.9 Foreign exchange reserves



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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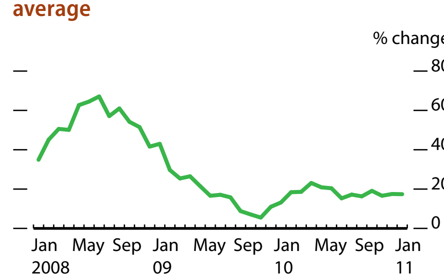
Development challenges

Creating jobs for the country's burgeoning young population is a major challenge; unless managed properly, it could put at risk the country's economic growth prospects. Some 450,000 workers enter the labor market annually. More than half of them seek—and get—jobs in the Middle East and East Asia, particularly low-end work in construction and manufacturing. But it is Nepal that bears the social costs.

While under- and unemployment are widespread in all segments of the population, the position is particularly depressing for youth. Their nationwide unemployment rate is twice the national average. It is even worse in urban areas, where the decade-long conflict, lack of job opportunities in rural areas, and the concentration of higher level education institutions there have contributed to an influx of younger people.

3.19.10 Remittance inflows, 5-month moving average



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Labor laws in Nepal—the most rigid in South Asia—are a major block to job creation, and need to be reformed to facilitate quicker recruitment and release of workers. Moreover, the academic curriculum needs to be modified to reflect labor market needs and to facilitate self-entrepreneurship, in part to capitalize on close ties to India and its prominence as a business services hub.

Progress toward completing the peace process, thereby leading to stronger investor confidence, will be important for faster job creation. The policy agenda should aim to strengthen business security, reduce red tape on firms' entry and exit, and scale up current initiatives, such as incentives for entrepreneurs in tourism.

Finally, the authorities should continue to work on developing a clear policy for public–private partnerships. It would assist the country to unlock the massive hydropower potential, paving the way for large infrastructure projects—their implementation has so far remained elusive.

Pakistan

Pakistan's economy faces considerable challenges. Floods in summer 2010 hit agricultural output and damaged transport and communication. Still high inflation, though recently falling, may well accelerate. Fiscal developments are worrisome: the rollback in recent oil price rises, a partial increase in electricity tariffs, delays in carrying out revenue-increasing measures, broad tax exemptions for residents of flood-affected areas, and continued heavy fiscal support to state-owned enterprises add to pressures on the fiscal deficit. The current account balance is improving, but capital and financial inflows continue to decline. Still, despite devastation and economic distress, growth will likely stay positive.

Economic performance

Pakistan's economic performance in FY2010 (ended June 2010) and into FY2011 reflects largely the same structural weaknesses that contributed to its FY2008 macroeconomic crisis. Energy shortages and security issues held the economic rebound for FY2010 to 4.1% (Figure 3.20.1), slowing growth for FY2008–FY2010 to an average of only 3%, well below the 8% needed to create jobs for the predominately young population.

Little recent progress has therefore been made in raising per capita incomes or reducing poverty. Delays in implementing policy measures and fiscal management practices necessary for macro stability have undermined investment in infrastructure and production capacity.

The modest expansion in FY2010 benefited from fiscal and monetary policies in FY2009 that eased macroeconomic imbalances by year-end, and from a decline in inflation that improved consumer confidence. Higher remittances provided additional support to an expansion of private consumption, as did improvements in rural income from increases in administered commodity prices. Heightened security concerns lifted public consumption, pushing total consumption's contribution to growth to nearly 80%.

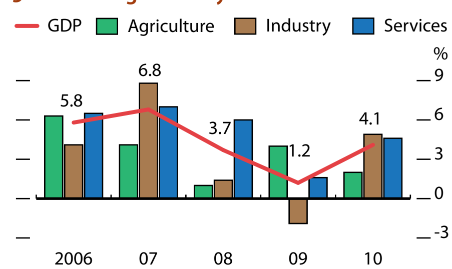
From the supply side, transitory improvements in large-scale manufacturing partly reversed 2 years of declines and supported a recovery in services, led by wholesale and retail trade. Agriculture expanded by a modest 2%, due to weak performance by major crops.

The fragility of the recovery was underscored by continued investment contractions. Infrastructure shortages and security issues contributed to a 5.1% decline of gross private capital formation. Gross fixed capital formation contracted by 2.0% in FY2010, coming on the heels of an 11.3% decline the previous year.

FY2010 also saw a third consecutive year of declines in investment in large-scale manufacturing (down 15.4%) and electricity and gas (11.0% lower). Overall, the steady decline in total gross fixed investment as a

This chapter was written by Dawn Elizabeth Rehm of the Central and West Asia Department, ADB, Manila; and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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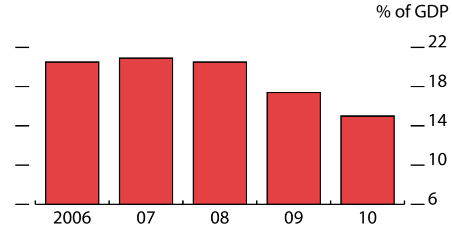
3.20.2 Fixed investment



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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share of GDP from 20.5% in FY2006 to 15.0% in FY2010 will crimp future growth prospects (Figure 3.20.2). Private savings have similarly declined, owing in part to the failure of key asset rates to keep pace with inflation, leading to either negligible or negative real returns.

Pakistan's fiscal balance deteriorated in FY2010, reflecting delays in putting through planned policy measures to improve revenue performance and limit the burden on the deficit of losses at state-owned enterprises (SOEs) and of energy-related subsidies. It widened from 5.3% of GDP in FY2009 to 6.3% in FY2010 (Figure 3.20.3), well in excess of the (revised) target of 5.1%. Revenue targets in the FY2010 budget, too, were missed and Federal Board of Revenue (FBR) tax receipts continued to decline as a share of GDP, reaching a 30-year low of 9.0% in FY2010.

Pakistan's current budget expenditure is relatively rigid, and it is difficult to offset overruns in one category with reductions in another. Inflexible current expenditure (such as security, interest, and pensions) alone absorbed revenue of 7.4% of GDP in FY2010, or about 82% of FBR tax receipts. Subsidies amounted to another 1.7% of GDP.

The government sharply curtailed the federal public sector development program (PSDP) to 3.5% of GDP to ease deficit pressure. Federal government borrowing from the State Bank of Pakistan (SBP), the central bank, as well as from commercial banks rose to PRs339.7 billion (2.3% of GDP), reflecting a widening deficit and lower external financing. Escalating losses from SOEs reached an estimated 1.7% of GDP for FY2010, adding to pressures.

Inflation fell to 11.7% in FY2010 from 20.8% in FY2009 (Figure 3.20.4). As it moderated, the SBP lowered the policy rate in steps from 14% to 12.5%. Broad money expanded by 12.5%, much faster than the 9.6% of the previous year.

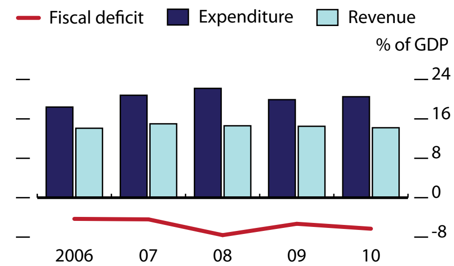
Developments in the external balances were mixed (Figure 3.20.5): the current account deficit narrowed, as imports declined by 1.7% with weaknesses in key industries (such as steel and oil refining) and a slump in investment; exports expanded by a modest 2.9% on higher exports of textiles, rice, and pharmaceuticals. Improvements in the service and income accounts contributed.

Yet financing the current account deficit became more difficult over the year: the capital and financial accounts fell by almost 13.4%, after a 26.2% decrease the year before. Foreign direct investment flows continued their downward path in response to infrastructure and security concerns, with communications, transport, and power accounting for much of the decline.

Gross reserves improved, benefiting from International Monetary Fund (IMF) releases under a stand-by arrangement, rising to $16.8 billion by end-FY2010. The nominal exchange rate depreciated by 6.3%, but inflation—high relative to trading partners'—lifted the real exchange rate by 1.0%.

Pakistan's public debt (excluding guarantees) as a share of GDP continued to climb in FY2010 (Figure 3.20.6). Government domestic debt amounted to 37.0% of GDP, including commodity debt and liabilities of SOEs. External debt rose to 31.9% of GDP, including 0.6% of GDP in external liabilities of SOEs. Interest payments due on domestic debt represent a heavy burden, accounting for 3.9% of GDP in FY2010, or

3.20.3 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk

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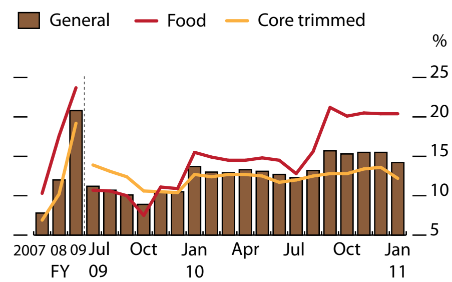
3.20.4 Year-on-year inflation



Note: Core trimmed inflation eliminates extreme outlying sample observations from the calculated average.

Sources: State Bank of Pakistan. *Annual Report 2009–2010* and Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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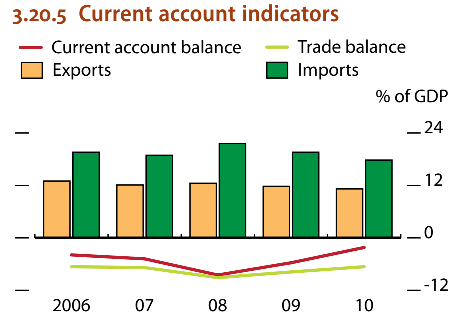
3.20.5 Current account indicators



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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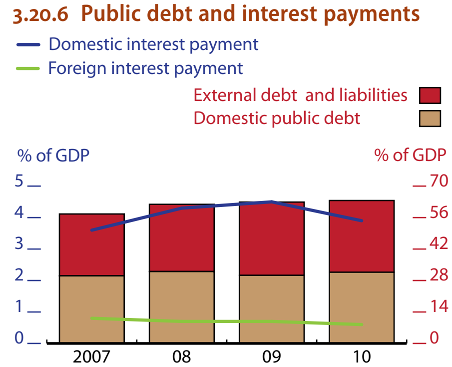
3.20.6 Public debt and interest payments



Sources: State Bank of Pakistan. *Annual Report 2009–2010* and *Statistical Bulletin March 2011*. http://www.sbp.org.pk.

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43% of FBR revenue. External debt amortization payments, excluding amounts owed to the IMF, are relatively stable for FY2010–FY2013 at about $3.3 billion. Amounts due for FY2012 and beyond will be raised substantially by repayment obligations to the IMF.

Government borrowing in the form of advances for commodity operations rose sharply in FY2009, in response to the bumper crop and increases in government-set procurement prices for wheat. With domestic prices higher than international prices, excess inventory was not sold. As this inventory looked as if it would not be sold nor loans repaid, banks' lending rates for government commodity operations rose, to exceed those for the private sector.

Prospects

Severe floods in July–August 2010 have affected FY2011's prospects. Damage was less severe than initially feared, but agriculture and communications were hit hard. Total damage is put at more than $10 billion, half in agriculture. For other areas, notably power and transport, damage was mild but widespread.

Information for the first 6 months of FY2011 points to a 1.7% contraction of large-scale manufacturing centered on textiles, food processing, and petroleum products, bringing the large-scale manufacturing index for September 2010 to its lowest since July 2007 (Figure 3.20.7).

With growth prospects reduced to 2.5% for FY2011 (Figure 3.20.8), average growth for FY2008–FY2011 is seen falling to 2.9%. Persistent energy shortages and security issues are expected to hold growth to 3.7% for FY2012, providing scant improvement on recent trends.

Inflation accelerated after the floods, to 15.7% in September, reflecting actual and expected shortages. It remained above 15% through December, falling to 14.2% in January owing to a government-freeze on oil and electricity prices. It is expected to stay high through FY2011, for an average annual 16.0%, and is then expected to recede in FY2012 to 13.0% (moderation in international food prices is likely to be at least partly offset by electricity price rises).

Pakistan began FY2011 with a budget that was based on policy measures that proved difficult to carry out. Revenue targets called for 26% growth of tax receipts, well over the 5-year average of 14%. Meeting them would have been hard even if a reformed General Sales Tax had come into effect. A reformed tax was initially scheduled for July 2010, but the process remains politically contentious, and any changes to the tax will have a limited effect on FY2011 receipts.

This tardiness, combined with the impact of the floods and wide tax exemptions for those in flood-affected areas, held FBR tax revenue growth to 10.9% in the first 7 months of FY2011, making a further decline in the tax-to-GDP ratio likely (Figure 3.20.9). (Total fiscal resources have also been affected by declines in nontax revenue.)

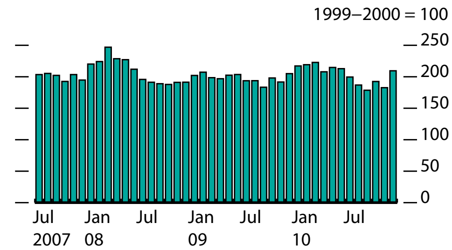
Current expenditure was under pressure due to a 50% wage increase for government workers, exacerbated by government failure to budget adequately for subsidies needed to cover the gap between notified and cost-recovery electricity tariffs. An annual budget allocation of

3.20.1 Selected economic indicators (%)

	2011	2012
GDP growth	2.5	3.7
Inflation	16.0	13.0
Current account balance (share of GDP)	-1.7	-2.3

Source: ADB estimates.

3.20.7 Large scale manufacturing index



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; Federal Bureau of Statistics. http://www.statpak.gov.pk (accessed 11 March 2011).

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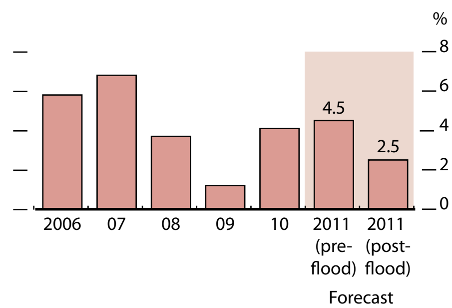
3.20.8 GDP growth



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; ADB estimates.

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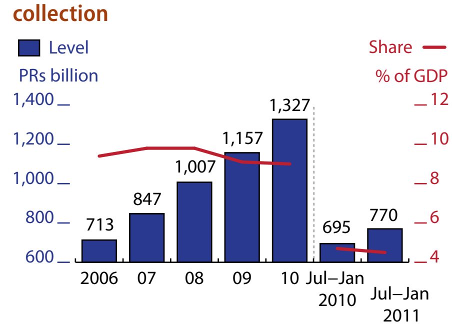
3.20.9 Federal Board of Revenue tax collection



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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PRs30 billion to cover the tariff differential turned out well short of expected cost, and because of lack of policy measures total energy-related subsidies are expected to reach PRs200 billion. Part of this gap was to be covered by 2% monthly increases in electricity tariffs to bring them into line with cost recovery. Energy-related circular debt (due to payment arrears in the sector), which stood at PRs446 billion at end-FY2010, is expected to surge by end-FY2011.

For a third year, overruns on recurrent spending were met with a compression of the federal PSDP (Figure 3.20.10). For the first half of FY2011, only PRs66 billion was made available for PSDP activities, less than 25% of the PRs280 billion earmarked in the FY2011 federal budget, with spending limited to key projects and priority development programs. The federal PSDP for FY2011 faced a further cut of PRs100 billion on a lack of resources. The government is giving priority to completing projects. The remainder of the PSDP (PRs373 billion) in the combined provincial budgets is also under substantial pressure from resource constraints.

With a fiscal deficit at 2.9% of GDP in the first half of FY2011, the annual fiscal target was also revised to 5.5% under the weight of higher international food and energy prices, escalating subsidies, and subdued revenue performance.

With lower foreign funding, deficit financing is expected to rely heavily on the domestic banking system. After easing in FY2010, government borrowing from that source has surged in FY2011, reaching PRs379 billion by 12 February, compared with PRs330.4 billion for FY2010 as a whole (Figure 3.20.11). Of this, about 34% reflected borrowing from the SBP, consistent with commitments from the government in late January to roll back borrowing from the SBP to September 2010 levels.

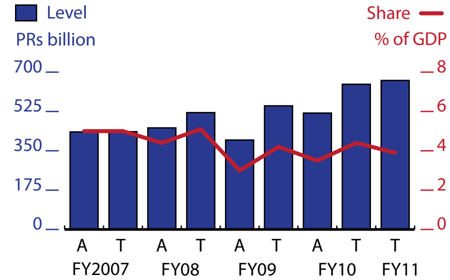
Credit to the private sector picked up but remained on the low side for various reasons. Banks expressed a preference for low-risk lending to government to offset flood-related increases in nonperforming loans, while weak postflood economic activity and rising borrowing costs held back demand for borrowing.

The pace of government borrowing from the banking system has supported a rapid expansion of broad money and reserve money: broad money growth for FY2011 through 26 February 2011 was much higher (7.7%) than in the same period of FY2010 (5.7%); the equivalent figures for reserve money were 14.9.% and 10.6%.

In response to the increase in inflation and growing evidence of its likely persistence, the SBP increased the policy rate in three successive 50 basis point increments from August 2010 to end-November 2010, bringing the rate back to 14.0% and reversing the cuts of FY2010 (Figure 3.20.12). In January 2011, the SBP left the policy rate unchanged, partly on the basis of commitments from the government to limit borrowing from the central bank.

Fiscal prospects for FY2012 are likely to improve as the political environment eases sufficiently to implement the revenue-enhancing and fiscal-management initiatives. Progress is expected in implementing reforms for the energy sector consistent with a move toward financial viability with a phased elimination of subsidy requirements, leaving enhanced fiscal space for development programs.

3.20.10 Public sector development program



A = Actual; T = Target.

Source: Ministry of Finance. *Fiscal Operations*. Various issues. http://www.finance.gov.pk

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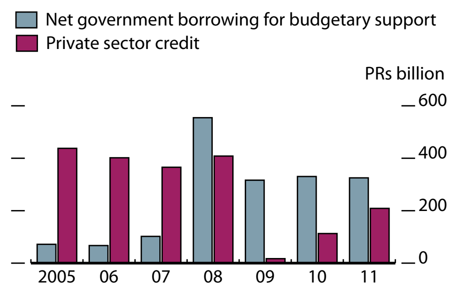
3.20.11 Budgetary and private sector credit



Note: 2011 data cover the period July 2010 to February 2011.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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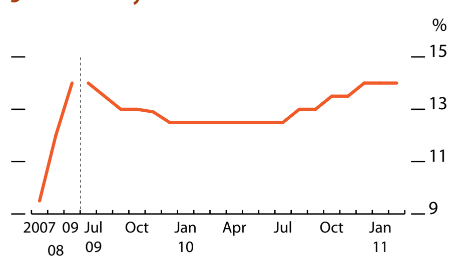
3.20.12 Policy rate



Source: State Bank of Pakistan. *Annual Report 2009–2010*. http://www.sbp.org.pk

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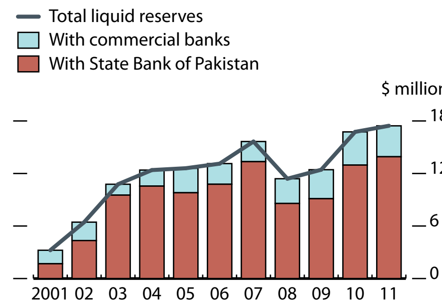
The extensive pickup of Treasury bills bought by the SBP through December 2010 reflected government reluctance to allow auction cutoff rates to rise enough for commercial banks to participate. Without a sufficient increase in 1-year bill rates, most purchases have shifted to shorter maturities of 3 and 6 months. In recent auctions, most banks' bids for bills with a maturity longer than 6 months have not been high enough to be accepted. But with an average maturity falling to 1.5 years, the possibility of roll-over risk and disorder in the auction market rises. The likely outcome is that, in time, the government will have to pay higher interest rates to fund its borrowing requirements.

Pakistan's external reserves reached a record high of $17.4 billion in early February 2011 (Figure 3.20.13), amounting to more than 5 months of imports of goods and services. This buildup essentially reflects IMF releases of $7.1 billion under the stand-by arrangement, an additional $450 million in emergency support in September 2010, and support from the Coalition Support Fund ($633 million) at end-December 2010. The central bank's holdings of liquid foreign exchange reserves ended FY2010 at $13.9 billion.

While import growth remains modest, a significant expansion of exports during the first 7 months of FY2011 moved the current account deficit into near balance, at 0.5% of GDP, but it is expected to widen to 1.7% for full-year FY2011, reflecting higher international food and commodity prices. For the first 7 months of FY2011, exports of textiles and rice showed strong growth in value terms, mainly on higher world prices. Remittances increased further, broadly in line with inflation, but non-debt-creating inflows continued to decline, with private FDI inflows about 16% below the same period of the previous year (Figure 3.20.14).

The current account deficit is expected to edge upward in FY2012 to 2.3% of GDP as projected declines in global food and commodity prices are more than offset by the impact of improved growth and increased demand for imports, including for postflood reconstruction.

3.20.13 Foreign exchange reserves



Note: Data for 2011 are as of 12 February.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
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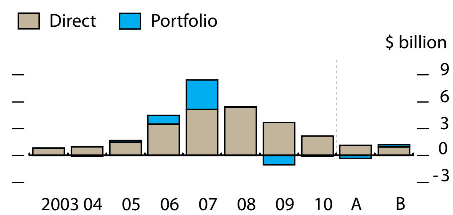
3.20.14 Foreign direct and portfolio investment, net inflows



A = July 2009–Jan 2010; B = July 2010–Jan 2011.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
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Development challenges

The government recognizes that current subsidy requirements and support for SOEs are incompatible with creating the fiscal space needed to support investment in infrastructure and technology for a diversified and higher-value-added export base. The current pattern of lower imports, lower development spending, and exploding unproductive current outlays undermines domestic and external confidence in the economy's prospects and deters investment. Pakistan therefore needs to develop a systematically transparent revenue policy, and operate it effectively.

Elsewhere, energy shortfalls are lowering real growth by at least 2 percentage points annually. While the federal government increased electricity tariffs by 37% in FY2010, its decision not to push through with incremental monthly step-ups represents a reversal of its efforts to reach cost recovery. Again, it will be critical to design and implement policies that bring the sector to financial viability.

Sri Lanka

The economy bounced back strongly in 2010, reflecting post–civil war optimism and the global recovery. The outlook, too, is positive for healthy growth provided the fiscal consolidation process meets targets and the burgeoning inflation pressures are addressed. The medium term presents a need to greatly lift private investment, if the country is to reap the full rewards of the peace dividend.

Economic performance

The economy rebounded in 2010, with GDP growth estimated at 7.6%, after 3.5% in 2009 (Figure 3.21.1). Continued benefits from the end of the long-running civil conflict in 2009, such as improved business and tourist confidence plus more land available to agriculture, as well as the global return to growth, underpinned the strong performance. The overall optimism was reflected in the stock market's doubling.

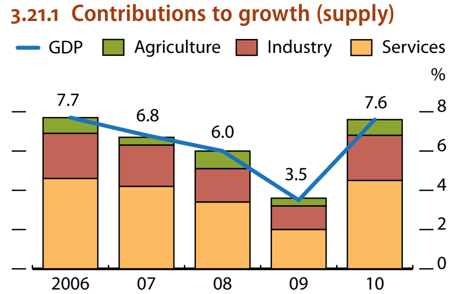
With the revival of paddy and fisheries production in the former conflict areas of Northern and Eastern provinces, agriculture grew at 6.5% in 2010. Good weather and fertilizer support by the government helped. With the improved domestic business climate, the upturn in domestic and external demand, and gradually improving infrastructure, industry grew by 8.0%.

Services, which account for nearly 60% of GDP, recorded growth of 7.6%. This was mainly due to the expansion of wholesale and retail trade, revival in tourism—which contributed to robust performance in hotels and restaurants—and the impressive performance of the banking, insurance, and real estate subsector. Tourist arrivals leaped by 46% to 654,477 in 2010, the highest number on record.

Annual average inflation as measured by the Colombo Consumer Price Index reached 5.9% in 2010, up from a 25-year low of 3.4% in 2009. Import duty reductions and subsidies that maintained stable fuel prices partly reined in rising global commodity prices' impact on domestic inflation. Nevertheless, overall inflation increased steadily from midyear to reach 7.8% in February 2011, with the rise due to escalating food prices that were 13% higher than a year earlier (Figure 3.21.2). Core inflation was on a downward trend throughout 2010 that continued in the first 2 months of 2011.

Commercial banks' average weighted prime lending rate continued to decline gradually in 2010 to 9.3% by year-end (Figure 3.21.3). The central bank reduced the reverse repurchase rate, the main policy rate, twice (and again in January 2011 to 8.5%). As interest rates edged down, growth in credit to the private sector came back strongly after 2009's shrinkage,

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Annual Report 2009.* http://www.cbsl.gov.lk; ADB estimates.

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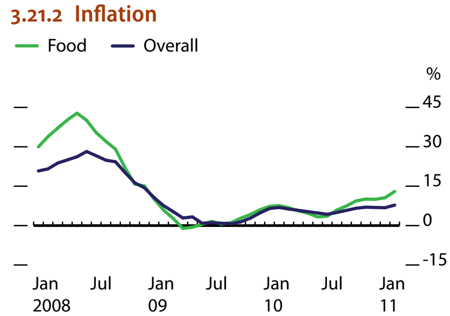
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 2 March 2011).

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This chapter was written by Nimali Hasitha Wickremasinghe and Savindi Jayakody of the Sri Lanka Resident Mission, ADB, Colombo.

reflecting commercial banks' improved lending appetites. Credit to the private sector increased by 25.1%, and broad money by 15.8%.

Per plan, the government tightened the budget deficit to 8.0% in 2010 from 9.9% in 2009 (Figure 3.21.4). It took minor steps to expand the revenue base, preferring to focus on simplifying the tax system, including reducing customs duty bands from five to four, removing the import duty surcharge, revising taxes relating to imports of motor vehicles and selected electronic items, and revising cess rates. Domestic revenue as a share of GDP at 14.6% was only marginally above 2009's. Grants added 0.4% of GDP to budget revenue.

The deficit narrowed therefore through current expenditure being cut by 1.5 percentage points as a share of GDP. All major categories of current expenditure saw a reduction as a share of GDP, including salaries and wages, interest payments, and transfers and subsidies. As a share of GDP, public investment was lower than in 2009, at 6.5%. Total expenditure was 23% of GDP in 2010.

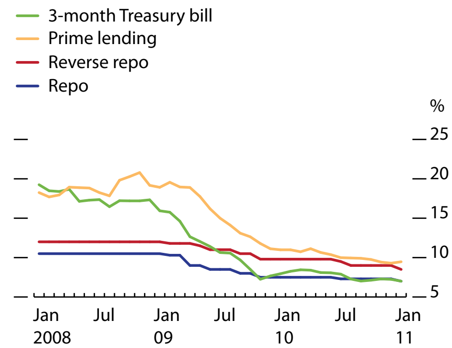
The ratio of government debt to GDP fell to an estimated 84% at end-2010 from 86% a year earlier but the total stock of government debt increased by 11%. While the debt ratio has fallen in recent years, the structure of debt has adversely changed, as the mix shifted from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. By August 2010, the share of concessional debt had declined to 68% from 72.2% at end-2009. In September 2010, the government issued its third international sovereign bond offering of $1 billion, after issues in 2007 and 2009. This issue was oversubscribed six times, with a yield substantially lower than the two previous issues.

After a 12.7% fall in 2009, exports recovered to expand by 17.3% in 2010. Industrial exports accounted for 74% of export earnings (of which more than half came from textiles and clothing) and agricultural exports 25%. Exports to major regions increased even though the European Union withdrew concessions under its Generalized System of Preferences Plus in August 2010. As the economy recovered in 2010 there was a marked increase in imports (about 32%), though this upsurge in large part reflected higher global prices, especially of oil. The steeper rise in imports than exports pushed out the trade deficit to 10.5% of GDP, from 7.5% a year earlier.

The strong resurgence in tourism as well as freight- and port-related activities brought an upturn in the services sector surplus. Growth momentum in remittances continued, reaching 24%. These items helped to counterbalance the large trade deficit to hold the current account deficit to 3.8% of GDP (Figure 3.21.5). Supported by healthy capital flows, the balance of payments recorded an estimated overall surplus of about 1.8% of GDP in 2010. Foreign direct investment strengthened sharply, to an estimated $500 million from $384 million in 2009, though at only about 1% of GDP it is very low for an economy of Sri Lanka's size and development level.

Investor sentiment was strengthened by the simultaneous approval of the third and fourth tranches of the International Monetary Fund (IMF) stand-by arrangement in June, and the fifth tranche in September, 2010. Both Standard and Poor's and Moody's raised the country's outlook to

3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 February 2011).

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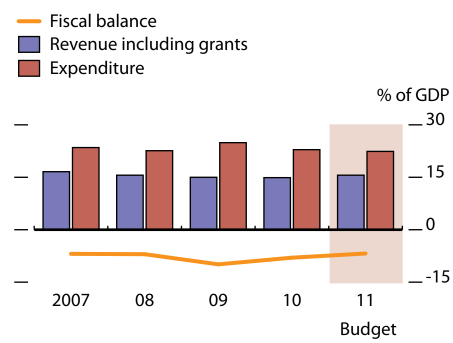
3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2011*. http://www.treasury.gov.lk

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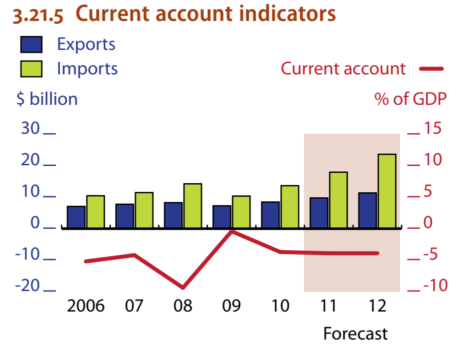
3.21.5 Current account indicators



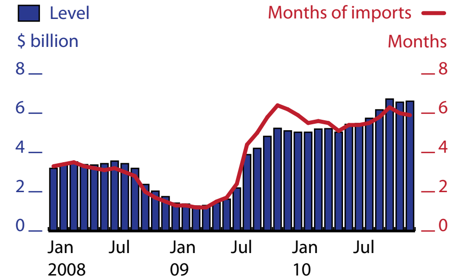
Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2010 and Prospects for 2011*. http://www.cbsl.gov.lk; ADB estimates.

Click here for figure data

stable, and Fitch to positive. Supported by the success of the bond issue and the release of IMF funding tranches, gross official reserves reached $6.6 billion, covering 5.9 months of imports (Figure 3.21.6).

The Sri Lanka rupee climbed gradually against the US dollar by about 3% to reach SLRs111.1 by end-2010 (Figure 3.21.7). The real effective rate appreciated by about 5% because of higher inflation than in trade partners. The central bank intervened to buy foreign currency, though this move created excess rupee liquidity in the economy, leading to inflation concerns.

3.21.6 Gross official reserves



Source: Central Bank of Sri Lanka. Weekly Economic Indicators. Various issues. http://www.cbsl.gov.lk

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Economic prospects

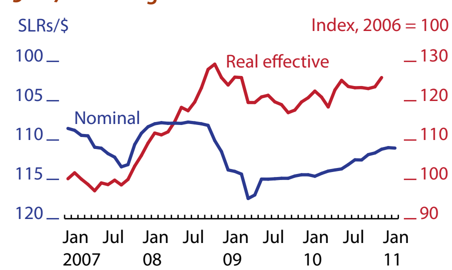
After last year's rebound, the economy is expected to show continued high growth of 8.0% in 2011, supported by some strengthening in external demand, and maintain growth at that level in 2012. Sustaining such performance will require fiscal consolidation, state enterprise and finance sector reforms, as well as flexible exchange rate management.

Services and industry will lead growth in 2011; agriculture is likely to be hampered by heavy rains and consequent flooding that affected several provinces in January–February 2011. Continued and planned infrastructure- and tourism-related building will support construction growth, while services, especially hotels and restaurants, will perform well, catering to the likely prolongation of the tourist boom.

Rising global food and oil prices and a shortfall in domestic supply of agricultural produce due to the flooding will stoke inflation, but only up to around 8%. In January 2011, the government reduced customs duty on gasoline from SLRs15 a liter to SLRs5 to avoid passing through global price rises. As with similar tariff-lowering steps on some imported food items, the fiscal implications are unclear. A recent hike in electricity prices will also contribute to upward price pressures this year.

In a surprise move, the central bank cut policy rates in January even though inflation was on an upward trend, reasoning that the prevailing economic conditions provided the space for monetary relaxation to facilitate greater private investment without creating inflation pressures. With the economy now on a higher growth trajectory and inflation pressures rising, however, monetary tightening may well be needed later in the year.

3.21.7 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 March 2011).

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The budget deficit is expected to come down to 6.8% of GDP from 8.0% in 2010, split equally between a 0.6% increase in revenue and a 0.6% cut in expenditure. Revenue buoyancy is likely, stemming from budget measures to simplify the tax system and move from tax concessions as the principal tool for attracting investment to increased economic activity.

Expenditure is forecast to rise moderately in nominal terms as the government is looking to cap public investments at around the 2010 level of 6%–7% of GDP. A sharp one-third increase in private investment is seen driving growth higher.

The budgeted fiscal consolidation is prudent, but meeting its target will require further measures as the costs of the humanitarian and reconstruction expenses related to the flooding in 2011 and the reduction in customs duty on gasoline were not provided for in the budget adopted in 2010.

3.21.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-4.0	-4.0

Source: ADB estimates.

The government expects to move to a 5% of GDP deficit target in 2012. To achieve this it would be necessary to look closely at closing loopholes in the tax system and to improve efficiency in tax collection, together with further steps to broaden the tax base. Moreover, with infrastructure development a compelling priority, expenditure rationalization would have to focus rigorously on recurrent expenditure.

Export performance will depend on the recovery in Sri Lanka's major markets and is likely to grow by, say, 16% in 2011 and 2012. Rising global prices, especially of food items and petroleum, as well as high domestic demand, are expected to push up imports by around one-third in 2011 and 2012. Higher remittances and net services receipts are expected to hold the current account deficit to some 4% in both years.

FDI is projected to increase, supported by policy measures reinforced in the 2011 budget, including streamlining the role of the Board of Investment and ensuring that incentives to unproductive investments are canceled. The government wants FDI to hit about 3% of GDP this decade. The reserve position is likely to remain strong, supported by capital flows and the IMF program.

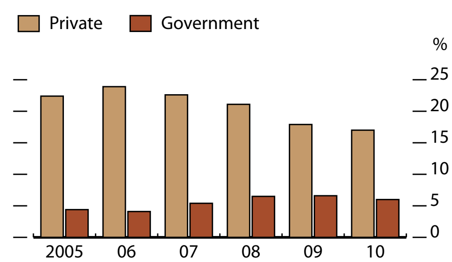
Development challenges

Investment is too low to achieve national development goals, and private investment in particular needs to be scaled up substantially (Figure 3.21.8). But several areas need to improve to secure an investment climate conducive to large-scale private investments. The 10-year development plan, the Mahinda Chintana, emphasizes the need to improve the business environment more widely. The World Bank's *Doing Business 2011* report ranks Sri Lanka at 102 out of 183 economies, suggesting the need to eliminate red tape. It also includes strengthening institutions, building human resources capacity, and simplifying procedures.

The finance sector requires development, as part of the thrust toward macro stability and hence greater investment. Improvements are needed in the legal framework for financial services and commercial transactions, and more generally in strengthening and enforcing prudential norms. The challenge for Sri Lanka will be enforcing different institutional and regulatory policy reforms in ways that are effective but without excessive bureaucracy.

It is also important to encourage both competition and consolidation in various parts of the finance sector to achieve efficiency and economies of scale. The capital markets are underdeveloped. Developing the corporate bond market is important to diversify funding sources in order to reduce reliance on banks and the equity market.

3.21.8 Fixed investment



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; ADB estimates.

Click here for figure data

SOUTHEAST ASIA

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

Brunei Darussalam

Recovery in 2010 stemmed from higher oil and gas production coupled with moderate growth in the nonenergy private sector. Inflation remained subdued. Growth in the near term is projected to return to slightly higher than recent trend levels, in a context of low but rising inflation. The major challenge remains diversifying the sources of growth

Economic performance

The economy recovered by an estimated 2.0% in 2010, driven by higher production of oil and natural gas, stronger energy demand from traditional export markets such as Japan and the Republic of Korea, expansion of liquefied natural gas (LNG) production, and the opening of a new methanol plant in May 2010. Production of hydrocarbons, including LNG, accounts for nearly half GDP. Nonenergy-related private sector activity picked up moderately.

On the demand side, recovery benefited from estimated rises of 12% in private consumption and 10% in exports of goods and services. Investment was likely flat.

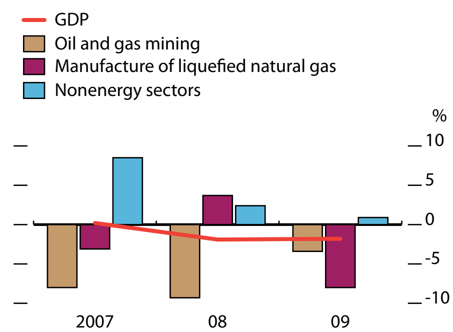
The GDP contraction in 2009 was revised to 1.8%. In that year, production of oil and gas fell by 3.4%, and LNG output by 8.0% (Figure 3.22.1), largely a consequence of weaker external demand and maintenance-related stoppages. Growth in the nonenergy sector in 2009 slowed to 0.9%, reflecting the impact of the global recession on trade, tourism, and manufacturing.

Contracting economic activity in 2009, with lower global commodity prices and a broadly stable Brunei dollar, brought inflation down to 1.0%. Official data for the first 8 months of 2010 indicate that inflation eased further, but the consumer price index likely picked up after that, in tandem with global commodity prices (most commodities are imported). Average inflation for 2010 is estimated at 1.5%.

Preliminary and unadjusted data indicate that the budget recorded a deficit of US$192 million in FY2009 (ended 31 March 2010), or 1.7% of GDP. This was on the back of sharply lower tax and nontax revenue (dividends and royalties) from oil and gas, as well as higher current and capital spending. In FY2010, available data indicate that the budget returned to surplus of US$860 million in the first half of the fiscal year. The turnaround reflects a combination of higher tax revenue, lower current expenditure, and a cut in capital spending.

Broad money supply increased by 8.2% in the 12 months through June 2010, marking a continued buildup in net foreign assets and an expansion of domestic credit. Credit to the private sector rose by 20.9%, while net

3.22.1 GDP growth by sector



Source: Brunei Darussalam Department of Economic Planning and Development (JPKE).

Click here for figure data

3.22.1 Selected economic indicators (%)

	2011	2012
GDP growth	1.7	1.8
Inflation	1.5	1.5
Current account balance (share of GDP)	50.0	50.0

Source: ADB estimates.

This chapter was written by Eric Sidgwick of the Southeast Asia Department, ADB, Manila.

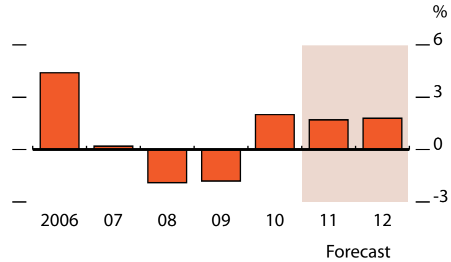
claims on the government declined (government deposits in the banking system expanded) as the budget returned to surplus.

Exports of oil and gas, which represent over 90% of total exports, slumped by 33.1% to US$7.2 billion in 2009. This was due to both lower export volumes and prices. Exports of LNG to Japan, which accounted for about 30% of Brunei's GDP in recent years, declined by 21.8%. Imports also dropped sharply, by 20.1%, due to the downturn in economic activity. It is estimated that the current account surplus fell by over US$3 billion to around US$4 billion (but still high at 37% of GDP).

Data on the capital and financial accounts are not available but international reserves, excluding amounts held by the Brunei Investment Agency, were estimated at US$1.4 billion at end-2009.

For the first half of 2010, exports of oil and gas picked up by 14.1%, and imports increased slightly. The current account surplus rose to US$5.4 billion in January–June 2010 and is estimated to have totaled about the same amount for the full year (43% of GDP).

3.22.2 GDP growth



Sources: Asian Development Outlook database; ADB estimates.

Click here for figure data

Economic prospects

The outlook for the forecast period is based on the *ADO 2011* assumptions of continued modest growth in industrial economies and significantly higher global oil prices through 2012.

As the high-base effect from the rebound in 2010 dissipates, economic growth is projected at the slightly higher than trend rates of 1.7% in 2011 and 1.8% in 2012 (Figure 3.22.2), reflecting buoyant global energy markets and an increase in domestic demand. Oil and gas production is expected to rise moderately and the new methanol plant will contribute a full year's production to GDP.

Private consumption is forecast to rise and investment to pick up this year as a result of construction projects and an improving business environment. Projects include the Pulau Muara Besar port (scheduled to be completed by end-2012), an upgrade of the international airport, and a power transmission line between Brunei and Malaysia.

Inflation is seen rising in the forecast period, mainly due to higher prices for imported food. Still, it should remain relatively low at 1.5%, given the government's policy to subsidize many consumer items and the currency's peg to the Singapore dollar.

The current account surplus is likely to return to levels reached before the economic contractions of 2008 and 2009—about 50% of GDP—on the back of higher export receipts from oil and gas and a rebound in net income inflows from the recovery in foreign asset prices. Demand from Japan for LNG could increase owing to damage to its nuclear industry from the March 2011 earthquake.

A maritime border agreement reached with Malaysia will encourage exploration and foreign investment in oil and gas. Drilling has begun in two offshore exploration zones and an international company plans to bring a new gas discovery into production in about 3 years.

3.22.1 Development challenges

The long-term challenge is to make the economy less dependent on oil and gas. The increase in the global price of oil this year and next will likely lead to moderately higher levels of production, but could also quicken the depletion of hydrocarbon reserves (unless offset by new discoveries).

A gradual transition to more diversified sources of growth will require progress in fostering a more conducive business environment for the private sector, improvements in the institutional capacity of the government, including service delivery, and finance sector development.

The authorities seem to have made a start: according to the World Bank's *Doing Business 2011* report, Brunei Darussalam was in the top 10 countries to have improved its business environment over the previous year. The country climbed 19 places in ease of starting a business (to 133 out of 183 countries)—though this is still a poor ranking—and ranks relatively well in ease of paying taxes (22) and trading across borders (52). However, the ranking remains low in investor protection (120), ease of obtaining credit (116), and ease of doing business (112).

As part of finance sector development, the government set up a Brunei Monetary Authority in January 2011 to improve regulation and supervision of the financial system.

Cambodia

Based on a rebound in tourism and clothing exports, recovery in 2010 was also supported by a good year in agriculture. However, there are indications that poverty has increased in recent years. The pace of economic growth is expected to pick up in the forecast period. Inflation will also rise. A new effort to promote rice production and exports goes some way to addressing the need to diversify sources of growth and reduce rural poverty.

Economic performance

A bounceback in tourism and clothing exports, coupled with increased production of paddy rice, drove a 6.3% recovery in GDP last year (Figure 3.23.1) from a sharp slowdown in 2009 caused by the global economic crisis.

The primary sector, producing about a third of GDP, grew by an estimated 4.2% in 2010. Paddy rice output rose by about 5% to 7.9 million tons, mainly a result of favorable weather and better access by farmers to fertilizers and higher quality seeds. Livestock production increased by about 5.5%, whereas forestry and logging and fisheries output registered only slight growth.

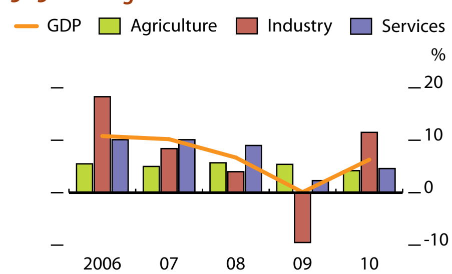
Recovery in global travel saw tourist arrivals rise by about 16% to 2.5 million, and tourism receipts by 14.5% to $1.78 billion (Figure 3.23.2). The sharpest gains were in arrivals from Asia, including Viet Nam (up 48% to 466,700), the Republic of Korea (up 47% to 289,700), and the People's Republic of China (PRC—up 39% to 177,700). This rebound in tourism contributed to estimated growth of 4.3% for services.

Industry was the main contributor to GDP growth in 2010, expanding by an estimated 11.6% (it had contracted in 2009). External demand for Cambodian garments, principally from the United States (US) and the European Union (EU), rebounded. Data from the US Department of Commerce showed that US garment imports from Cambodia rose by 19% in US dollar terms in 2010 (Figure 3.23.3). Construction activity remained sluggish, reflecting a fall in foreign investment in property during the global crisis and slow pickup in residential building.

Increased deposits of foreign currency at banks drove a 20.0% year-on-year increase in M2 money supply in December 2010. Bank lending to the private sector picked up from 6.5% year on year at end-2009 to 27% 12 months later, reflecting the economic recovery. The riel appreciated by 2.4% against the US dollar over 2010.

A less expansionary fiscal stance saw the overall budget deficit trimmed to an estimated 6.0% of GDP, from 6.4% in 2009. Domestic revenue bounced back to the equivalent of 12.7% of GDP, higher than the

3.23.1 GDP growth



Sources: National Institute of Statistics; ADB estimates.

Click here for figure data

3.23.2 Tourism indicators

Source: Ministry of Tourism.

Click here for figure data

This chapter was written by Peter Brimble and Poullang Doung of the Cambodia Resident Mission, ADB, Phnom Penh.

budget plan of 12.3% and the 2009 outturn of 11.9%. Given that revenue collection is still relatively low, the government aims to raise it by 0.5 percentage points of GDP a year over the medium term.

Government expenditure amounted to an estimated 18.6% of GDP, somewhat above the 17.6% budget target but lower than the 2009 peak of 20.5%. The higher than target spending was due principally to externally financed capital works. The deficit was largely financed by grants and concessional loans, with the drawdown of government bank deposits estimated at 0.5% of GDP, much lower than the 2009 outturn of 2%.

Consistent with a modest recovery in domestic demand, inflation in 2010 averaged 4.0% (Figure 3.23.4), a turnaround from 2009 when the consumer price index fell slightly in year-average terms.

In the external accounts, merchandise exports rose by an estimated 20.8% in US dollar terms, largely reflecting growth in garment exports to the US. Imports rose by an estimated 15.9%, mainly on increases in oil and in raw materials for garments. Overall, the 2010 current account deficit (excluding official transfers) narrowed slightly to an estimated 11.0% of GDP.

Foreign direct investment inflows rose by about 50% to $801 million, reflecting strong growth in agriculture and garments. Special economic zones are attracting investments in light industry, especially those in Phnom Penh, Sihanoukville, and Svay Rieng. Donor inflows remained buoyant, and gross international reserves increased by 12% over the year to $2.65 billion, equivalent to 4.7 months of imports of goods (Figure 3.23.5).

Current levels of public debt are considered manageable. External public debt is estimated at $3.5 billion and domestic debt is very small. The PRC accounted for about 58% of total bilateral loan disbursements in 2010.

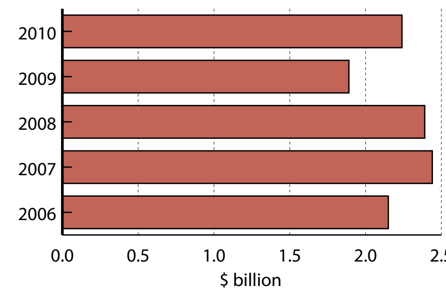
Latest available data show that 30% of the population lived in poverty in 2007, with the majority of the poor and vulnerable in rural areas. There are indications that poverty has increased since 2007 as a result of sharply higher food prices in 2008 and the economic slowdown in 2009. In response, the government has drafted a social protection strategy, expected to be launched in 2011. Immediate priorities of this strategy involve the expansion of targeted programs such as free health care for the poor, and the pilot testing of programs including conditional cash transfers and labor-intensive public works.

The government last year adopted an ambitious plan to increase paddy rice production and promote the milling of rice for export, which should benefit the 70% of the population that earns a living from rice. Targeting 1 million tons of milled rice exports by 2015 (compared with just 13,000 tons in 2009, according to the official estimate), the plan includes steps to expand irrigation facilities; improve the use of water, seed, fertilizer, and equipment; provide credit to farmers; encourage the private sector in rice processing and export; and reduce transport costs.

Longer-term measures in the rice plan will focus on improving farm yields and export competitiveness, for example by building roads, railways, and ports, and by improving land management.

Reflecting the gradual expansion of the private sector, the number of licensed enterprises grew to 38,023 at end-2010 from 36,116 in 2009. The government is eager to encourage new firms and new industries, but

3.23.3 United States imports of textiles and clothing from Cambodia



Source: US Department of Commerce.
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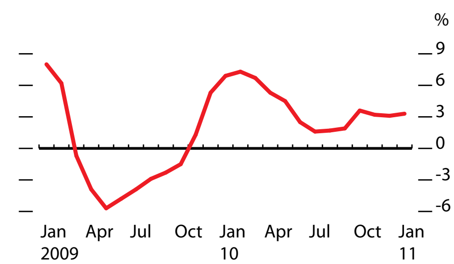
3.23.4 Inflation



Source: National Institute of Statistics.
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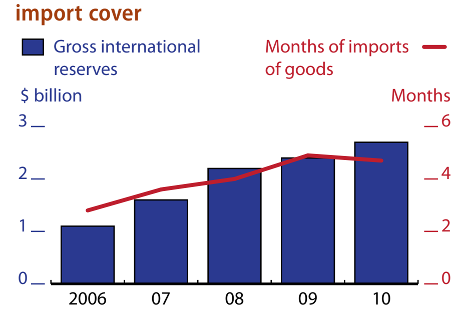
3.23.5 Gross international reserves and import cover



Source: National Bank of Cambodia.
Click here for figure data

developing the private sector is constrained by infrastructure deficiencies, including the high cost of electricity and lack of access to affordable finance, especially for small and domestically focused firms.

The government adopted an anticorruption law in 2010 which, if well implemented, could significantly reduce the costs of doing business, strengthen the country's competitiveness, and improve public sector governance. A stock market is scheduled to open in 2011, with three selected state-owned enterprises planned for listing.

Economic prospects

Assuming global economic growth in line with the *Asian Development Outlook 2011* assumptions, as well as favorable weather for agricultural production, GDP is projected to expand by 6.5% in 2011 and 6.8% in 2012 (Figure 3.23.6).

Growth in industry is projected at 10.8% in 2011, based largely on external demand for Cambodian garments from the US and EU. US garment imports from Cambodia in January jumped by 41% to $214 million. A relaxation of EU rules of origin under the Generalized System of Preferences from January this year gave Cambodian garments duty-free access to the EU, regardless of the origin of the fabric. Cambodian milled rice also received preferential access to the EU. Consequently, milled rice exports to that market rose by 228% to 10,495 tons in the first 2 months of this year from the prior-year period.

Construction is projected to expand by a modest 3% this year. The government in 2010 liberalized restrictions on foreign ownership of apartments, which is expected to help stimulate some additional demand. Offshore oil and gas production is expected to come on stream in late 2012.

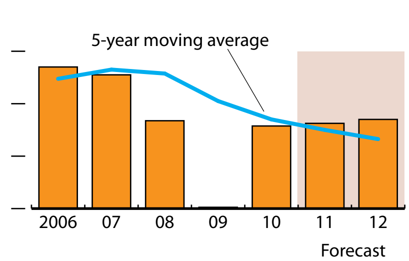
Growth in services looks set to pick up to about 5% this year. Tourist arrivals rose by 18% in January 2011 from the prior-year period, while trade and transport and communications are likely to continue expanding, as domestic consumption and the business outlook improve. Agricultural production is seen increasing by 4.3%, supported by the government's commitment to promote rice production and exports.

Government spending is forecast to grow marginally faster than revenue in 2011, owing to increases in capital outlays, and the budget deficit is expected to be 6.2% of GDP. External financing (concessional loans and grants from bilateral and multilateral lenders) will cover most of the deficit, leaving a shortfall equivalent to 0.9% of GDP (compared to an estimated 0.5% of GDP in 2010) to be financed by drawdowns on government bank deposits at the central bank.

Upward pressure on prices will be generated by the strengthening domestic demand, generally expansionary fiscal policy, and higher global prices for food and fuel. Inflation is forecast to average 5.5% (Figure 3.23.7).

The planned increase in domestic financing of the budget, coupled with the quickening of economic growth and inflation, suggests the need for a gradual tightening of monetary policy during the forecast period. However, the high degree of dollarization of the economy (amounting to as much as 95% of currency in circulation) limits the effectiveness of monetary policy.

3.23.6 GDP growth



Source: Asian Development Outlook database.

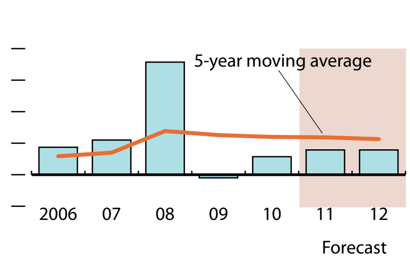
Click here for figure data

3.23.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.5	6.8
Inflation	5.5	5.5
Current account balance (share of GDP)	-10.7	-10.2

Source: ADB estimates.

3.23.7 Annual inflation



Source: Asian Development Outlook database.

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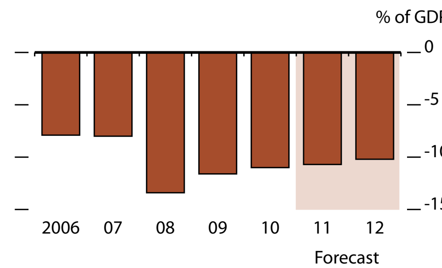
The trade deficit is expected to remain substantial, in part a result of the higher cost of imported oil in 2011. On the positive side, a rise in tourism receipts will contribute to a surplus in services trade. The current account deficit (excluding official transfers) is forecast at 10.7% in 2011 and 10.2% in 2012 (Figure 3.23.8). Gross international reserves are projected to rise to $2.84 billion in 2011.

Risks to the forecasts center on external events, such as unexpected global economic weakness or higher than assumed oil prices, which could hurt the prospects for Cambodia's tourism and clothing exports and push up inflation. Tourism could also be affected by any intensified conflict on the border with Thailand or by renewed political strife in Thailand. Lack of progress on fiscal consolidation, with low tax revenue and absence of government debt securities, may lead to problems in funding the fiscal deficit. The relatively low involvement of Japan in Cambodia's trade, tourism, and foreign investment suggests a modest effect on the economy from the earthquake in Japan in March 2011.

3.23.8 Current account balance



Source: Asian Development Outlook database

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Development challenges

The impact of the global recession on the economy highlighted the need for Cambodia to reduce vulnerability to external shocks by accelerating economic diversification and improving competitiveness of industries.

Sources of growth in recent years—garments, tourism, and construction—were all hit hard by the global downturn. A stronger agriculture sector would not only diversify sources of growth but also help to extend development to rural areas where 90% of the poor live. Food exports to Asian markets such as the PRC would reduce the heavy reliance on the US and EU clothing markets—hence the government's efforts to promote rice production and milled rice exports.

The clothing and tourism industries are hampered by high costs for electricity, until Cambodia builds its generation and distribution capacities, and for trade, which involves numerous bureaucratic procedures and unofficial fees. These industries need to raise the quality of their products and services and develop skills to support higher-value-added activities.

Cooperation is increasing with neighboring countries to enable Cambodia to tap into growing markets through increased connectivity. The country lies at the heart of the Greater Mekong Subregion southern economic corridor extending from Thailand to Viet Nam through highways and railway links that form part of the Singapore–Kunming rail project. To meet competition in these markets and to strengthen value chains in agriculture, manufacturing, and tourism, Cambodia needs to intensify efforts to reduce transport and logistics costs, especially at ports and border crossings.

Indonesia

A welcome increase in investment and expansion of private consumption contributed to a quickening in GDP growth in 2010, as external trade rebounded. Economic growth is forecast to step up this year and next. Near-term challenges are to curb inflation and manage surges in capital inflows, while reaching the government's medium-term growth target requires higher levels of investment in infrastructure.

Economic performance

A pickup in economic growth last year was driven by strong private consumption, buoyant investment, and robust recovery in export demand. GDP increased by 6.1%, recovering from a slowdown during the global recession in 2009 (Figure 3.24.1).

Private consumption, supported by a strengthening labor market and rising prices for agricultural commodities, increased by 4.6% and contributed 2.7 percentage points of GDP growth.

Fixed capital investment grew by 8.5% and contributed 2.0 percentage points to GDP growth. Investment in machinery and equipment rebounded by 17.1%, from a contraction in 2009, while that in buildings, including infrastructure, grew by 7.0% in 2011. Investment's healthy rise was underpinned by improvements in the domestic and global investment climate, an appreciation of the rupiah, and growth in credit. Gross fixed capital formation as a ratio to GDP rose to 32.2% (Figure 3.24.2).

Net exports also contributed to GDP growth, but government consumption did not, as the authorities unwound fiscal stimulus and lagged in disbursement of capital spending.

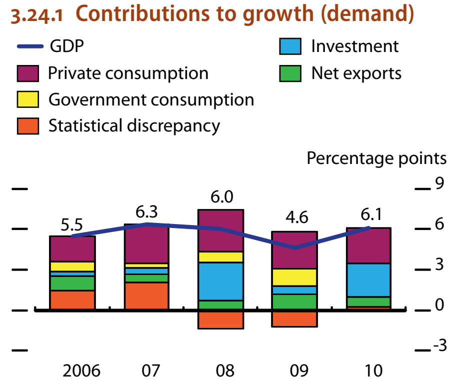
From the supply side, services again came in with the strongest expansion, at 8.4%, contributing 3.8 percentage points to GDP growth. Transport and communications recorded double-digit strengthening. Industry grew by 4.7%, reflecting a modest recovery in manufacturing, offset in part by slower growth in mining and quarrying. Manufacturing is still hindered by poor infrastructure and stringent labor regulations, while mining activity slowed during periods of unusually heavy rain last year.

Agriculture grew by 2.9%, the weakest increase in 5 years, as it, too, was set back by heavy rain.

Food supply disruptions caused by the bad weather and by infrastructure weaknesses drove inflation up from 2.8% in late 2009 to 7.0% in December 2010 (Figure 3.24.3). It exceeded the central bank's target of 4.0%–6.0% in some months (the year-average rate was 5.1%). Food price inflation was running at nearly 16% late in 2010.

Faced with rising inflation and a surge of capital from abroad, Bank

3.24.1 Contributions to growth (demand)



Source: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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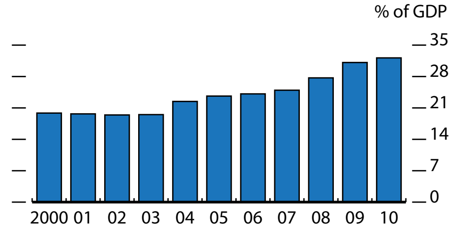
3.24.2 Gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

Indonesia left its policy interest rate unchanged at 6.5% for 18 months (after cutting it by 300 basis points during October 2008–August 2009). Only in February 2011 did the central bank start to return the policy rate to more normal levels, edging it up by 25 basis points.

Bank Indonesia did, though, raise the reserve requirement for commercial banks, from 5.0% to 8.0% in November 2010. This measure absorbed an estimated Rp53 trillion of excess liquidity in the banking system (equal to about 3% of total bank lending). A 4.5% appreciation of the rupiah against the US dollar in 2010 provided some cushion against imported inflation.

Commercial banks passed on to borrowers only part of the central bank's policy rate cuts through August 2009. Credit growth was low until mid-2010, when it accelerated with economic activity, and was running at about 22% by year-end (Figure 3.24.4). That was still a little below Bank Indonesia's target, in part because lending rates remained relatively high. Banks' gross nonperforming loans fell by 1 percentage point in 2010, to 3.4% of total loans.

Recovery in world trade and higher commodity prices produced a 32% surge in merchandise exports to $158.2 billion in 2010 (Figure 3.24.5). Exports of natural rubber more than doubled, and exports of palm oil rebounded by about one-third. The value of metal ore and coal shipments jumped by 32%. Imports rose even faster than exports, by 42% to $127.1 billion, reflecting strong demand for intermediate and capital goods.

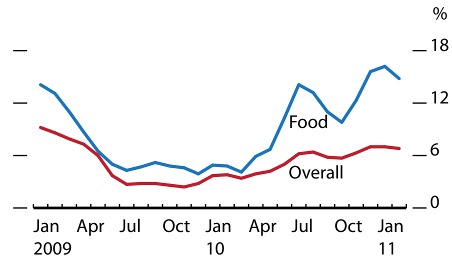
Nevertheless, the trade surplus rose to $31.1 billion in 2010 owing to a higher base for exports. The current account surplus moderated to $6.3 billion (0.9% of GDP). The transfers account recorded a marginally greater surplus, owing to growing remittances from migrant workers. However, the surplus was fully offset by widening deficits in the income and services accounts, due to higher interest payments and dividends to foreign investors and steeper freight costs attributable to a larger volume of exports.

The capital and financial account recorded a $26.2 billion surplus in 2010, up significantly from $5.0 billion in 2009, driven by higher inflows of portfolio and foreign direct investment. Portfolio inflows surged by 47.1% to $15.2 billion. Net foreign equity purchases estimated at $23 billion pushed the Jakarta Stock Exchange index of share prices up by 46% in 2010. Foreign holdings of government rupiah bonds increased by the equivalent of about $9.8 billion (81.3%—Figure 3.24.6) and their yields fell steeply.

Foreign direct investment more than doubled to $12.7 billion, reflecting the better domestic and international investment climate. Gross international reserves climbed by over $30 billion, to $96.2 billion at year-end, covering 7.1 months of imports and government debt payments.

More new jobs were generated in 2010 than new entrants to the labor market, helping to lower the unemployment rate to 7.1% in August 2010 from 7.9% a year earlier (Figure 3.24.7). This played a role in bringing back into the formal sector many of the workers who had been laid off from that sector during 2009's slowdown and had been working informally. Most new jobs created were in services. The employment share of the informal sector remains high, though, at around two-thirds.

3.24.3 Monthly inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2011).

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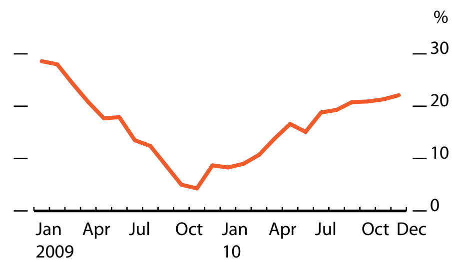
3.24.4 Credit growth



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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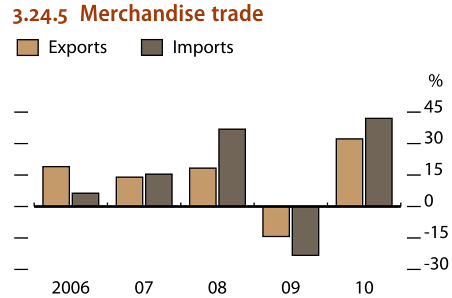
3.24.5 Merchandise trade



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 March 2011).

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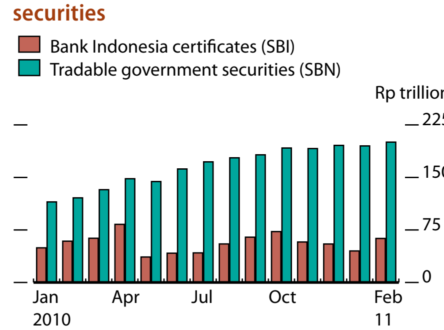
3.24.6 Foreign ownership of government securities



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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Household survey data show that poverty incidence fell to 13.3% in March 2010 from 14.1% in March 2009, and the number of poor in both rural and urban regions fell below 2004's levels for the first time.

Lower than budgeted spending, an increase in the tax-to-GDP ratio, and the impact of higher commodity prices on revenue tightened the budget deficit to an estimated 0.6% of GDP in 2010, well below the government's 2.1% of GDP projection. Central government revenue rose by 19.5% from the previous year. Government spending was 6.5% below projection, mainly because capital expenditure fell 20.6% short of budget.

Total spending on subsidies reached Rp214.1 trillion (3.4% of GDP), 6.4% more than projected, due to higher electricity subsidies and expansion of a program that provides rice to the poor. As a share of GDP, central government debt fell to about 26%, less than half its proportion in 2004 (Figure 3.24.8).

Efforts to improve the investment climate were illustrated by a reduction in the corporate income tax rate to 25% in 2010, the opening of a few more sectors to foreign investors, and new tax concessions for certain investments. The government launched a new system to reduce the time and costs of importing and exporting by allowing single submission, processing, and approval of import and export documents.

Recognizing such improvements (as well as the macroeconomic performance) the World Economic Forum's *Global Competitiveness Report* upgraded Indonesia's ranking by 10 places in 2010 to 44.

Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's upgraded its rating in January 2011 from Ba2 positive to Ba1 stable. Fitch raised its BB+ rating outlook from stable to positive in February 2011, which suggests an upgrade to investment grade within 12 months.

Economic prospects

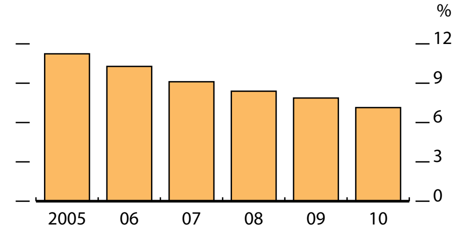
Forecasts assume that the government will continue to improve the investment environment, and that last year's bad weather (which hurt agriculture and mining) is not repeated in 2011.

Private consumption is forecast to expand on the back of increases in incomes brought about by the stronger labor market and high prices for agricultural commodities. Bank Indonesia's consumer confidence index rose sharply in January 2011 (Figure 3.24.9).

Private investment is expected to remain robust, given projected growth in domestic consumption and in external demand for agricultural products and minerals. Investment is supported by the growth in credit and higher levels of confidence in the country.

As for public investment, the government has budgeted for a near 30% rise in capital expenditure this year from the 2010 allocation, aimed at addressing infrastructure bottlenecks. Given chronic weakness in implementing capital works programs, the budgeted amount is unlikely to be fully drawn. To address this issue, the government is simplifying budget execution procedures and strengthening procurement capacity in spending agencies. It is also targeting higher overall spending and a wider budget deficit, equivalent to 1.8% of GDP, which should support GDP growth.

3.24.7 Unemployment rate



Source: CEIC Data Company (accessed 14 March 2011).

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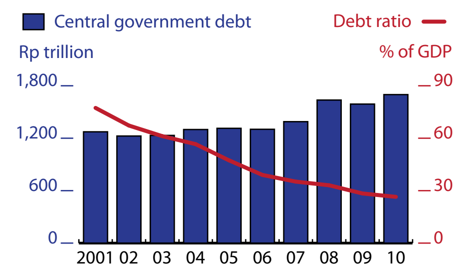
3.24.8 Government debt



Source: Directorate General of Debt Management. http://www.dmo.or.id (accessed 14 March 2011).

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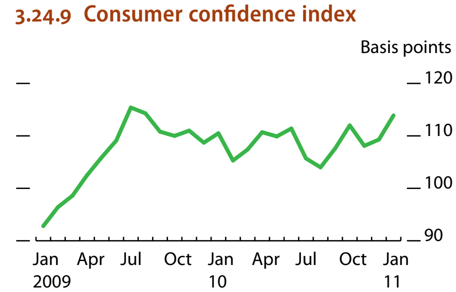
3.24.9 Consumer confidence index



Note: The index is constructed from a survey of Bank Indonesia among households. An index above 100 indicates optimism about the economy.

Source: CEIC Data Company (accessed 14 March 2011).

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From the production perspective, signs point to manufacturers in several important subsectors preparing for higher levels of output: investment in machinery has increased in some industries, including paper and printing, rubber, plastics, food and beverages and, to a lesser extent, the labor-intensive industries of textiles, leather, and footwear.

A survey by the statistics office in March 2011 showed that business managers expect business conditions to continue to improve in the second quarter (Figure 3.24.10).

Growth in services will be underpinned by the forecast rise in domestic demand. Agriculture and mining are likely to put in better performances than last year on the basis of better weather and high global prices for agricultural commodities, energy, and metals.

On this basis, GDP is forecast to expand by 6.4% in 2011 and 6.7% in 2012 (Figure 3.24.11), stepping up from average growth of 5.6% over the past 7 years. The growth forecast for the next 2 years would be the best rates achieved since 1996.

Merchandise export growth is forecast to decelerate to about 15% this year, given the high base set by the rebound in 2010. The earthquake in Japan will likely have a brief and modest impact on exports (Japan accounts for about 12% of exports). Reconstruction there will stimulate demand for Indonesia's energy and raw materials. Imports are projected to increase by about 17%, attributable to robust investment and consumer demand.

The trade surplus is expected to rise modestly, but deficits in the services and income accounts will widen due to higher freight costs associated with larger trade flows and repatriation of profits and dividends. The current account surplus is seen declining to 0.5% of GDP in 2011 and 0.1% in 2012. The overall balance of payments is forecast to remain in surplus as a result of continued (but moderating) portfolio inflows and foreign direct investment.

Inflation was about 7% in the first 2 months of 2011 and is likely to remain relatively high through the first half of the year before moderating in the second half on base effects and an expected improvement in domestic food supplies. For the full year, inflation is forecast to average 6.3%. It will subside a little in 2012 if global food and commodity prices decelerate as projected (Figure 3.24.12).

Deviations in inflation from Bank Indonesia's 4.0%–6.0% target risk eroding the credibility of monetary policy, thus entrenching expectations of higher inflation. If the current inflation pressure persists, the central bank is expected to gradually raise its policy interest rate to more normal levels and is likely to allow the rupiah to appreciate further.

To address localized food shortages, the government has directed its rice procurement agency Bulog to intervene in the market to ensure adequate supplies. It has also expanded a program that distributes 15 kilograms of rice each month to 17.5 million poor households and has suspended import duties on some food items.

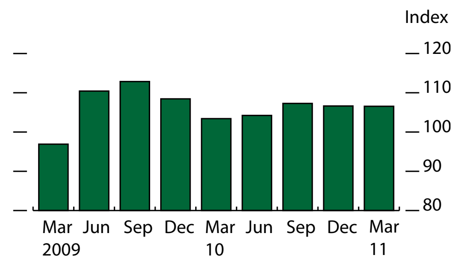
But inflation still poses a risk to the economic outlook. An unexpected sharp acceleration in prices could cloud the prospects for growth in private consumption, prompt a faster tightening of monetary policy, and raise fiscal outlays on subsidies, possibly at the expense of capital spending.

3.24.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.4	6.7
Inflation	6.3	5.8
Current account balance (share of GDP)	0.5	0.1

Source: ADB estimates.

3.24.10 Business tendency index



Note: An index higher than 100 means that business managers think that the current quarter will be better than the previous one.

Source: CEIC Data Company (accessed 14 March 2011).

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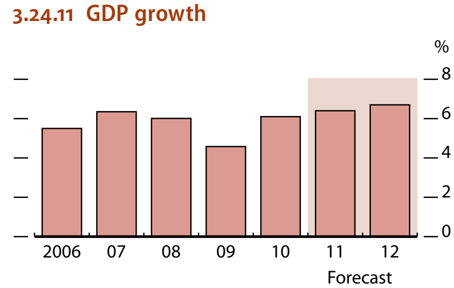
3.24.11 GDP growth



Source: Asian Development Outlook database.

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When combating inflation, the authorities must also manage surging capital inflows that exacerbate inflation and make the economy vulnerable to swings in investor sentiment. The focus has been on macroprudential regulation to damp short-term inflows. Bank Indonesia last year imposed a minimum 30-day holding period for central bank certificates (SBIs), changed auctions of these securities to monthly from weekly, issued longer-maturity SBIs, and introduced a new term-deposit facility for commercial banks to reduce the need to issue SBIs. The central bank introduced higher reserve requirements for foreign currency deposits and stepped up its monitoring and reporting of foreign exchange transactions and capital inflows.

In the first quarter of 2011, Bank Indonesia limited banks' short-term foreign loans to a maximum of 30% of their capital and decided to rely more on 9-month SBIs, further discouraging short-term investments.

Concerns over the rise in inflation, coupled with international financial markets jitters in early 2011, resulted in some reversal of short-term capital inflows.

For its part, the government proposed measures to Parliament to cushion the local-currency government bond market from capital flight. Under them, funds from state-owned enterprises and the budget can be used to buy bonds in the event of a sudden capital reversal. In addition, Bank Indonesia can draw on the country's foreign exchange reserves and bond buyback funds allocated in the 2011 budget to support the bond market.

Development challenges

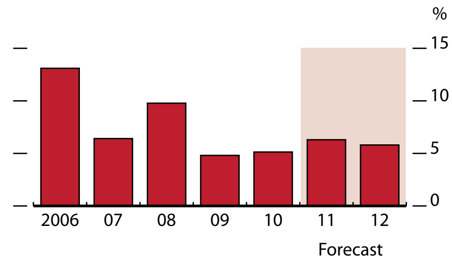
Although economic growth averaged 5.2% in the past decade, it remains below the 7%–8% rate recorded before the Asian financial crisis. This slowing of growth since the mid-1990s has been accompanied by lower growth in employment (Figure 3.24.13). The contribution of investment to growth has declined: the share of gross fixed investment in GDP fell from 26% in 1991–2000 to around 24% in 2001–2009 (although it has recently picked up to 32.2% in 2010). The contribution of private consumption has risen.

From the production side, growth has been driven by the nontradable sector (Figure 3.24.14), mainly services, while the performance of tradables, particularly manufacturing, has been lackluster. Employment generation in manufacturing has been stagnant, so that a large proportion of the labor force works in the informal sector, where wages and conditions are usually poor. Exports have become more dependent on volatile world commodity markets.

Significant gains in investment and exports are required if the government is to achieve its 2014 GDP growth target of 7%–8%. Investment is needed in infrastructure particularly, which would support growth of the more productive tradable sector. Government infrastructure spending as a share of GDP has fallen by nearly 50% from the first half of the 1990s and is well below that for faster-growing Asian economies. Logistics costs in Indonesia are estimated at about 14% of total production costs, compared with about 5% in, say, Japan.

Given that fiscal policy has focused on limiting budget deficits and

3.24.12 Inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 14 March 2011).

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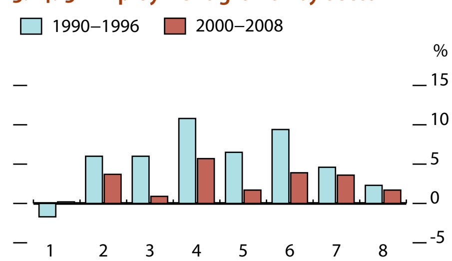
3.24.13 Employment growth by sector



1 = Agriculture; 2 = Mining and utilities; 3 = Manufacturing; 4 = Construction; 5 = Wholesale trade; 6 = Transport; 7 = Other activities; 8 = Total.

Source: ADB Statistical Database System.

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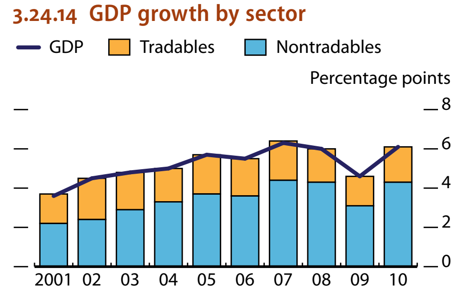
3.24.14 GDP growth by sector



Note: Tradables refer to agriculture, mining and quarrying, and manufacturing. Nontradables refer to utilities, construction, wholesale trade, transport, and other activities.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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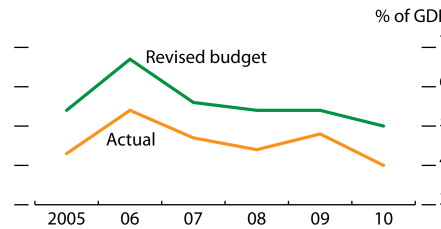
reducing public debt, at the same time as reorienting spending toward education and poverty reduction, the government needs to create greater budget resources (after accounting for essential spending) to lift infrastructure investment. Such space in the budget in the past 5 years has been low, at the equivalent of 4%–5% of GDP (Figure 3.24.15).

Pursuing reforms in tax administration would help generate such resources. The number of registered taxpayers increased by about 13 million in 2006–2010 and the tax-to-GDP ratio rose from 11.0% in 2009 to 11.7% in 2010. What is needed now are systems and procedures to increase compliance with tax laws, including a better tax database and modern information systems, risk-based compliance enforcement, and improvements in tax staff training and probity.

On the expenditure side, interest costs will fall if the government continues to bring down public debt as a ratio to GDP, and as a result of upgrades in the sovereign credit rating. Savings could also be made by better targeting of subsidies and avoidance of duplication across different levels of government.

Yet budget resources that were available were not always fully used. Indeed, the government has missed its budget deficit target by an average of 1% of GDP annually over the past 5 years, mainly because of an inability to complete spending programs. Moreover, a large proportion of budget spending is pushed through in the last quarter of each year. Efforts to improve budget execution by the public sector are getting greater attention from the authorities.

3.24.15 Discretionary expenditure



Sources: Ministry of Finance; ADB estimates.

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Lao People's Democratic Republic

Strong demand for exports of metals and electricity, coupled with a recovery in tourism, spurred GDP growth in 2010. Similar factors are forecast to underpin a slightly higher expansion this year and next. But inflation has been rekindled, so far at moderate levels. A central challenge is to preserve macroeconomic stability while pursuing growth.

Economic performance

After decelerating a little during the global recession, economic growth picked up to 7.5% in 2010 (Figure 3.25.1), returning to the average expansion rate of 2004–2008. This prolonged period of growth mainly reflects substantial investment in mining and hydropower.

Industry, representing about one-quarter of GDP, grew by 18.0% in 2010 and contributed most of the growth. Output of electricity more than doubled as the Nam Theun 2 hydropower plant, the biggest in the country at 1,070 megawatts, reached full capacity in April. Some smaller new plants, including Xeset 2 and Nam Leuk 1 and 2, also started generating power. Most of their output is exported to Thailand (Figure 3.25.2).

Mining production rose by 19.0% last year, spurred by higher global metal prices. Output of copper from the two main mines—Phu Bia and Sepon—rose by 21.0% to 147,500 tons. Gold production rose by 7.0% to 173,000 ounces and silver by 13.5% to about 500,000 ounces.

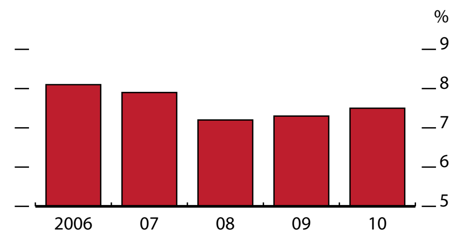
Construction activity benefited from expansionary fiscal and monetary policies.

The global recovery in travel lifted the number of tourists by about 25% to 2.5 million in 2010, with a strong rebound in tourism from Europe and the United States. That supported growth of 6.0% in the hotel and restaurant industry. Other services to grow by at least 6% were financial services, wholesale and retail trading, and transport and communications (boosted by the introduction of third-generation mobile telephone and Internet services). Services as a whole grew by 5.0%.

Agriculture, in contrast, which accounts for a third of GDP but employs about three-fifths of the workforce, suffered from bad weather (droughts followed by floods) as well as from diseases in pigs and cattle. Production of rice, the main crop, increased by about 4% to 3.26 million tons and fisheries recorded solid growth of 7.0%. The sector as a whole, though, grew by just 2.0%.

Consumer prices were on an upward trajectory last year, putting average inflation at 6.0%. Higher global oil prices pushed up the cost of fuel and transport, and bad weather and animal diseases disrupted food supplies, raising food prices. Strengthening domestic demand, the rollout of a value-added tax from April 2010, and growth in credit also fueled

3.25.1 GDP growth



Sources: Lao Statistics Bureau; Asian Development Outlook database.

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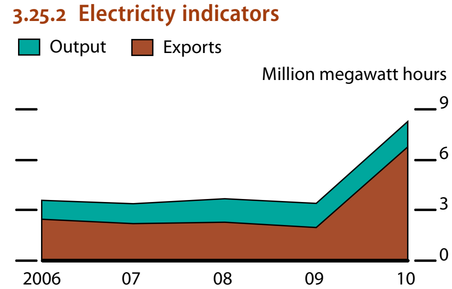
3.25.2 Electricity indicators



Source: Ministry of Energy and Mines.

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This chapter was written by A. Barend Frielink and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

inflation. Bank credit expanded by 46% last year, moderating from over 80% in 2008 and 2009. Growth in M2 money supply quickened to 39% in 2010 from 31% in the previous year (Figure 3.25.3).

Moving to counter inflation pressures, the Bank of the Lao PDR in September 2010 raised its policy interest rate, from 4.0% to 5.0% for loans of less than 1 week. It phased out direct lending for off-budget infrastructure projects, which had been a cause of high rates of growth in credit. However, disbursement of central bank lending committed in 2009 continued to feed credit growth.

The central bank also uses exchange rate policy to address inflation, aiming to limit fluctuations in the Lao kip to 5% a year against major currencies. In 2010, the kip rose against the US dollar by 3.0% but fell by 5.0% against the Thai baht (Thailand is a major source of imports).

The effectiveness of monetary policy is hampered by the widespread use of the US dollar. To promote use of the kip, the government has directed most of its revenue departments to accept only that currency and has asked wholesalers and retailers to use it for quoting prices. Such measures have helped to lower the level of dollarization to below 50% in 2010, from a peak of 79% in 1999.

Strong growth in government revenue, in part a result of high global prices for copper and gold, helped to rein in the budget deficit in FY2010 (ended 30 September 2010). Growth in spending moderated relative to FY2009, when the government had lifted outlays to cushion the impact of the global recession. The budget deficit, including grants but excluding off-budget spending, narrowed to an estimated 3% of GDP from 5.1% in FY2009. Including off-budget spending, it was close to 5%.

Higher metal production and prices, along with the start of exports from Nam Theun 2, raised the US dollar value of merchandise exports by an estimated 30% to $1.9 billion in 2010. Mineral exports exceeded $1 billion for the first time and electricity exports rose to $375 million. Shipments of clothing increased in value by about 14% to $184 million, mainly on better demand from Japan and the Republic of Korea.

Merchandise imports rose by an estimated 13.5% to $2.8 billion. The trade and current account deficits narrowed, the latter to an estimated 9% of GDP from 12% in 2009 (Figure 3.25.4). After accounting for capital inflows, gross international reserves climbed to $727 million at end-2010, sufficient for about 3.5 months of nonresource imports.

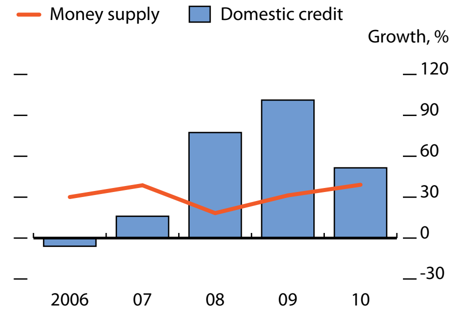
As part of a more than decade-long effort to join the World Trade Organization, the government made progress in bringing foreign exchange, investment, tax, and trade regulations into line with the organization's requirements, and completed bilateral goods and services agreements with the People's Republic of China and Japan.

Economic prospects

The government's Seventh Socio-Economic Development Plan (2011–2015) strongly emphasizes growth, targeting annual average GDP expansion of 8% and moving the country from least developed country status by 2020.

Scheduled hydropower and mining activity in 2011 and 2012 will underpin growth. Nam Theun 2 will contribute to GDP for a full year from this year, and another relatively large new plant, Nam Ngum 2

3.25.3 Monetary indicators



Source: *Asian Development Outlook* database.

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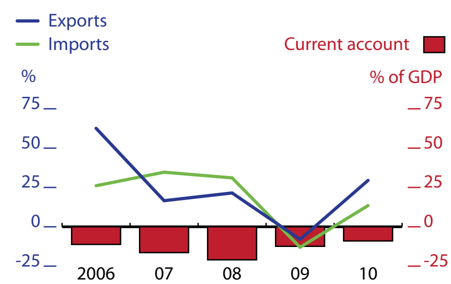
3.25.4 Current account indicators



Sources: *Asian Development Outlook* database.

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3.25.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.7	7.8
Inflation	6.5	6.0
Current account balance (share of GDP)	-9.0	-10.0

Source: ADB estimates.

(615 megawatts) is expected to be running at full capacity from April this year. Construction is set to start on a Nam Ngum 3 plant by midyear.

The Phu Bia and Sepon mines are scheduled to increase output this year, and construction is getting under way at the Hongsa coal-fired power plant (1,878 megawatts) and an associated coal mine. This project will cost more than $3 billion and is scheduled to generate electricity, mainly for export, from 2015.

A potash mine is being brought into production and a new rail line from the capital Vientiane to Yunnan province in the People's Republic of China is scheduled to be built by companies from that country. If this 5-year rail project starts as planned, it will likely have only a small impact on GDP this year but a greater contribution from 2012.

Services and construction are expected to maintain solid growth, bolstered by expansion of domestic demand and of tourism. Export orders suggest that clothing shipments will increase by about 10% in 2011.

Further, agriculture is expected to return to trend growth of about 2%, if weather permits, while higher global prices for cassava, corn, and sugar are likely to encourage wider planting. Private investment in plantation and contract farming is laying the basis for production gains for coffee, sugarcane, and some other crops in the years ahead.

Taking these factors into account, GDP growth is forecast to edge higher to 7.7% in 2011 and to 7.8% in 2012.

The government has budgeted to increase spending by 23% in nominal terms in FY2011, and it expects revenue to rise by about 27% owing to projected high prices for metals and April's rollout of the value-added tax. This would put the budget deficit at about 3% of GDP. On monetary policy, the target is to restrain growth in M2 money supply to 20% and in credit to 25% in 2011. The phasing out of central bank lending for off-budget projects should facilitate this tightening.

Higher prices for imported oil, coupled with growth in credit and a possible further depreciation of the kip against the Thai baht, will maintain upward pressure on inflation, which is projected at about 6.5% in 2011.

Merchandise exports are forecast to rise by about 25% in value this year, reflecting buoyant copper and gold prices and higher exports from the Nam Theun 2 and Nam Ngum 2 power plants. Exports of clothing and farm products, too, are projected to increase. Merchandise imports will likely grow at a slower rate than exports this year, but imports of machinery and materials for new projects are expected to pick up in 2012. The current account deficit is forecast to remain at around 9% of GDP in 2011 before widening in 2012 as imports accelerate.

The stock of external public debt, most of which is on concessional terms, has increased to $3.3 billion in absolute terms, but as a share of GDP it has declined to 52% from 82% over 5 years, owing to the growth in the economy and the kip's appreciation.

3.25.1 Development challenges

A central challenge is to pursue growth, as called for in the new development plan, while preserving macroeconomic stability.

A related issue is banking system soundness: high rates of growth in credit and a rapid expansion in the number of banks (from 13 to 23 in the 3 years to 2010) has increased risks for the banking system, which need to be addressed through vigilant supervision and a recapitalizing of state-owned banks.

Enduring challenges involve reducing poverty (the incidence was about 27% in 2008) and, related to this imperative, diversifying the economy's narrow base. Mining and hydropower have limited potential for job creation, and a heavy reliance on mining leaves the economy and the budget vulnerable to the inevitable downswings in global metal prices.

These twin goals therefore require investment and reforms in agriculture, which still supports the majority of the population, and improvements in the business environment to encourage a vibrant private sector.

Progress on the latter depends heavily on reforms in public sector management (including state-owned enterprises) and in public service delivery, as well as a more transparent and predictable policy and legal environment. The country is near the bottom (171 out of 183 countries) in the World Bank's *Doing Business 2011* ranking.

Transparency International places the country 154 out of 178 on its 2010 Corruption Perceptions Index, partly because the implementation or enforcement of approved laws and regulations remains weak.

The government has strategies to address governance and corruption, which focus on the public service, public participation, rule of law, and public finance. Their success will, though, depend on commitment from political leaders to ensure enforcement.

Malaysia

A robust recovery in 2010 was driven by stronger domestic demand and a recovery in exports. Domestic demand is expected to stabilize and GDP growth will moderate in 2011. Inflation is forecast to rise from low levels, but remain contained. The official goal to reach high-income country status by 2020 rests on effective implementation of a landmark but intricate structural reform program launched in 2010.

Economic performance

Strong domestic demand and a recovery in merchandise exports drove a 7.2% rebound in GDP in 2010 (Figure 3.26.1), after the global recession had pushed the economy into a 1.7% contraction in 2009.

Private consumption rose by 6.6% in 2010, buoyed by positive consumer sentiment, favorable labor market conditions, and rising credit to households and businesses. Public consumption was flat, reflecting reductions in operational expenditure as part of the government's fiscal consolidation efforts, which resumed (after a recession-related hiatus) in 2010.

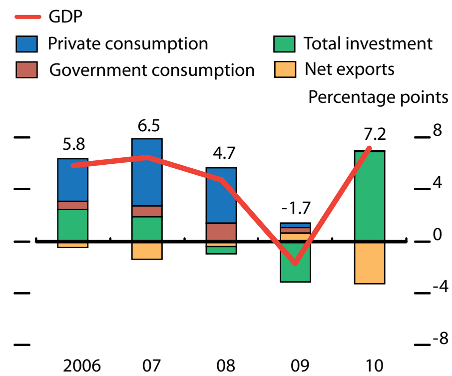
Investment, as measured by gross fixed capital formation and including public investment, surged by 9.4% and contributed most of the total growth in GDP last year. Private investment benefited from an expansion in production of domestically oriented manufacturing. The increase in exports of goods and services (9.8% in real terms) was more than offset by stronger growth of imports of goods and services (14.7%).

On the supply side, growth was supported by a relatively strong recovery in manufacturing output (11.4%) and by robust growth in services (6.8%) and construction (5.2%) (Figure 3.26.2). The recovery in manufacturing, which accounts for just over a quarter of total output, was driven by the strong growth in domestically oriented industries, notably those supplying construction and consumers. Export-oriented manufacturing was led by a surge in electrical and rubber products, and a more moderate expansion in chemical products.

Services, which account for 57% of GDP, experienced broad-based growth. The strongest gains were in real estate and business services, transport and storage, and wholesale and retail trade. Construction activity reflected a recovery in residential building, expansion in office and retail spaces, and progress in infrastructure projects. Agriculture, however, was subdued, as a rise in natural rubber production was largely offset by declines in crude palm oil and cocoa, while mining output was stagnant largely as a result of a 3.3% decline in crude oil production.

Inflation increased to average 1.7% in 2010, mainly owing to higher prices of food and drink and nondurable goods. Rising global commodity and energy prices lifted inflation to 2.4% year on year in January 2011 (Figure 3.26.3). An increase in the administered price of sugar in late 2010

3.26.1 Contributions to growth (demand)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

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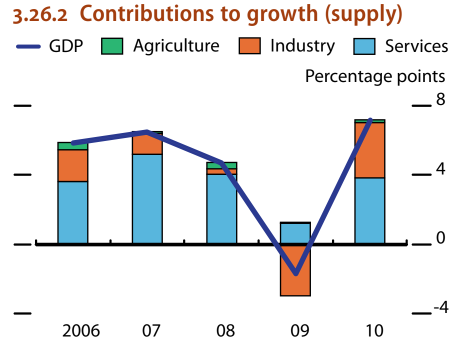
3.26.2 Contributions to growth (supply)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

Click here for figure data

This chapter was written by Eric Sidgwick of the Southeast Asia Department, ADB, Manila.

contributed to inflation. Core inflation, which excludes the more volatile food and drinks, has been edging up steadily since February 2010.

Residential property prices rose quite sharply in 2010, with the house price index up by about 6% through end-September (the latest available data) reflecting higher prices in Kuala Lumpur and Selangor state.

As private sector demand rebounded, Bank Negara Malaysia, the central bank, unwound a good part of the monetary stimulus injected in 2009. It raised the overnight policy rate three times during March–July 2010, by a cumulative 75 basis points, to 2.75%, and kept it there through the rest of the year. The economy's output was still below its potential and there were no strong signs that rising inflation stemmed from demand pressures. Moreover, the appreciation of the ringgit against trading partner currencies, of around 10% in 2010, helped to damp imported inflation.

Labor market conditions generally mirrored the rebound in domestically generated economic activity. While the labor force increased by 2.2% in 2010, to 11.7 million, the number of people employed rose by 2.5%, to 11.3 million. The unemployment rate fell to 3.2% in December 2010, from 3.4% at end-2009.

In United States (US) dollar terms, total merchandise exports rebounded in 2010, by 26.4%, to $198.6 billion (Figure 3.26.4)—following a contraction of 21.1% in 2009—recovering 2008's level of exports. Shipments of electrical and electronic products (40% of total exports), rose by 20%, and other manufactured exports by about 30%. Exports of petroleum products, palm oil, liquefied natural gas, and crude petroleum (together a quarter of total exports) recorded surges of 33%–44%. The top five export destinations—Singapore, the People's Republic of China, Japan, the US, and Thailand (in that order)—represented just over half of total exports.

Imports rebounded faster than exports, surging by 33.6% to $156.2 billion, more than offsetting the 21.0% contraction in 2009. Imports of intermediate goods, which account for over two-thirds of the total, rose by about 34%. The trade surplus of $42 billion remained broadly unchanged from 2009 in US dollar terms.

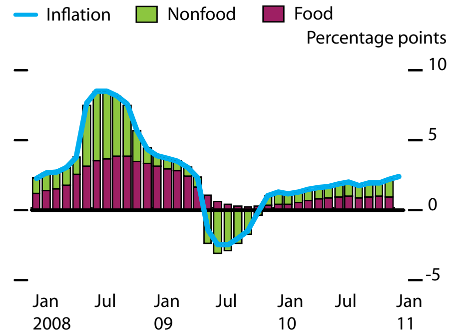
Higher payments for transport and other services linked to the initial sharp pickup in trade caused the services account to deteriorate. Deficits on the income and transfers accounts widened, the latter owing to higher remittances from foreign workers in Malaysia. As a result of these moves, the current account surplus declined by 11.7% to $28.1 billion, equivalent to 11.8% of GDP.

The capital and financial account deficit narrowed greatly, owing to lower net foreign direct investment (FDI) outflows, and a surge in portfolio inflows of $14.0 billion (Figure 3.26.5), reflecting a strengthening ringgit and sharply higher equity inflows, mostly from Europe, into government securities, corporate bonds, and stocks.

Inward FDI climbed to $8.6 billion, with a particularly steep rise in investment in services, while outward FDI surged to $13.2 billion. Other capital outflows decreased slightly, on account of lower private capital outflows. International reserves at end-February 2011 were up to $109.8 billion, sufficient to finance 8.1 months of retained imports and equivalent to 4.3 times short-term external debt.

Following an expansionary fiscal policy in 2009, consisting of two

3.26.3 Monthly contributions to inflation



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

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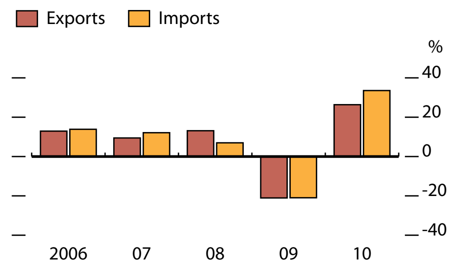
3.26.4 Trade growth



Source: CEIC Data Company (accessed 16 March 2011).

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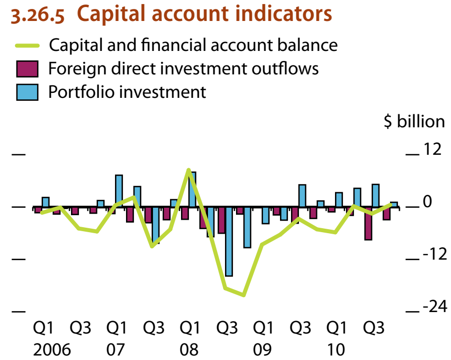
3.26.5 Capital account indicators



Source: CEIC Data Company (accessed 16 March 2011).

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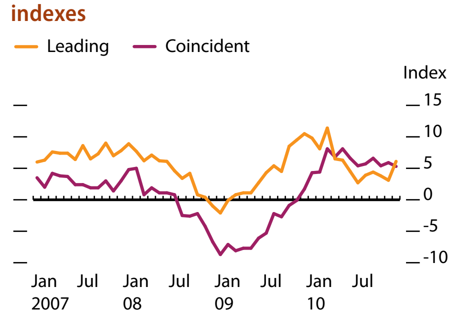
3.26.6 Growth of leading and coincident indexes



Source: CEIC Data Company (accessed 16 March 2011).

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fiscal stimulus packages that widened the overall federal budget deficit to 7.0% of GDP, preliminary figures indicate that the deficit narrowed in 2010 to 5.6% of GDP, as budgeted. This outcome was achieved mostly through a modest increase in revenue and restrained operational spending.

By mid-2010, direct subsidies had risen to nearly 11% of federal government operating expenditure, with over half going for fuel subsidies. Moving to rein in this cost to the budget, three times in 2010 the government raised fuel prices (they are still lower than in neighboring countries) and sugar prices by just over 10%.

Reflecting the reduction in the federal budget deficit, the ratio of federal government debt to GDP declined from 54.0% in 2009 to 51.3% in 2010. Only 3.5% of the public debt was external.

Economic prospects

The outlook for the forecast period are predicated on two key assumptions (in addition to the *Asian Development Outlook 2011* baseline for the global economy). First, the surge in mostly short-term capital inflows stabilizes and does not generate inflation pressures. Second, the government can quickly start carrying out its structural reform program (Box 3.26.1), which will require not only effective horizontal coordination across line ministries and agencies but also vertical coordination between the federal and state governments.

On this basis—and against the backdrop of slowing growth in external demand from major industrial countries, continuing domestic fiscal consolidation, and dissipating base effects—GDP growth is projected to moderate to 5.3% in 2011.

Domestic demand is likely to be the key driver of growth, reflecting broadly positive consumer and investor sentiment. Net exports are expected to exert a continued (though lightening) drag as the rate of growth of imports of goods and services stabilizes following the rebound in 2010.

Private consumption is seen staying robust and benefiting from relatively favorable employment, good real wages in manufacturing, rising commodity prices, and the accommodative financing environment. Consumer sentiment, for example, rose in the fourth quarter of 2010.

Private investment is expected to pick up later in 2011—the Department of Statistics' leading index rose by 2.7% in December last year (Figure 3.26.6). With ample liquidity, private investment is seen gathering momentum as the government starts implementing its structural reforms.

Exports are projected to rise moderately in 2011, by 8.0%, as softer demand from Japan and the US is only partly compensated by more robust demand from Asia. Imports are foreseen to rise by 10.0%, reflecting continued imports of capital equipment and intermediate goods. The current account surplus is likely to decline further in 2011, to 10.0% of GDP. The capital and financial account deficit is set to shrink, on the back of healthy portfolio inflows and FDI, bringing about an increase in international reserves.

In 2012, growth is forecast to remain at 5.3%, as the projected modest rise in export growth is offset by the anticipated adverse impact on inflation and domestic demand stemming from increased global food prices this year. Also in 2012, higher capital imports associated with

3.26.1 Structural change

The goal of the structural reform program launched by the government in 2010 is to enable Malaysia to break free of a middle-income trap and reach high-income country status by 2020.

The intended structural sea-change is to be achieved by four main approaches:

- generating growth that is more inclusive and sustainable, through the implementation of eight "strategic reform initiatives" to ease constraints to higher private investment;
- implementing market-friendly affirmative action programs that target the bottom 40% of households, many of which are in Sabah and Sarawak;
- improving public service delivery while reducing large and persistent fiscal deficits stemming in part from high subsidies; and
- placing equal emphasis on protecting the environment and economic growth.

An Economic Transformation Program prepared with private sector input identifies about 130 projects that involve huge, primarily private, investment over 10 years. Another 60 projects have been identified for subsequent implementation.

The success of the structural transformation, the first phase of which begins under the recently endorsed Tenth Malaysia Plan 2011–2015, will be measured against set objectives and delivery of impacts over the next decade.

In the nearer term, the credibility of the program will be judged on how well strategic reform initiatives improve the investment environment, and how effectively the associated projects are implemented, as measured by consumer and investor sentiment and higher actual investment.

stronger private investment are likely to outweigh the rise in exports, and the current account surplus is expected to narrow to around 9.0% of GDP (Figure 3.26.7).

The 2011 budget aims for a slight reduction in the federal government deficit to 5.4% of GDP by reducing gross development expenditure by 9% in ringgit terms from the 2010 outturn.

Inflation is seen rising this year, mainly reflecting global increases in food and fuel prices and reductions in fuel subsidies domestically. Average inflation is put at 3.0% in 2011 and 2012 (Figure 3.26.8).

While the monetary stance remains accommodative, large shifts in global liquidity—including from potentially volatile portfolio inflows—are building liquidity in the domestic financial system. Bank Negara Malaysia, in a preemptive bid to help offset the risks of economic and financial imbalances arising from such a buildup, doubled the statutory reserve requirement of commercial banks to 2%, from 1 April this year. It had already indicated in March that it might need to raise interest rates if domestic demand rose and put upward pressure on prices.

The economy relies heavily on external markets, and the main downside external risk to the forecasts is a lower than expected recovery in demand from major industrial countries. The competitiveness of manufactured exports could be dented by further real appreciation of the ringgit.

Domestic risks center on any apparent lack of progress by the government's structural reform program, which includes steps to quickly improve the investment climate. Such perceptions could drag down investor sentiment, inhibiting the required increase in private investment.

Development challenges

Over three decades, Malaysia has largely eradicated poverty, built a world-class infrastructure, and become a major exporter. Yet the country is stuck in a middle-income trap—per capita gross national income was around $7,350 in 2009—in which the strategies adopted to attain the current level are inadequate to take it to the next stage.

The ratio of private investment to GDP has stagnated at below 25% of GDP for a decade, compared with rates of over 30% of GDP in the mid-1990s, partly because doing business in Malaysia is still too difficult. The country is also losing its attractiveness as an investment destination, seen in its falling ranking in the Global Competitiveness Index—26 in 2010 (Figure 3.26.9).

Another vulnerability is that exports are heavily concentrated in electrical and electronic products—eventually destined for industrial-country markets where demand is volatile—and primary commodities (such as petroleum and palm oil) whose prices are volatile. Both types of export generate little value added and employ workers mainly of low-skills on low-wages. And although labor productivity is growing, it is doing so slowly, inhibiting creativity and innovation. Socially, the gap between rich and poor is widening.

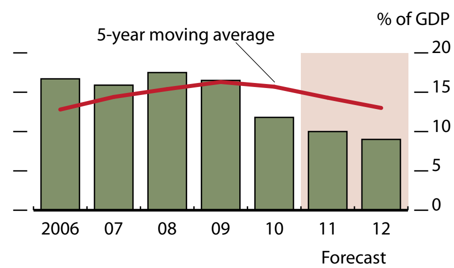
It is in this context that the government has embarked on its ambitious structural reform program (Box 3.26.1).

3.26.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.3	5.3
Inflation	3.0	3.0
Current account balance (share of GDP)	10.0	9.0

Source: ADB estimates.

3.26.7 Current account balance



Sources: Asian Development Outlook database; ADB estimates.

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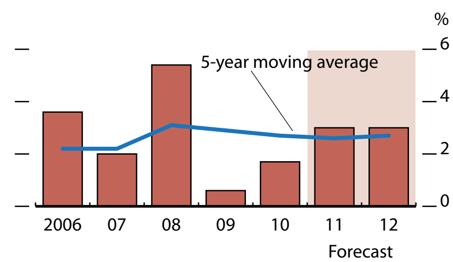
3.26.8 Annual inflation



Sources: Asian Development Outlook database; ADB estimates.

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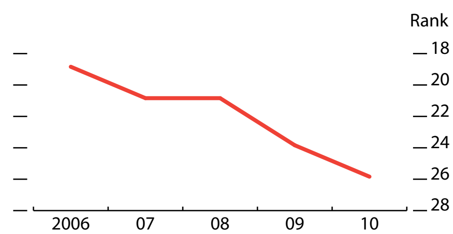
3.26.9 Global competitiveness



Note: The Global Competitiveness Index covers 139 economies.

Source: World Economic Forum. *Global Competitiveness Report*. Various years. http://www.weforum.org

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Myanmar

Economic growth edged up over the past 2 years, accompanied by relatively modest inflation. The economy is expected to grow moderately over the forecast period, supported by foreign investment in construction and higher levels of credit to agriculture. The government that took office in March 2011 faces an extensive agenda of reforms if the country is to reach its potential.

Economic performance

Growth recovered to an estimated 5.1% (Figure 3.27.1) in the fiscal year ended 31 March 2010 (FY2009), after slowing in the previous year owing to the impact of Cyclone Nargis and weakness in demand for imports from neighboring economies. The recovery in FY2009 was led by improved results from agriculture, mining, manufacturing, and the transport and communications subsectors. Living standards remain low, however.

Agriculture, including fisheries, forestry, and livestock, accounts for over half of employment and about 40% of GDP. Production from this sector picked up in FY2009 as areas damaged by the cyclone, mainly in the Ayeyarwady and Yangon divisions, were gradually rehabilitated.

More recently, economic growth edged up to an estimated 5.3% in FY2010 (ending 31 March 2011), with a solid contribution from construction, particularly in Naypyidaw, the new capital, and Mandalay (a highway connecting these cities was under construction). Economic recovery in neighboring countries that import goods including food and natural gas from Myanmar supported the lift in growth in FY2010.

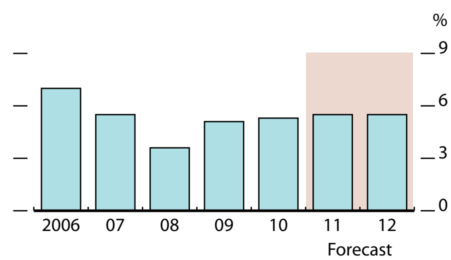
Agriculture in FY2010 was sluggish, however, a result of persistent drought in the central region and residual soil salinity in cyclone-affected areas.

(Official GDP growth figures, which are considerably higher than these unofficial estimates, are inconsistent with variables that are closely correlated with economic growth, such as energy use. Economic data are not timely either, making it difficult to assess economic developments.)

The government has financed part of its fiscal deficit through Treasury bond issues in the past 3 years, rather than relying completely on money creation to finance the fiscal gap. This approach has contributed to lowering inflation from over 20% to single digits in that period. Average inflation was estimated at 8.2% in FY2009 and 7.3% in FY2010.

Export income from natural gas continued to support the external accounts. Export prices for gas fell by about 20% in FY2009, dragging down earnings from this source, but receipts recovered to $2.7 billion in FY2010 as demand from Thailand picked up. However, higher levels of

3.27.1 GDP growth



Source: Asian Development Outlook database.

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This chapter was written by Alfredo Perdiguero of the Southeast Asia Department, ADB, Manila.

imports of construction materials and equipment widened the current account deficit to the equivalent of 2.2% of GDP in FY2010, from 1.3% in FY2009.

Inflows of foreign direct investment into the hydrocarbon sector helped to lift international reserves to about $5.3 billion at end-FY2010, equivalent to 7 months of imports (Figure 3.27.2). The market exchange rate of the kyat appreciated from about MK1,000/$1 to MK830/$1 in the year to January 2011.

Estimates of the consolidated fiscal deficit, covering the central government and state economic enterprises, indicate it widened to 5.7% of GDP in FY2010 from 5.4% in FY2009 (Figure 3.27.3). Expenditure on the construction of Naypyidaw remained a drain on the budget, while revenue growth was sluggish. The practice of valuing exports of state enterprises at the official exchange rate of MK5.5/$1 (as opposed to the market rate) undervalues revenue available for spending.

High administered bank interest rates (17% for lending and 12% paid on deposits) discourage banks from buying the lower-yielding Treasury bonds. Consequently, bond issues funded only about one-third of the fiscal deficit in FY2010.

The government privatized several state assets in 2010, including an airline, 243 gasoline stations, public buildings, and rice distribution operations. Further asset sales are expected.

Economic prospects

Forecasts assume both normal weather patterns and a start to gradual economic reforms by the government that took office in March 2011.

A modest increase in rural incomes, owing to increased exports and prices of cash crops, is expected to underpin private consumption in FY2011.

The Myanmar Agriculture Bank doubled credit to farmers in 2010. Further increases are planned in the next 2 years, going some way to addressing severe shortages of credit to agriculture. These moves, coupled with the gradual easing of controls on agriculture over recent years, are expected to stimulate production.

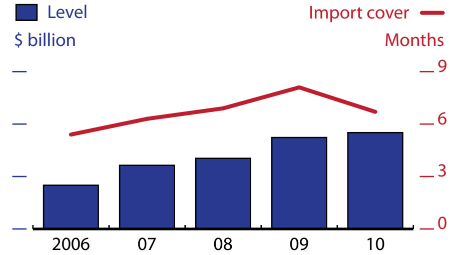
Investment is projected to rise in the forecast period, notably in construction. Projects planned or under way include new hydropower plants, gas fields, and oil and gas pipelines to the People's Republic of China, largely financed by foreign investment. A Thai company agreed last year to build a port, power plant, and industrial estate in Dawei in southern Myanmar starting this year, and a company from the People's Republic of China signed a contract to build an airport at Naypyidaw.

Gas production is projected to be fairly flat in the forecast period, before new projects come on stream in about 3 years. Gas export prices will likely rise, together with global energy prices and solid demand from Thailand. (This will have a limited impact on GDP because gas income is converted at the official exchange rate rather than the market rate.)

On the balance of these factors, GDP is forecast to grow by about 5.5% in the next 2 years.

Inflation is projected at 8.0% in the forecast period (Figure 3.27.4), reflecting higher domestic demand and increased global prices of food

3.27.2 International reserves



Sources: *Asian Development Outlook* database.

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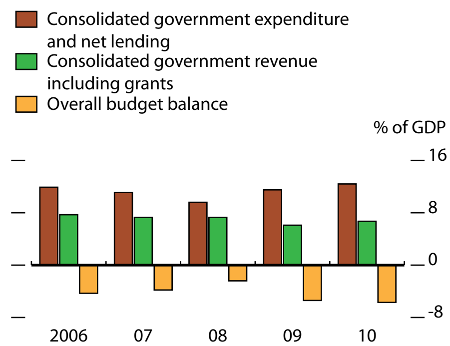
3.27.3 Fiscal indicators



Source: *Asian Development Outlook* database.

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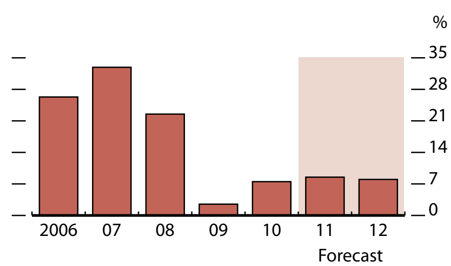
3.27.4 Inflation



Sources: *Asian Development Outlook* database.

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and fuel. The domestic price of rice surged in early 2011. A government decision to suspend rice exports in March 2011 is expected to moderate price increases, but much rice is still exported illegally.

The current account deficit is seen widening to 4.1%–4.7% of GDP (Figure 3.27.5). Increases in export earnings from gas and food crops will likely be offset by stronger imports of capital equipment and construction materials.

3.27.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	5.5
Inflation	8.0	8.0
Current account balance (share of GDP)	-4.1	-4.7

Source: ADB estimates.

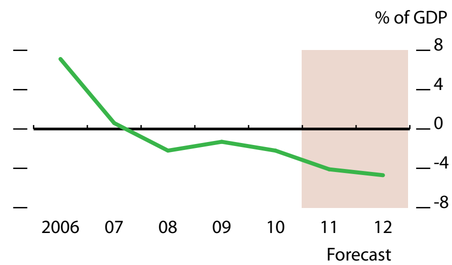
Development challenges

The country faces an extensive agenda of reforms to realize its potential. It lags its neighbors in living standards and poverty reduction, requiring a steep increase in economic growth, as well as a more equal distribution of income and wealth, to narrow this gap.

A comprehensive process of reforms includes improving the climate for investment, generating fiscal resources to expand social and infrastructure expending, unifying the exchange rate, developing the finance sector, strengthening macroeconomic management, and liberalizing agriculture and trade.

The finance sector is undeveloped but has considerable potential to support economic growth. Four new banks and 49 new bank branches were approved in 2010, helping lift private credit significantly. However, banking assets remain low and only about one-third of all private financing is sourced from the formal sector. Expanding access to formal finance involves allowing state banks to operate on a fully commercial basis, liberalizing interest rates, easing collateral requirements, and relaxing bank deposit-to-capital ratios.

3.27.5 Current account



Source: Asian Development Outlook database.

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Agricultural credit is inadequate, despite last year's improvement. Farmers are often unable to afford sufficient farm inputs and have reduced the intensity of land cultivation. Eliminating barriers for private banks to expand in rural areas, introducing crop insurance, and issuing land-use certificates to farmers could be useful reforms to expand credit. Such measures could be complemented by public investment in rural infrastructure.

Privatizing state assets has the potential to encourage private sector development if the outcome leads to greater competition and investment. Making the process more transparent would improve investor confidence and asset valuations. Developing the private sector more generally depends on upgrading the regulatory, legal, and policy environment, as well as introducing higher standards of governance.

Gas export income adds to foreign exchange reserves, but has little impact on GDP or the budget owing to conversion at the official exchange rate. Such income would greatly lift government revenue if it was converted at the market exchange rate, enabling increases in expenditure on health, education, and infrastructure (social spending as a ratio to GDP, at about 1%, is well below that of most developing countries).

Further in this direction, unifying the multiple exchange rates would create additional fiscal resources, as would broadening the tax base (with fewer tax exemptions), a simplified tax structure, and greater emphasis on direct (rather than indirect) taxes, which are fairer to the poor.

Philippines

Robust private consumption alongside recoveries in exports and investment drove a vigorous economic rebound in 2010, while inflation remained moderate and the external position strengthened. Yet progress remained slow in reducing poverty and generating jobs. The forecast is for solid economic growth this year and next, and sustained increases in investment now appear achievable—provided that the government pushes through with policy and governance reforms.

Economic performance

A strong recovery in 2010 lifted GDP by 7.3%, as private consumption accelerated and exports and investment rebounded from a slump in 2009 (Figure 3.28.1). Nearly 60% of total growth came from private consumption, which rose by 5.3%. Remittances from overseas workers remained a key support to consumption, growing by 8.2% to $18.8 billion (the increase in peso terms was 2.4%).

Investment contributed about 40% of total growth, the highest proportion in 10 years. Fixed capital outlays climbed by 17.1%, with equipment investment surging by 25.7%. Double-digit growth was recorded for investment in a broad range of equipment, including that for agriculture, construction, mining, metalworking, transport, and telecommunications. Fixed investment as a ratio to GDP edged up to 15.7%, the strongest rate in 6 years (Figure 3.28.2).

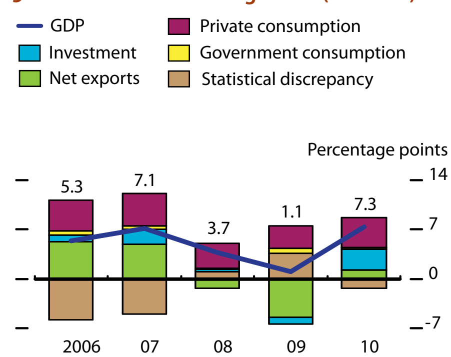
Recovery in exports and robust consumption underpinned this strong investment, with support from higher corporate earnings and low interest rates. Presidential and legislative elections in May 2010 went smoothly, and businesses generally were optimistic about the new government's commitment to improve the business climate. Surveys on business expectations showed steady gains in confidence throughout the year. Net exports, which had been a drag on GDP growth during the global recession, also made a positive contribution.

Government expenditure rose in the first half, before the new administration reined in some spending in the second half to curb the fiscal deficit.

On the production side, industry was the main contributor to growth (Figure 3.28.3), overtaking services. Manufacturing output increased by 12.3%, after shrinking in 2009. Export-oriented electrical machinery manufacturing shot up by nearly 33%, and industries such as food processing, petroleum products, and textiles recorded significant output gains. Construction activity rose by 10.5%, driven by strong demand for office space, particularly from the business process outsourcing subsector, and for housing. Low interest rates also stimulated construction.

This chapter was written by Teresa Mendoza and Norio Usui of the Philippines Country Office, ADB, Manila.

3.28.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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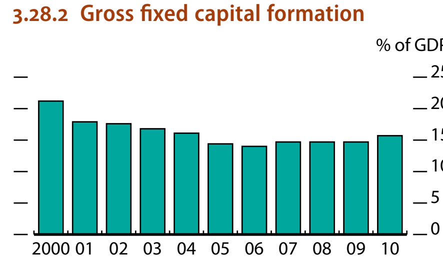
3.28.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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Services, still the biggest sector and generating about half GDP and employment, grew by 7.1% last year. Much of the growth came from retailing, which is bolstered by remittance inflows. Other high-growth components were business process outsourcing, finance, and real estate.

Dry weather caused by an El Niño weather pattern cut agricultural output, however, by 0.5%, a second consecutive year of weak performance (production was flat in 2009 mainly owing to severe tropical storms). Agriculture's share of GDP fell to just under 17%, although the sector still accounts for about a third of employment.

The strong economic rebound did not spark inflation (Figure 3.28.4): consumer prices rose by an average of 3.8%, within the 3.5%–5.5% target range set by Bangko Sentral ng Pilipinas, the central bank. Higher global oil prices pushed up transport costs (although an appreciating peso helped to damp imported price pressures) and electricity costs rose as the dry weather limited output from hydropower plants. Food price rises were relatively subdued, in part because rice imports countered local production shortfalls caused by the bad weather.

With moderate inflation, the central bank kept policy interest rates in 2010 at the low levels it set during the global downturn—the overnight borrowing rate at 4.0% and the overnight lending rate at 6.0%. Pressures to raise rates to more normal levels as the economy rebounded were lessened by the appreciation of the exchange rate and the fact that real policy rates remained positive. The central bank did, however, withdraw some of the liquidity-enhancing measures that it took during the recession. Domestic liquidity rose by about 11%, a moderate increase given the strength of the economic recovery.

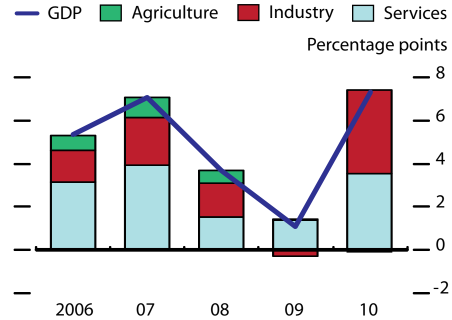
Merchandise exports shot up by 34.8% to $50.7 billion in 2010 (an increase of $13.1 billion over 2009), recovering from a 22% plunge in 2009 (Figure 3.28.5). Electronic products including semiconductors (three-fifths of total exports) surged by 40% as global demand bounced back. Shipments to the People's Republic of China and Southeast Asia nearly doubled from 2009, on healthy recovery there. The People's Republic of China accounted for 11.1% of total exports, well up from 7.6% in 2009, while Southeast Asia's share went up to 22.5% from about 15%. The share of exports going to the United States fell to 14.7% from 17.7%.

Imports rose by 31.5% or by $14.6 billion, reflecting strong demand for capital equipment, consumer goods, imported inputs for export-oriented manufacturing, and dearer oil. The deficit in merchandise trade widened by 17% to $10.4 billion, reflecting the higher growth in imports than exports.

The current account posted a surplus of $8.5 billion, equivalent to 4.5% of GDP, as a result of higher services receipts (mainly from business process outsourcing) and remittances. Coupled with the turnaround to net inflows in the capital and financial account in 2010, the overall balance-of-payments surplus rose to 7.6% of GDP.

Net portfolio investment amounted to $4.0 billion, driven by renewed global appetite for emerging markets. Partly on these inflows, stock prices soared by 38% and total stock market capitalization by 47% in 2010. The yield spread between United States and Philippine government bonds narrowed further (Figure 3.28.6). Still, net foreign direct investment remained low by regional standards, at $1.2 billion in 2010.

3.28.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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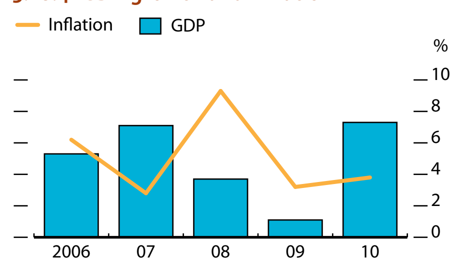
3.28.4 GDP growth and inflation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011); National Statistics Office. http://www.census.gov.ph (accessed 10 March 2011).

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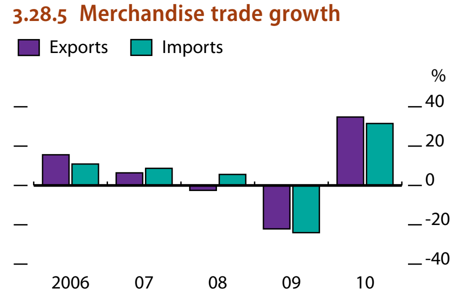
3.28.5 Merchandise trade growth



Sources: Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph; CEIC Data Company (both accessed 26 March 2011).

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Robust external accounts supported a 41% increase in gross international reserves to $62.4 billion at end-2010, equivalent to more than 10 months of import cover. The strong current account and capital inflows also drove a 5% appreciation of the peso against the US dollar in 2010. To temper gains, the central bank approved higher ceilings on foreign exchange purchases such as those for outward investment and import payments, and it encouraged the public and private sectors to prepay foreign currency–denominated debt.

Successful issuance of sovereign bonds eased concerns about financing the fiscal deficit. The government sold its first issue of peso-denominated global bonds in September 2010, and followed up with another large issue (equivalent to $1.25 billion of 25-year bonds priced to yield 6.25%) in January 2011. These issues, sold at a time of relatively low global interest rates, helped to reduce the government's foreign exchange risk and lengthen its debt profile. The government further raised $1.5 billion from the issuance of 15-year US dollar global bonds in March 2011. These issues were heavily oversubscribed.

Economic prospects

The outlook for this year and next assumes that the government follows through on its commitments to improve the fiscal position, governance, and the business environment, and that some of its planned public–private partnership projects start in the forecast period.

On fiscal policy, the government pulled back the deficit in 2010 to 3.7% of GDP from 3.9% in 2009. It trimmed noninterest expenditure in the second half by 0.4% year on year, after 15.8% growth in the first half (Figure 3.28.7). It also showed some progress in strengthening tax collection: tax revenue for the year rose by 11%, but was still short of target.

Fiscal policy will likely be less stimulative to the economy in 2011, given that the authorities aim to reduce the deficit to 3.2% of GDP (Figure 3.28.8). The budget approved in December 2010 restrains growth in public spending, but also puts greater emphasis on social services such as conditional cash transfers to the poor. It reduces infrastructure spending as the government looks to the private sector to play a greater role.

Five initial infrastructure projects (including construction of expressways and the privatization of light railway operations in Manila) are to be put out for bidding by midyear under public–private partnership arrangements.

The forecasts assume that monetary policy will be tightened gradually, continuing the first step made in March 2011 when the central bank raised the policy rates by 25 basis points to 4.25% for the overnight borrowing rate and to 6.25% for the overnight lending rate. They also assume that political uncertainties and natural disasters in countries that host many Filipino workers do not seriously hurt remittance inflows (about 16% comes from the Middle East and around 5% from Japan—Figure 3.28.9).

Sustained business optimism points to further growth in private investment. The outlook for business confidence for the second quarter of 2011 rose to the highest level since the survey started in 2001

3.28.6 Sovereign risk spreads

Source: Bloomberg (accessed 11 March 2011).

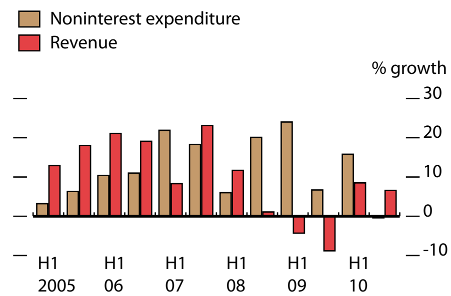
Click here for figure data

3.28.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.3
Inflation	4.9	4.3
Current account balance (share of GDP)	4.1	3.9

Source: ADB estimates.

3.28.7 Fiscal indicators



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 11 March 2011).

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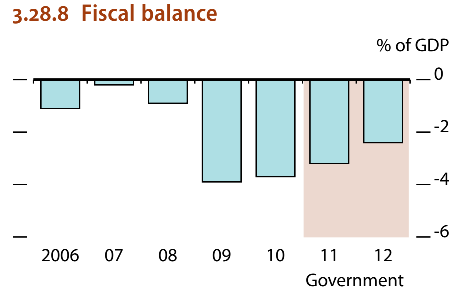
3.28.8 Fiscal balance



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 11 March 2011).

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(Figure 3.28.10). Investment pledges reported by government agencies rose by 73% in 2010, mainly for manufacturing, utilities, and real estate. Capacity utilization in some manufacturing industries is at high levels, which is conducive to investment.

Upgrades by credit rating agencies support the investment environment. Standard & Poor's raised the Philippines' long-term foreign currency debt rating in November 2010 to BB, or two notches below investment grade, at par with Fitch's. Moody's, which rates the Philippines Ba3, in January 2011 lifted its outlook on the country's foreign- and local-currency bonds to positive, from stable, citing the stronger external position, well-managed inflation expectations, and improved prospects of economic reform.

On the supply side, services will benefit from growth in private consumption and investment. Manufacturing will get support from increased domestic and export demand, though its growth will decelerate after last year's strong bounce. Private construction is seen remaining healthy because of sustained demand for office space and housing. Agriculture is projected to recover from last year's contraction, but a La Niña weather pattern evident early in 2011 could bring heavier rainfall than usual for part of this year.

Taking into account these factors and the base effect of the strong recovery in 2010, GDP growth is projected at 5.0% in 2011, quickening to 5.3% in 2012 (Figure 3.28.11) on the assumption that good progress is made on starting some public–private projects.

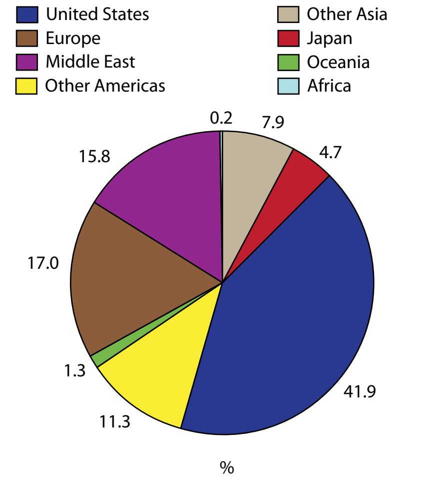
Inflation is forecast to rise to 4.9% in 2011 (it was 3.9% in the first 2 months). This projection reflects, besides higher prices for imported oil, hikes for utility charges and public transport fares. Higher global food prices will also put upward pressure on inflation, although this is cushioned by rice inventories and expectations of an improved harvest. On the basis of a deceleration in global commodity prices, inflation in 2012 is forecast to ease to 4.3% (Figure 3.28.12).

Growth in merchandise exports is seen pulling back from last year's levels to about 11% in the forecast period. Imports will likely grow slightly faster than that on the back of the projected growth in consumer demand and investment, as well as higher oil and commodity prices. The trade deficit is set to widen, but the services account will remain in surplus, largely because of growth in business process outsourcing. Remittances will remain a significant contributor to current account surpluses, which are forecast at about 4% of GDP during the forecast period (Figure 3.28.13).

In the context of still high national government debt (equivalent to 55.4% of GDP in 2010) the government has committed to reduce the budget deficit to 2.0% of GDP by 2013 and the debt to 47% of GDP by 2016. The focus on the revenue side of the budget is to raise the tax-to-GDP ratio from 12.8% in 2010 to 16%–18% over several years, through (at least for now) tighter tax administration and reforms to excise tax and investment incentives, rather than increases in tax rates.

For spending, the plan is to weed out programs that are no longer relevant or efficient and to strengthen the finances of government-controlled corporations. The government is also pushing for a fiscal responsibility law, under which proposals to grant fiscal incentives or

3.28.9 Remittances by region, 2010



Source: CEIC Data Company (accessed 11 March 2011).

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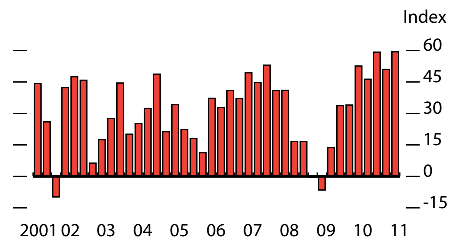
3.28.10 Business expectations index



Notes: Represents index for the next quarter. 2001 data is for June.

Source: CEIC Data Company (accessed 11 March 2011).

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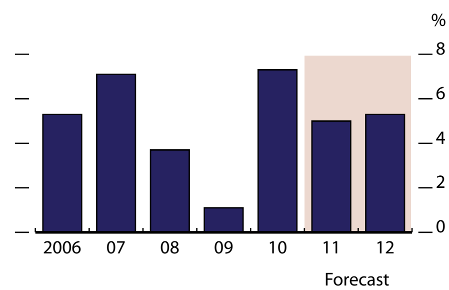
3.28.11 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 11 March 2011).

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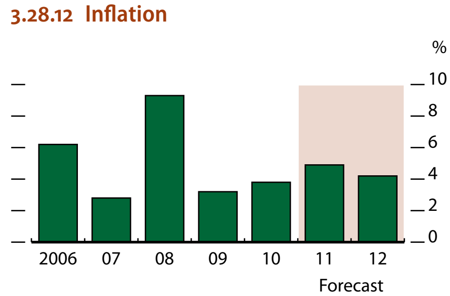
3.28.12 Inflation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 11 March 2011).

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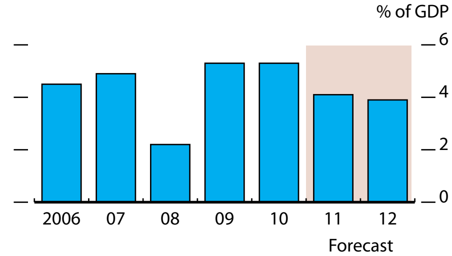
permanent increases in national government expenditure would require supporting revenue-raising measures or offsetting spending cuts.

Risks to the growth and inflation forecasts on the downside are global economic growth that is weaker than expected, interruptions to remittance inflows, and higher than forecast increases in global oil and food prices. There is a risk that the disruption to supply chains after the Japanese earthquake could dent manufacturing production and exports in 2011. Electronics and semiconductors, major export industries in the Philippines, depend heavily on components from Japan. Lack of progress in the public–private partnership program or in efforts to improve governance and public finances would likely undermine business confidence. A severe La Niña could delay agriculture's recovery.

3.28.13 Current account



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 26 March 2011).

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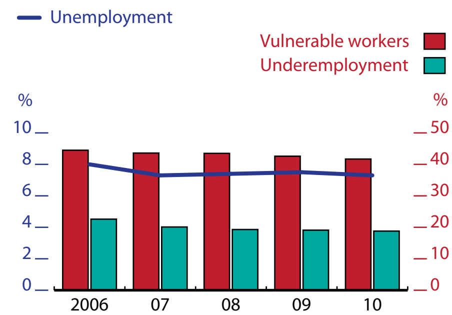
Development challenges

Lackluster growth in employment is a chronic problem. Despite strong economic growth last year, the unemployment rate fell only slightly to 7.3% (Figure 3.28.14). Young people aged 15–24 account for about half the unemployed. The underemployment rate also remained high at about 20%. The proportion of workers classified as vulnerable—unpaid family members and the self-employed, most of whom are in the informal sector—has declined since 2006, but remains high at nearly 42%. Moreover, the lack of jobs drives large numbers of Filipinos to work abroad.

3.28.14 Labor indicators



Sources: CEIC Data Company (accessed 11 March 2011).

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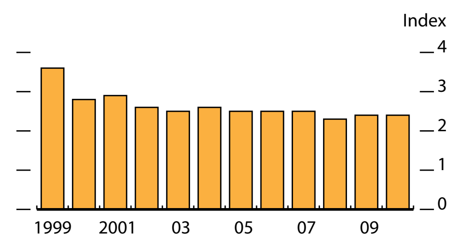
Weak employment generation and low productivity equate with slow reductions in poverty. The number of people living in poverty increased by 3.3 million to 23.1 million in the 6 years to 2009, when the incidence of poverty rose to 26.5% from 24.9%. Progress has been slower than hoped for on the Millennium Development Goals relating to poverty, maternal health, and primary education.

Much remains to be done to improve the business environment so that private investment and employment grow consistently. According to the World Economic Forum, the global competitiveness ranking of the Philippines in 2010/11 was 85 (out of 139 countries), compared with Malaysia (26), Thailand (38), Indonesia (44), and Viet Nam (59). Investors cited concerns such as poor infrastructure and policy instability.

The World Bank's *Doing Business 2011* report also showed the Philippines below these countries, ranked 148 out of 183, and slipping from the previous year's 146. Transparency International's 2010 Corruption Perceptions Index had the Philippines scoring just 2.4 out of 10 (Figure 3.28.15), where zero represents highly corrupt.

3.28.15 Transparency International's Corruption Perceptions index



Note: The index focuses on corruption in the public sector. It ranges from 0 to 10, with 0 the most corrupt.

Source: Transparency International. http://www.transparency.org/policy_research/surveys_indices

Click here for figure data

Against this backdrop, one key policy challenge is for the government to sustain the higher level of investor confidence built up last year by pushing ahead with policy and governance reforms. Another is to raise state revenue so as to fund the social development and infrastructure programs required to reduce poverty and underpin a stronger private sector.

Singapore

The economy recovered to grow at a blistering pace in 2010. A rebound in exports revived manufacturing, investment, and private consumption. Inflation increased, mainly owing to higher costs for transport, housing, and food, and it will quicken through the first half of 2011. GDP growth will moderate this year and next. With the strong rebound bringing the economy back to its potential output, an immediate challenge is to expand production capacity.

Economic performance

This open economy rebounded to the scorching pace of 14.5% in 2010. Export-oriented manufacturing and financial services rode the global recovery in trade and investment. Growth was particularly strong in the first half of 2010, given the low base set by the contraction a year earlier (Figure 3.29.1).

Exports of goods and services in real terms grew by 19.2%, driven by chemicals and electronic components and parts. Imports rose by 16.6%, with sharp increases in imports of raw and intermediate materials and capital goods. Net exports of goods and services rose by 38% to contribute the bulk of total GDP growth (10.5 percentage points).

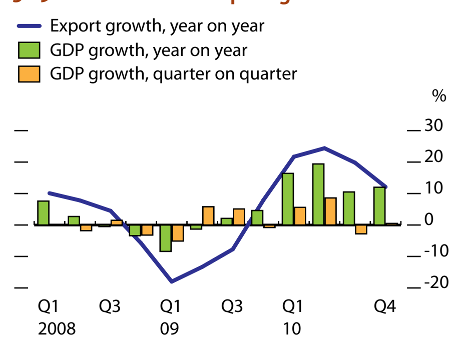
The impact of rebounding external trade and manufacturing spilled over into private consumption and investment. Private consumption increased by 4.2% in 2010, adding 1.6 percentage points to total growth. A stronger labor market lifted employment and wages. Visitor arrivals jumped by 20.2%, helping to fuel a 7.1% rise in retail sales in real terms.

Fixed investment increased by 5.1%, adding 1.4 percentage points to GDP growth. That reflected public and private sector investment in buildings as well as business investment in machinery, equipment, and software. Government consumption rose by 11.0%, accounting for 1.2 percentage points of the GDP growth, largely on increased social spending in education, health, and public housing.

On the production side, the more export-oriented sectors saw the fastest growth. Manufacturing accounted for nearly half the GDP growth, after contracting in 2008–2009 (Figure 3.29.2). Precision engineering and electronics posted gains of 40% and 35%, respectively, on the back of revitalized export demand for semiconductor-related equipment and consumer electronics. The biggest surge was in biomedical manufacturing, which jumped by 50% owing to higher production of pharmaceutical ingredients and a more diverse production mix. Growth in overall manufacturing peaked at 41.5% in June 2010, on a 6-month moving average basis (Figure 3.29.3).

Resumption of growth in consumer spending boosted wholesale and

3.29.1 GDP and net export growth



Source: CEIC Data Company (accessed 14 March 2011).
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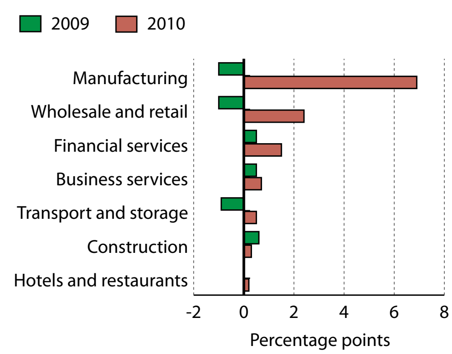
3.29.2 Contributions to growth (supply), selected sectors



Source: Singapore Ministry of Trade and Industry. 2010. *Economic Survey of Singapore*. http://www.singstat.gov.sg
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This chapter was written by Arief Ramayandi and Aleli Rosario of the Economics and Research Department, ADB, Manila.

retail trading, which grew by 15% and contributed 2.4 percentage points to GDP growth. Significant gains were seen in sales of such items as household furnishings, clothing, and footwear (Figure 3.29.4). Financial services accelerated by 12.2% in 2010, accounting for 1.5 percentage points of GDP growth, because of increased nonbank and business lending and expansion by investment banks.

Growth in construction moderated to 6.1% in 2010 from 17.0% in the previous year, as some major public projects were completed. Private construction picked up for housing (due to rising house prices) and for commercial and industrial buildings (benefiting from the economic recovery). Construction contracts awarded to private-sector firms doubled in value in 2010, to US$14 billion.

Services, accounting for 70% of total employment, generated nearly all the new jobs last year. The number of people employed rose by 112,500 to 3.1 million. The overall unemployment rate, including foreign workers, declined to 2.2% (3.1% for citizens and permanent residents).

The rapidly expanding domestic and external demand was accompanied by a rise in inflation to 4.6% by year-end (Figure 3.29.5); inflation averaged 2.8% in 2010. Major causes were an increase in the cost of automobile certificates of entitlement and rising prices for housing, which contributed to higher accommodation costs. Food prices also started to pick up from about April 2010, and by year-end contributed about one-tenth of overall inflation.

The Monetary Authority of Singapore (MAS) tightened its policy stance as recovery took hold and inflation picked up. The MAS sets policy by managing the Singapore dollar in a band against a basket of currencies by changing the midpoint, slope, or width of the band. In April 2010 it recentered the band, providing more room for the Singapore dollar to appreciate. Later in the year, as the labor market tightened and capacity utilization rose, the MAS steepened and widened the band, allowing for still further appreciation. During 2010, the currency appreciated by 6.8% against the US dollar. Liquidity in the economy remained high, and broad money grew by 8.6%.

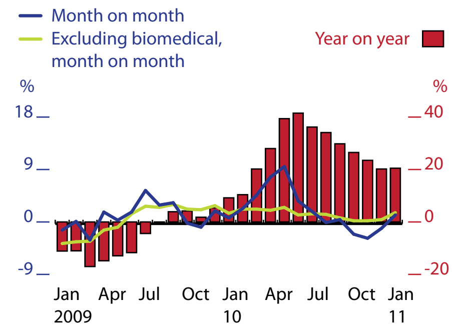
In the external accounts, a 31.1% rise in merchandise exports in 2010 outpaced a 27.6% increase in merchandise imports (both in US dollars), and the trade surplus rose to US$46.6 billion. Together with the external balances for services and income, the current account surplus climbed to the equivalent of 22.2% of GDP. International reserves rose by about 20% to US$225.7 billion (cover for 6.6 months of goods and services imports).

Economic prospects

Global economic growth, in particular projected strong expansion in much of Asia, lays the ground for solid growth in Singapore this year and next. However, growth in net exports will moderate substantially in 2011 due to base effects and higher imports to support investment.

Expected growth of manufacturing suggests that industries, including electronics and biomedical, will need to invest in capacity expansion. Investment will remain strong in construction, given solid demand for residential and commercial buildings and extension of the mass transit rail system.

3.29.3 Manufacturing growth, 6-month moving average



Source: Singapore Economic Development Board. *Monthly Manufacturing Performance, January 2011*. http://www.edb.gov.sg

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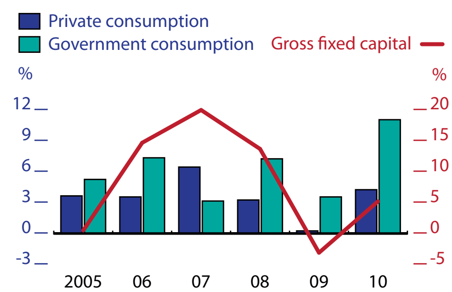
3.29.4 Growth in consumption and investment



Source: CEIC Data Company (accessed 12 March 2011).

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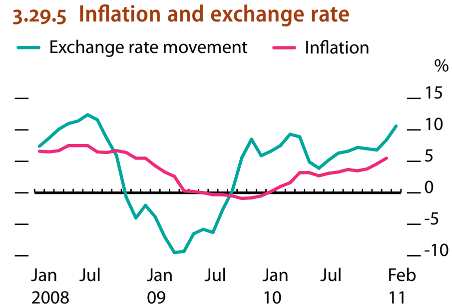
3.29.5 Inflation and exchange rate



Source: CEIC Data Company (accessed 14 March 2011).

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The low rate of unemployment, however, coupled with a government commitment to restrict the use of low-skilled foreign labor (in moves to raise productivity) will put upward pressure on costs and could act as a drag on some industries.

Retail sales, excluding automobiles, rose by 13.5% in real terms in January 2011. Further growth in incomes and the upward trend in visitor arrivals will continue to stimulate growth in retail sales this year.

Monetary policy is expected to tighten further. Strong recovery in 2010 put the economy back on, if not above, its potential output, so that further growth this year is likely to exert pressure on inflation. The monetary authorities will likely consider steepening the slope of the currency's trading band, giving more room for it to appreciate.

Fiscal policy, in contrast, is likely to have a neutral impact on the economy. Operating expenditure in FY2011 (ending 31 March 2012) has been increased to support social spending in education, health, and public housing. Growth in development expenditure is budgeted to decelerate, since some transport projects have been completed. The government is making a cash transfer to citizens this year, but the amount is relatively small.

Once these strands are woven, the economy is forecast to grow by 5.5% in 2011, with the potential to surprise on the upside (if a better than expected performance by industrial economies and Asian trading partners materializes). In 2012, growth is forecast to moderate further to 4.8% (Figure 3.29.6) as the economy returns to its long-run trajectory.

Inflation quickened to 5.5% in January 2011, driven by rising costs of transport and housing (Figure 3.29.7). It is seen staying relatively high through the first half of 2011 before moderating. Year-average inflation is put at 3.2%, easing in 2012 as the rate of cost increases of imported food and fuel decelerates.

Growth in merchandise exports is forecast to slow to 13% in nominal terms this year and imports to just below 17%. (Exports increased by 17% year on year in January 2011.) The current account surplus as a share of GDP is expected to decline to about 19% in the forecast period, reflecting the impact on trade of higher prices for imported fuel and food, imports of capital equipment, and the firmer Singapore dollar.

Risks are both on the down- and upside. As well as the tight domestic labor market that could retard expansion in some industries this year, higher than assumed global commodity prices would hurt manufacturing industry, as would weaker than projected global trade. The impact on supply chains from the March earthquake in Japan is unclear, but Singapore's direct trade with that country is now low (as a proportion of total trade, exports to Japan averaged 5.8% in the past decade, down from 7.4% in the 1990s, while imports declined to an average of 10.5% from 18.0%).

On the upside, a better performance by industrial economies and Singapore's Asian trading partners would likely have a significant impact on this open economy.

Development challenges

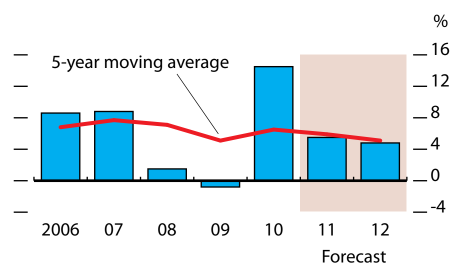
Expanding the economy's capacity is an immediate imperative. Even moderate economic growth will likely push up prices and costs of

3.29.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	4.8
Inflation	3.2	2.0
Current account balance (share of GDP)	18.8	19.2

Source: ADB estimates.

3.29.6 GDP growth



Sources: Singapore Department of Statistics. http://www.singstat.gov.sg (accessed 14 March 2011); ADB estimates.

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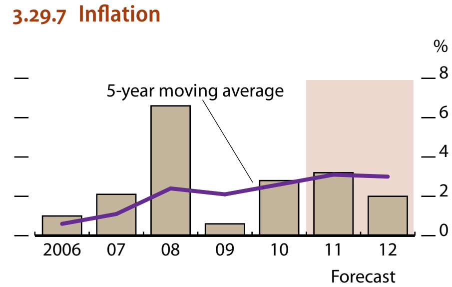
3.29.7 Inflation



Sources: Singapore Department of Statistics. http://www.singstat.gov.sg (accessed 14 March 2011); ADB estimates.

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production. The government's strategy, laid out in 2010, is to pursue policies that raise productivity by 2%–3% a year over the next 10 years, more than double the rate of increase in the past decade.

By making low-skilled foreign labor more costly—it is increasing levies on companies that employ foreign, low-skilled workers—the government is encouraging employers to focus on improving productivity. This year's budget reiterates the government's 2010 commitment to provide incentives for firms to automate operations and invest in skills development.

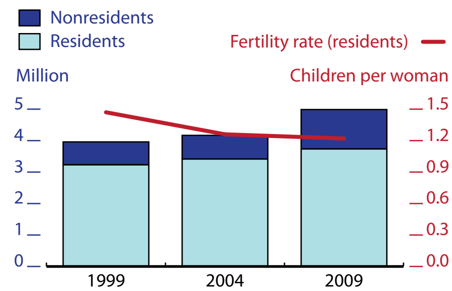
Discouraging the use of foreign workers in less productive tasks, at a time of strong economic growth, has tightened the labor market and raised operating costs, particularly for small and medium-sized businesses that employ cheap foreign labor. But as there will be a lag before the productivity gains feed through, measures may be needed to soften the policy's impact on firms during that period.

Singapore's aging population is another challenge. The old-age support ratio (the number of people 15–64 years relative to those 65 years and over) has declined from 10.1 in 1999 to 8.3 in 2009. Economic and social development has been associated with a decline in the fertility rate of residents. From 1.5 in 1999—already well below the replacement rate—it fell to 1.2 in 2009 (Figure 3.29.8).

To meet the labor requirements of an expanding economy, in past years Singapore turned to immigration and recruitment of foreign workers. Concerns about the increasing number of such workers (now at least one-third of the labor force) and the aging population have led the government to seek new ways to encourage population growth. The National Population and Talent Division, created in 2010, has been tasked with formulating policies and overseeing population programs to achieve a sustainable and integrated population.

Sharp increases in prices of housing last year (about 14% for public and nearly double that for private housing) prompted the government to act several times to curb speculative demand. It introduced a seller's stamp duty, paid if a property is resold within 1 year (as prices continued to rise it extended this period to 4 years and raised the rate of stamp duty); increased minimum downpayments; and lowered loan-to-value ratios. On the supply side, it accelerated its release of land for both public and private housing.

3.29.8 Population and fertility rate



Source: Statistics Singapore. *Population in Brief 2010*. http://www.singstat.gov.sg

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Thailand

Vigorous growth in private consumption and investment contributed to a strong economic recovery in 2010, though growth will moderate this year and next, reflecting more subdued external demand and a base effect. Inflation is forecast to be higher this year, prompting the central bank to maintain a tightening monetary stance. In the social arena, the government is drawing up programs to address differences of income and opportunity, including a stronger social safety net and investment in transport infrastructure.

Economic performance

A strong recovery from a contraction in 2009 propelled GDP growth to 7.8% in 2010. Rebounding demand for exports spurred a pickup in manufacturing and bolstered both consumer and business confidence. Political tensions that led to 7 weeks of violent demonstrations in central Bangkok during April and May 2010 had a limited and temporary impact on economic recovery.

The biggest contributor on the demand side came from a bounce in investment, which added 5.2 percentage points of GDP growth (Figure 3.30.1). Investment had slumped in 2009 and been slack for several years before that.

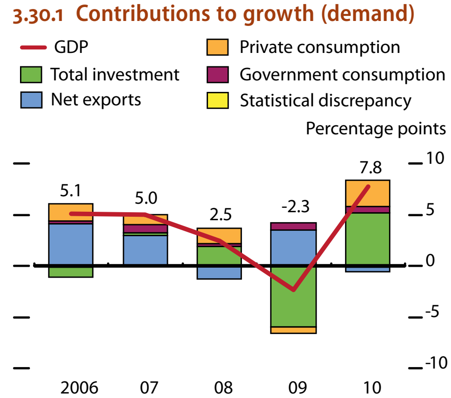
Private fixed investment grew by 13.8% in 2010, mainly in export-oriented manufacturing. As export orders picked up, higher capacity utilization in industries such as automobiles and electrical machinery prompted investment in new equipment, which rose by 14.7% for the year. Private construction expanded by 10.6%, supported by low interest rates.

Private consumption, which had also declined in 2009, rose by 4.8% last year and contributed 2.5 percentage points to GDP growth. Its rise was assisted by a strengthening of the labor market and higher farm incomes, owing to increases in prices for agricultural commodities. Consumer sentiment weakened in the second quarter when the violence broke out, but it recovered after that.

Public consumption spending also contributed to economic growth as the government continued to disburse the fiscal stimulus measures initiated in 2009.

Public fixed investment in 2010 was slightly below prior-year levels. Lower investment from the budget and by state-owned companies was partly offset by outlays on the Thai Khem Kaeng (Strong Thailand) infrastructure program. This program, involving projects that could cost more than $40 billion over 3 years, started in October 2009. Of B350 billion ($10.2 billion) budgeted to be spent on infrastructure last year, about 74% was disbursed, after some delays during the political unrest in the first half.

3.30.1 Contributions to growth (demand)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 11 March 2011).

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This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

On the supply side, industry generated most of the GDP growth. Manufacturing production surged by about 20% in the first half, then moderated to 8% growth in the second because of a base effect and softer global demand. Automobile production jumped by about 60% owing to a rebound in both domestic and export demand. Manufacturing contributed 5.4 percentage points of GDP growth, and industry as a whole added 6.0 percentage points.

Services contributed about 2 percentage points to total growth. Hotel and restaurant services expanded by 8.4%, supported by a pickup in tourism in the second half (arrivals had fallen during the protests in the capital—Figure 3.30.2). Tourist arrivals for the full year rose by 11.7% from 2009. Financial services grew by 8%, in line with expansion of business and consumer credit.

Agriculture, though, had another bad year because of drought, followed by floods. The sector contracted by 2.2%. Production fell for cassava, corn, fruit, palm oil, sugarcane, and rice.

Interruptions to food supplies caused by the bad weather added to inflation pressures induced by rising global prices for commodities and oil and stronger domestic demand. The consumer price index rose by 3.2% on average in 2010, after a period of deflation in 2009 (Figure 3.30.3). A 9.6% appreciation of the baht against the US dollar last year helped to temper the impact of rising import prices.

As economic recovery gained traction and the political situation settled in the second half of 2010, the Bank of Thailand started to normalize its policy interest rate (it had lowered the rate by 250 basis points to 1.25% during the global crisis). The central bank raised the rate five times between July 2010 and March 2011 (Figure 3.30.4) to 2.5% (still below the inflation rate).

Lending by commercial banks increased by 11.3% in 2010 (it had contracted by 1.8% in 2009), as business and consumer confidence improved, banks became more confident about the economy, and interest rates remained relatively low.

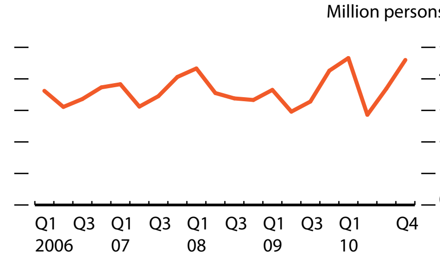
External trade rebounded (Figure 3.30.5). Merchandise exports rose by 28.5% to $193.7 billion, reflecting strong external demand for both agricultural and manufactured goods. Shipments of manufactured items, including autos and components, computers, electrical appliances, and machinery, rose by about 31%, agricultural products by 36%.

By destination, exports to the People's Republic of China, India, and Southeast Asia all jumped by about 35%, while those to major industrial economies (the European Union, Japan, and the United States) together rose by nearly 24%.

Recovery in domestic and external demand caused a near 37% surge in imports to $179.6 billion in 2010. Imports of raw materials and intermediate goods needed for export-oriented industries shot up by 42%, and the recovery in investment drove a 27.7% rise in imports of capital goods. Higher prices for imported oil added to the import bill. Surging imports brought down the merchandise trade surplus to $14.0 billion.

After taking into account a larger surplus in services, countered by a wider income deficit, the current account was in surplus equivalent to 4.7% of GDP. The capital and financial account recorded a net inflow of $15.6 billion.

3.30.2 Tourist arrivals



Source: Bank of Thailand, available http://www.bot.or.th (accessed 28 March 2011).

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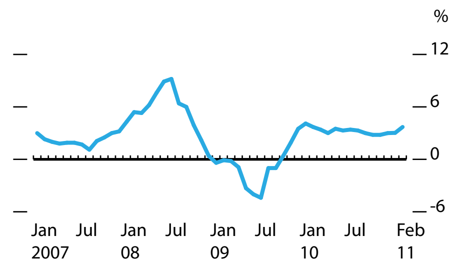
3.30.3 Monthly inflation



Source: CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 28 March 2011).

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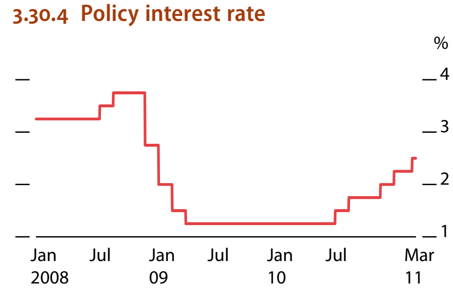
3.30.4 Policy interest rate



Source: Bloomberg (accessed 20 March 2011).

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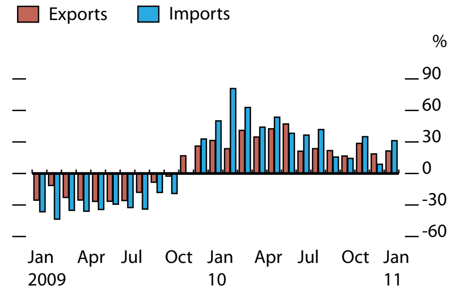
Current account surpluses and buoyant capital inflows into equity and debt securities ($55.2 billion in 2010) fueled the appreciation of the baht. To reduce that upward pressure, the Bank of Thailand liberalized restrictions on capital outflows, and the finance ministry removed a withholding tax waiver on bonds held by foreigners.

Foreign currency reserves rose by 24% to $165.7 billion in 2010, reflecting surpluses in the current, capital, and financial accounts as well as central bank purchases of foreign exchange to manage upward pressure on the baht. Reserves were equivalent to 9.5 months of imports of goods and services.

The government trimmed its budget expenditure in FY2010 (ending 30 September 2010) although total public spending increased, taking into account both on-budget and off-budget spending under the Thai Khem Kaeng program. Revenue collection was stronger than expected and exceeded the target by 10%, reining in the fiscal deficit to 2.1% of GDP from 4.8% in FY2009.

Public debt as a ratio to GDP fell to 42.5% at end-2010 from 43.9% in 2009, mainly the result of the larger GDP in 2010.

3.30.5 Merchandise trade growth



Source: Bank of Thailand. http://www.bot.or.th (accessed 28 March 2011).

Click here for figure data

Economic prospects

The government has indicated that national elections will be held in June 2011. Forecasts assume that the elections go smoothly and there are no serious disruptions that affect the economy.

Last year's strong rebound in GDP came from a low base brought about by the economic contraction in 2009. Consequently, economic growth will moderate considerably in 2011. Moreover, expected slower growth in major trading partners—the PRC, Southeast Asian neighbors, and major industrial countries—will damp the expansion in Thailand, as will the substantially higher cost of imported oil.

Merchandise exports are projected to increase by about 13% in nominal terms this year, less than half the rebound pace of 2010.

Private fixed investment is seen growing by about 9% in real terms, also below last year's pace. Capacity utilization rates suggest that some manufacturers will need to expand facilities to accommodate expected increases in domestic and external demand. Appreciation of the exchange rate has lowered the cost of imported machinery and equipment. Additionally, relatively low interest rates are conducive for investment.

An index of business sentiment in January 2011 indicated that business managers were confident about the outlook for orders and production, although they were concerned about rising costs.

Private consumption is forecast to grow by about 4% in real terms, due to growth in incomes. That marks a deceleration from 2010 but would still make a solid contribution to GDP growth. The labor market has tightened (businesses complain that they face difficulties in recruiting both skilled and unskilled labor), so that wages will likely increase.

Further, the government has said that it plans to raise minimum wages by 25% over 2 years if reelected, which would be on top of an increase in minimum wages in late 2010. Most government employees received a 5% wage increase from April 2011. Rural incomes are benefiting from high prices for many agricultural commodities.

3.30.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.5	4.8
Inflation	3.5	3.0
Current account balance (share of GDP)	2.0	1.0

Source: ADB estimates.

A new round of concessions for low-income households will also support consumption. The government unveiled in January 2011 a package of "new year's gifts" that included subsidies on cooking gas, diesel fuel, electricity, and public transport. The authorities have extended price controls on a range of food staples and animal feeds and directed state banks to set aside B5 billion ($166 million) for low-interest loans to taxi drivers and street vendors, who might otherwise find it difficult to borrow because they are not salary earners and do not have collateral. Unsurprisingly, consumer confidence is buoyant (Figure 3.30.6).

While fiscal policy is expected to be mildly expansionary in the forecast period, monetary policy seems set to continue tightening. The government has budgeted to increase spending in FY2011 by about 22%, and widened the deficit target to 4% of GDP. Budget disbursements in the fiscal first quarter exceeded the target for that period. The rest of the Thai Khem Kaeng program will be funded through the budget, rather than mainly by off-budget expenditure as was the case last fiscal year. The fiscal deficit is expected to narrow to 3.2% in FY2012.

The Bank of Thailand is likely to gradually raise interest rates further during the forecast period and it will probably allow a gradual appreciation of the baht to help keep imported inflation in check.

Taking into account the outlook for domestic and external demand, the base effect, and the policy stance, GDP is forecast to grow by 4.5% in 2011 and 4.8% in 2012 (Figure 3.30.7).

Inflation was 3.0% in the first 2 months of 2011. Domestic food prices climbed, partly a result of bad weather. Higher global food and oil prices are adding to price pressures, but the subsidies and price controls should alleviate the impact of inflation on low-income households. For all 2011, inflation is forecast at 3.5% (Figure 3.30.8). It will ease next year, if global food and oil prices decelerate and the policy stance tightens as anticipated.

Volatile capital inflows are expected to ease this year. To manage the flows the central bank is likely to focus on relaxing rules for overseas investment and hedging by domestic businesses, rather than on controls on inflows.

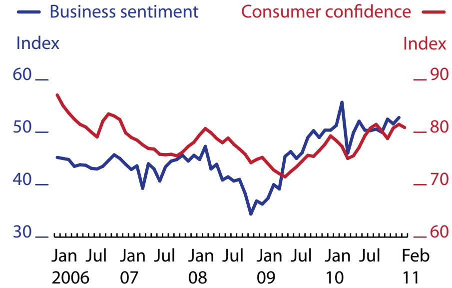
Higher prices for imported commodities and oil will likely mean that merchandise imports outpace exports in the forecast period. The trade surplus will decline slightly and the current account surplus is seen subsiding to about 2.0% of GDP in 2011 and 1.0% in 2012. Tourism, an important contributor to the surplus in services trade, got off to a good start in January 2011, when arrivals rose by 11.6% from the prior-year period.

Domestic risks to the outlook center on political uncertainty, which can have an impact on business and consumer confidence, and further bouts of bad weather (the south of the country saw extensive flooding in March 2011), which may reduce economic growth.

Development challenges

Political unrest over recent years, culminating in last year's violent demonstrations, has brought into focus gaps in incomes and opportunities in Thailand. The richest 20% of households account for

3.30.6 Confidence indicators



Note: A reading of less than 50 for business sentiment and less than 100 for consumer confidence denotes a deterioration.

Sources: Center for Economic and Business Forecasting; Bank of Thailand, http://www.bot.or.th (both accessed 28 March 2011).

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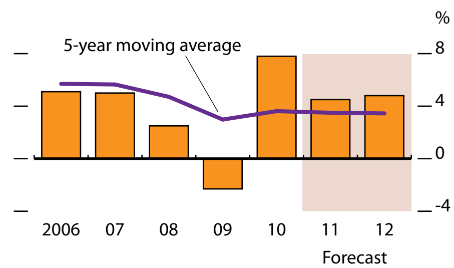
3.30.7 GDP growth



Source: Asian Development Outlook database.

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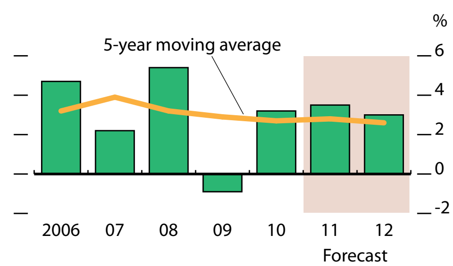
3.30.8 Annual inflation



Source: Asian Development Outlook database.

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nearly half of total household incomes and the Gini coefficient, a measure of income inequality, for the country is high at 0.51 (where 0 is perfect equality and 1 is absolute inequality).

Tackling regional inequality, the government is ramping up investment in transport infrastructure (roads, rail, and ports), which should encourage businesses to expand and generate employment outside the Bangkok area in the longer term. Faster decentralization should be used alongside this investment boost, giving local governments greater authority to make decisions over infrastructure and services to attract development to their areas as well as the fiscal resources to support this responsibility. (A decentralization act was passed in 1999, but implementation has lagged.)

Another government approach to mitigating inequality is to build a stronger social safety net. The draft 11th National Plan (2012–2016), to be finalized this year, includes a strategy to create a more equitable society. Based on this strategy, the government is setting up a voluntary pension fund for the informal sector and expanding social security benefits to people in that sector. The challenge is to design and operate programs that are well targeted and fiscally sustainable.

The cabinet has approved in principle the establishment of a Post Bank, using the post office network to provide low-interest loans of up to B10,000 ($330). Other microfinance arrangements are under consideration to assist low-income households.

Additionally, the government plans to distribute community land-title deeds to more than 200,000 landless people and farmers living on plots owned by the state.

Viet Nam

GDP growth quickened in 2010, supported by recovery in exports and an accommodative monetary policy. Inflation hit double-digit rates by year-end, and the currency slid. Moving to restore macroeconomic stability, the authorities in February 2011 unveiled comprehensive measures including tightened fiscal and monetary policies. Partly as a consequence, economic growth is forecast to moderate this year, then pick up next year. Inflation is seen subsiding late in 2011 and further in 2012. The immediate challenge is to follow through on the policy tightening; the longer-term one is to reinvigorate structural reforms.

Economic performance

Growth picked up to 6.8% in 2010 (Figure 3.31.1), supported by recovery in the global economy, the residual impact of domestic fiscal stimulus in 2009, and an accommodative monetary policy. Strong consumption growth of 9.7% stimulated private sector investment.

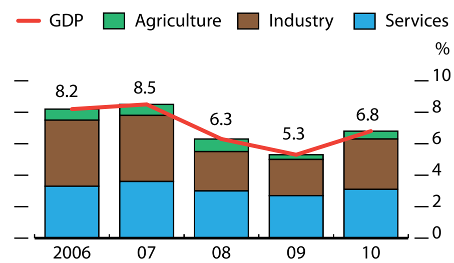
By sector, industry expanded by 7.7% and contributed 3.2 percentage points of total GDP growth. Stronger external demand spurred 8.4% growth in manufacturing, and public infrastructure investment pushed up growth of construction by 10.1%. Services grew by 7.5%, contributing 3.1 percentage points of GDP growth. Wholesale and retail trading climbed by 8.1%, reflecting the expansion in private consumption, and hotels and restaurants picked up by 8.7%, assisted by a steep 34.8% increase in visitor arrivals. Agricultural output was subdued, though, edging up by 2.8% in 2010, owing to flooding in central regions followed by drought in the north.

Faster economic growth helped to reduce urban unemployment, and poverty incidence fell to 10.6% from 12.3% in 2009, based on the official poverty measure.

Inflation accelerated to 11.8% in December 2010, averaging 9.2% for the year, the highest in Southeast Asia. By March 2011, it was running at 13.9% year on year (Figure 3.31.2), with rising food prices and school fees leading causes. Credit grew by 32.4%, above the official target of 25% but slightly slower than 39.6% in the previous year.

Concerns among the general population over loss of purchasing power, together with a slide in the currency—the dong—boosted purchases of gold and US dollars. Foreign currency deposits climbed by 21% in 2010. The currency came under steady depreciation pressure from about midyear, reflected in the spread between the black market rate and the reference rate of the State Bank of Viet Nam (SBV, the central bank); the spread increased to over 10% in January 2011. The SBV devalued the dong by 9.3% in February 2011, and narrowed the trading band for the dollar–dong exchange rate from ±3% to ±1%. During November 2009–

3.31.1 Contributions to growth (supply)



Source: General Statistics Office of Viet Nam. http://www.gso.gov.vn (accessed 14 March 2011).

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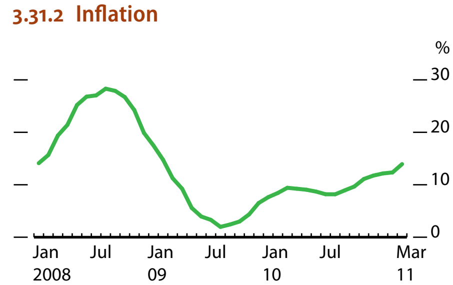
3.31.2 Inflation



Sources: General Statistics Office of Viet Nam; ADB estimates.

Click here for figure data

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

February 2011, the authorities devalued the dong, in four steps, by a total of about 20% against the US dollar (Figure 3.31.3).

Lack of clarity over the direction of monetary policy further eroded confidence. The SBV started to withdraw monetary stimulus from late 2009, raising its base rate and ending interest rate subsidies and caps, but in 2010 it urged banks to moderate lending-rate rises. With inflation accelerating, the SBV in November 2010 raised policy rates again. That tightening seemed insufficient to counter what was by then double-digit inflation or market expectations of further dong depreciation.

The SBV's capacity to support the dong was constrained by relatively low holdings of foreign exchange reserves, estimated at $12.4 billion at end-2010 (about 1.9 months of import cover—Figure 3.31.4).

A rebound in exports last year, reflecting recovery in global trade, reined in the deficit in merchandise trade to $7.1 billion on a balance-of-payments basis, from $8.3 billion in 2009. Exports rose by 26.4% in US dollars. Customs data showed strong increases in exports of textiles (up by 23%), footwear (25%), and electronics and computers (29%). Crude oil exports fell, however, by 20%, as volumes plunged by 40% owing to depletion of oil fields. Imports rose by 21.2%, reflecting demand for inputs for manufacturing and the country's reliance on imported capital equipment.

Trade with the People's Republic of China (PRC), Viet Nam's largest trading partner, was boosted by a free-trade agreement between the Association of Southeast Asian Nations and the PRC, from January 2010. Customs data show that imports from the PRC increased by 23% to about $18.0 billion and exports there shot up by 49% to $6.3 billion.

After increases in remittances and tourism receipts, the current account deficit contracted to $4.3 billion, equivalent to 4.0% of GDP, its narrowest in 4 years. The overall balance of payments showed a deficit of $1.8 billion in 2010 (Figure 3.31.5).

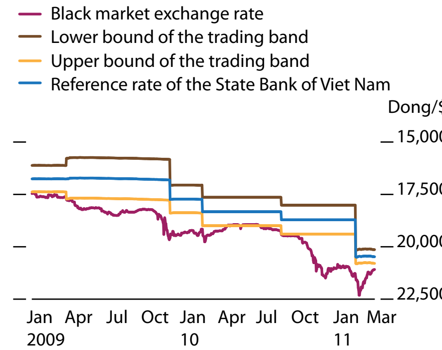
Net foreign direct investment (FDI) inflows rose by about 3% to $7.1 billion in 2010. FDI approvals at $18.6 billion missed the target, however, and were well below 2009's, likely reflecting investor uncertainties over policy direction. FDI approvals for real estate projects fell, but approvals for manufacturing more than doubled.

With most fiscal stimulus measures taken during the global recession expiring at end-2009, the overall fiscal deficit in 2010 narrowed to 8.0% of GDP. In real terms, government expenditure was estimated to be little changed from 2009, but revenue and grants rose by about 10%, reflecting stronger non-oil tax receipts.

Total public debt and publicly guaranteed debt, excluding state firms' contingent liabilities, is estimated to have declined by 1 percentage point to 51.5% of GDP in 2010, still above the government's target ceiling of 50%. Weakness in the stock market over the past 2 years (the VN Index of share prices fell by 2.0% in 2010) has hindered government plans to sell shares in state-owned enterprises.

State-owned Viet Nam Shipbuilding Industry Group (Vinashin) defaulted in late 2010 on a repayment of $60 million relating to a $600 million syndicated loan. Some international credit rating agencies downgraded Viet Nam's ratings, citing the government's contingent liabilities and the macroeconomic stresses.

3.31.3 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

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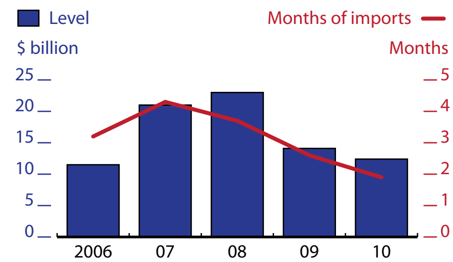
3.31.4 Gross official reserves



Note: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Sources: State Bank of Viet Nam; ADB estimates.

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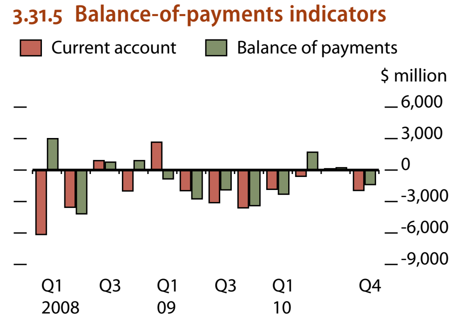
3.31.5 Balance-of-payments indicators



Source: State Bank of Viet Nam.

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The government indicated it would not bail out Vinashin, signaling to other state-owned firms that they would be held accountable if they overextended their borrowing. Vinashin will be restructured over 3 years to put its finances on a firmer footing.

Viet Nam's ranking in the World Bank's *Doing Business 2011* report rose to 78 from 88 the previous year. This reflected significant gains in the ease of starting a business, obtaining construction permits, access to credit, and tax administration. A government drive called Project 30, to reduce bureaucratic procedures for business, also helped.

Economic prospects

The Socioeconomic Development Strategy for 2011–2020, approved by the Communist Party of Viet Nam in January 2011, targets rapid average GDP growth of 7%–8%. In February, however, the government indicated that it was prepared to give a higher priority to stability than growth in the near term, when it committed to restore stability through a package of policies (Resolution 11—Box 3.31.1), notably tighter fiscal and monetary policies in 2011 aimed at curbing inflation and stabilizing the external position. Restoration of solid investor confidence will require sustained and consistent policy actions until inflation is subdued.

The SBV lifted its refinancing rate from 9.0% to 12.0% and its rediscount rate from 7% to 12% in the first quarter of 2011, although it

3.31.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.1	6.7
Inflation	13.3	6.8
Current account balance (share of GDP)	-3.8	-3.6

Source: ADB estimates.

3.31.1 Resolution 11

Resolution 11, issued on 24 February 2011, contains six sets of policy measures to restore macroeconomic stability and maintain social security: tightening monetary policy; tightening fiscal policy; containing the trade deficit; increasing electricity prices while shielding the poor and using a more market-based mechanism for petroleum pricing; strengthening social security; and improving dissemination of policy information.

On 1 March 2011, the SBV issued a directive to implement Resolution 11. It included a credit growth target ceiling of 20% (reduced from an original target of 23%) and a 15%–16% target for growth in M2 money supply in 2011 (down from 21%–24%). Both targets are considerably below the outcomes in 2010, when credit grew by 32.4% and M2 by 33.3%.

To achieve these targets, the SBV instructed banks and other credit institutions to curb credit growth to less than 20%. These institutions were also instructed to limit credit outstanding to "nonproductive" activities such as real estate and marketable securities to 22% of total lending by end-June 2011 and 16% by end-2011.

The SBV intends to penalize institutions that fail to meet these targets by doubling their required reserve ratios. It also is restricting foreign currency lending on imports of specified nonessential goods, including all consumer goods. The SBV aims to limit the import of gold to a few firms and to eventually prohibit trading in gold bars in the parallel market. These actions are intended to reduce speculative foreign exchange and gold transactions and so help to stabilize the dong.

On the fiscal side, the Ministry of Finance revised the 2011 budget deficit target to below 5.0% of GDP (down from an original 5.3%). Ministries and line agencies were told to withhold 10% of nonessential current expenditure (excluding salaries and wages) for the rest of this year.

The budget revenue target for 2011 was revised up by 7%–8%. The government aims to collect higher taxes through improved tax administration enforcement. It also intends to closely scrutinize all investments made by public agencies and state-owned firms.

The Ministry of Industry and Trade is developing a plan to contain the trade deficit. It will try to improve the efficiency of export production, while restricting certain imports.

Strengthening social security involves measures to shield vulnerable groups from the impact of the increase in electricity tariffs, as well as other targeted support.

The Ministry of Information and Communication has been directed to disseminate timely information on policy actions.

maintained the base rate at 9.0%, below the inflation rate (Figure 3.31.6). The refinancing rate was further increased to 13.0% on 1 April 2011. The higher rates increased the cost to commercial banks of borrowing dong from the central bank. The SBV is aiming to balance the need to tighten policy with the likely impact on firms that already face high dong-denominated borrowing rates of close to 20%.

Proposed policy actions include both market-based instruments and administrative controls. Such controls will likely have some temporary impact, but may not be effective further out. For example, controls on gold trading usually lead to increased illicit trading. They also create market distortions.

The forecasts assume that the government will follow through with the policy tightening until macroeconomic stability is restored. That will slow consumer spending and domestically financed investment.

Forecasts also take into account developments in the first quarter of 2011. Preliminary data show that GDP rose by 5.4% year on year in January–March 2011, slowing from 7.3% in the fourth quarter of 2010. Agriculture increased by 2.0%, industry by 5.5%, and services by 6.3%. Solid expansion in the first quarter was seen elsewhere: industrial production at 14.0%, retail sales at 9% in real terms, international visitor arrivals at 12%, and merchandise exports on a customs basis at 44%. For the whole year, crude oil production is projected at 15 million metric tons, similar to 2010.

Against this background, GDP is forecast to grow by 6.1% in 2011 (Figure 3.31.7). Growth is expected to pick up to 6.7% in 2012 as a more stable economic environment stimulates consumption and investment.

Inflation is projected to remain high through 2011, peaking at about 16% year on year in the third quarter and averaging 13.3% (Figure 3.31.8). Underpinning high inflation (which averaged 10.3% in the first quarter of the year) are a lagged pass-through of currency depreciation and hikes in price-controlled electricity (by 15.3%) and fuel (by about 30%) in March, as well as the base effect of low inflation in April–September 2010.

Sustained policy tightening will damp domestic demand and help to stabilize the dong exchange rate. Bringing year-on-year inflation down to single digits by end-2011 will require the average month-on-month rate to be below 0.4% for the rest of the year.

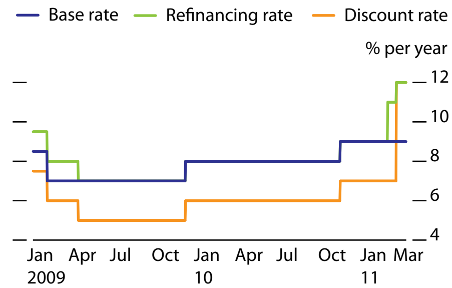
A deceleration in world trade from the rebound rates of 2010 alongside the impact of policy tightening on imports will contribute to slower growth in external trade this year. After inflows from tourism and remittances, the current account deficit is forecast at 3.8% in 2011 and 3.6% in 2012 (Figure 3.31.9).

The more stable macroeconomic situation should stimulate FDI in the forecast period. The overall balance of payments is expected to improve.

Risks to the outlook center on implementation of Resolution 11. Insufficient policy tightening or premature easing—or perception of easing—of policies would keep inflation high for longer and could lead to a deterioration of the external accounts. Such an outcome could require another round of policy tightening in a year or two.

Another domestic risk relates to state-owned enterprises. Vinashin needs to negotiate a debt rescheduling. Further evidence of debt distress among this or other state-owned firms would hurt investor confidence.

3.31.6 Interest rates



Source: State Bank of Viet Nam.

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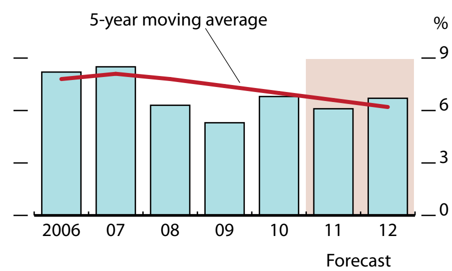
3.31.7 GDP growth



Source: Asian Development Outlook database.

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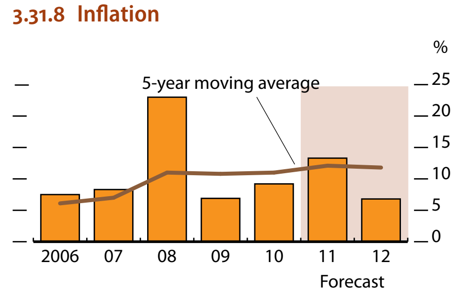
3.31.8 Inflation



Sources: General Statistics Office of Viet Nam; *Asian Development Outlook* database.

Click here for figure data

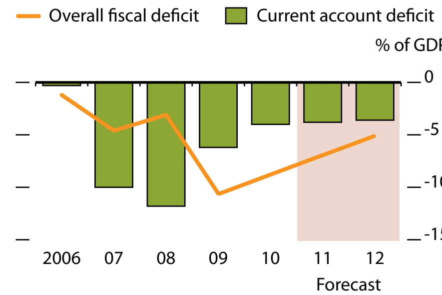
The large increase in the domestic credit stock, of about $100 billion during 2007–2010, raises concerns over banking asset quality, as does bank exposure to real estate and state-owned enterprises.

US dollar borrowing jumped in early 2010 as borrowers took advantage of new regulations that allowed firms earning dong revenue to borrow in US dollars (at lower rates than in dong). But such borrowing comes with a currency risk, and after the currency devaluations some firms might now face much bigger debt in dong terms.

There is also a risk that the supply of manufactured components from Japan for Viet Nam's export industries, or exports to that market, could be disrupted by the impact of the 11 March earthquake for longer than currently anticipated.

Overall, though, the change in policies this year has reduced domestic risks. The medium-term outlook remains favorable, with the proviso that macroeconomic stability is restored and maintained. Viet Nam remains an attractive destination for foreign investors, and is well positioned to benefit from economic developments in the PRC. Rising labor costs there will divert some FDI to other developing Asian economies, and growing domestic PRC consumption will increase its demand for imports.

3.31.9 Current account and fiscal balance



Source: Asian Development Outlook database.

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Development challenges

Much has been achieved in lifting the economy to lower-middle-income status in 2010 and in reducing poverty over two decades. High inflation, especially for food, puts poverty-reduction gains at risk, however. The immediate challenge is to restore stability in the economy by fully implementing the policy directives of February 2011.

Maintaining price stability and economic growth in the longer term requires further improvements in efficiency, particularly in the state-owned sector; development of the financial system; and heavy investment in infrastructure and education to address supply-side bottlenecks.

State-owned firms are a drag on the economy. They absorb many of the available resources but their efficiency is much lower than among private firms. Hence a better performance from them would stimulate economic growth and release budget resources for more productive uses. Regardless of ownership, putting them on a commercial footing, exposing them to competition, and holding them financially accountable—particularly for noncore activities—would improve their efficiency.

Further reforms are needed to safeguard the financial system (the SBV took the important step of raising minimum capital requirements in 2010). Supervision of banks would be strengthened if the capacity of the SBV to provide regulatory oversight were upgraded and if a risk-based supervision framework were adopted (shifting from a compliance-based approach). A move toward international standards for bank provisioning would also strengthen banks' stability.

Finally, timely publication of economic and financial data would help to build public and investor confidence.

THE PACIFIC

Fiji
Papua New Guinea
Timor-Leste

Cook Islands
Kiribati
Marshall Islands
Federated States of Micronesia
Nauru
Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji

After contracting in 2009 the economy achieved slight growth in 2010, based largely on a recovery in tourism and some goods exports, though the sugar industry weakened for a fourth consecutive year. Low levels of growth are forecast for 2011–2012, accompanied by moderate inflation. Reforms to improve the investment environment are key to generating stronger growth and reducing poverty.

Economic performance

Minimal GDP growth of 0.1% in 2010 continued the pattern of recent years—a period of contraction followed by slight growth—leaving GDP virtually unchanged since 2005. (Official revisions to GDP estimates for 2006–2009, due to rebasing, resulted in growth of 0.2% in 2008 and a contraction of 3.0% in 2009—Figure 3.32.1.)

In 2010, the impact of growth in tourism, mineral water exports, fisheries, and gold mining slightly outweighed downturns in agriculture; transport, storage, and communication; real estate and business services; health and social work; and other community services (these latter two on the back of reduced government expenditure).

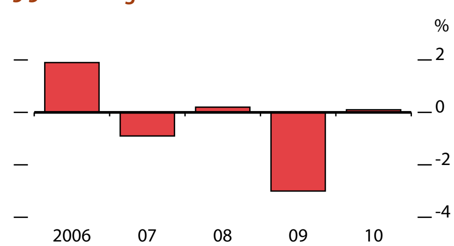
Visitor arrivals rose by 16.5% to a record 633,000 in 2010 (Figure 3.32.2). Increases were notable from Australia (helped by its buoyant economy) and from the People's Republic of China and India (reflecting marketing efforts). Despite a 20% devaluation of the Fiji dollar in April 2009, price discounting meant that growth in tourism earnings only kept pace with tourist arrivals.

Gold production from the Vatukoula mine rose by nearly 80% to 59,000 grams in the 12 months to August 2010, and is expected to reach an annual rate of 100,000 grams in 2011. Mineral water exports recovered from a downturn during the global recession, and fisheries benefited from favorable weather.

On the negative side, agriculture suffered from a cyclone in March 2010, then a drought. The sugar industry, which supports about a quarter of the population, has declined in recent years as the European Union phased out preferential prices it paid to certain nations, including Fiji. The European Union was to provide assistance to the country's sugar industry, but postponed the plan after a military coup in 2006.

Last year, the government initiated a sugar industry reform program that included funding for new cane planting, but farmers continued to leave the industry and cane production fell by 19%. Breakdowns at sugar mills caused production of raw sugar to slide by 20.8% (Figure 3.32.3). Fiji Sugar Corporation, after accumulating losses of more than F$200 million in 2009–2010, is being taken over by the government, and the firm's operations are now funded through the national budget.

3.32.1 GDP growth



Source: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2010* and *Budget Supplement 2011*. http://www.mfnp.gov.fj

Click here for figure data

3.32.2 Tourism growth

Sources: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2011*. http://www.mfnp.gov.fj

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This chapter was written by Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva.

Private consumption was supported by the increase in tourism and a rise in remittances. Remittances in US dollar terms rose by about 14% in the 7 months to July 2010. But investment remained low, reflected in a 0.5% fall in imports of investment goods and a 1.1% decline in new lending for investment.

Inflation accelerated early in 2010, propelled by the impact of the devaluation and then shortages caused by the cyclone, as well as by higher global oil prices. After peaking at 10.5% year on year in April, it slowed as the devaluation effect waned, but then picked up again to 5.0% in December, after some price controls on food were removed and electricity tariffs were put up. For the year, inflation averaged 7.8%.

The Reserve Bank of Fiji absorbed excess liquidity in the banking system by twice raising the statutory reserve deposit requirement for commercial banks in 2010, to 10.0%. It also implemented an overnight policy interest rate to signal the monetary policy stance. Late in the year it lowered that rate to 2.5% from 3.0% and relaxed exchange controls. The Fiji dollar firmed against the US dollar (by 4.5%) in 2010 and against the euro, but eased versus the yen and the Australian and New Zealand dollars.

Government data indicate that the budget deficit widened from the equivalent of 3% of GDP in 2009 to 3.6% in 2010 (Figure 3.32.4). Both revenue and expenditure targets were met, although it seems likely that some planned capital expenditure was used for operating expenses. Public debt rose to the equivalent of 58.0% of GDP, or 91.5% of GDP if government-guaranteed debt is included (Figure 3.32.5). The government took onto its books the debt of Fiji Sugar Corporation, a reminder of the risks posed by contingent liabilities.

Preliminary official figures indicate that merchandise exports rose by about 25% in 2010, assisted by higher output and prices of gold. Imports were subdued by slack domestic demand. On this basis, the trade and current account deficits likely narrowed. Foreign exchange reserves rose to US$672 million (about 4 months of imports).

Economic prospects

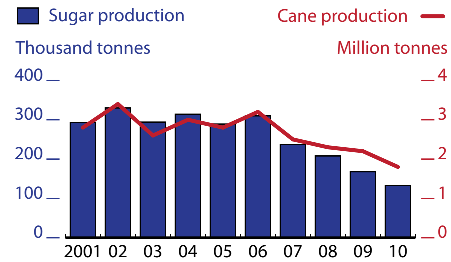
The outlook in the forecast period depends heavily on prospects for the sugar and tourism industries. Reforms in the sugar industry that started in 2010 are assumed to make slow progress, in view of capacity constraints in the government and the need to consult many stakeholders.

Visitor arrivals are influenced by marketing, and while it is assumed the government will continue to fund the Fiji Visitors Bureau, several other Pacific island economies have stepped up their marketing programs. The outlook also assumes no severe cyclones or other natural disasters.

Expected modest economic growth for many of the country's trading partners in 2011 clouds the prospects for both tourism (where deep discounting is set to continue) and merchandise exports. On the balance of these factors, GDP growth is forecast to remain low at 0.5% this year, picking up to 0.8% in 2012 if the sugar industry's reforms gain traction.

The 2011 budget targets a deficit of 3.5% of GDP (the same target set in 2010). It assumes a 16.0% revenue gain from actual levels last year, driven by an increase this year in the value-added tax to 15.0% from 12.5% and a new capital gains tax of 10.0%. It projects expenditure to rise by

3.32.3 Sugar and cane production



Sources: Ministry of Finance. *Budget Supplement 2008, 2009, 2010, 2011*. http://www.mfnp.gov.fj; Fiji Sugar Corporation.

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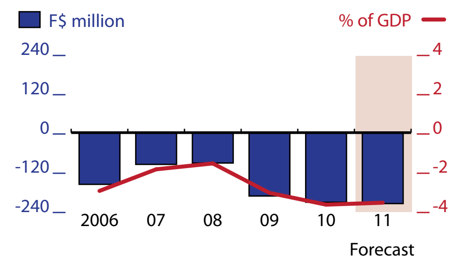
3.32.4 Budget balance



Source: Ministry of Finance. *Budget Supplement 2009, 2010, 2011*. http://www.mfnp.gov.fj

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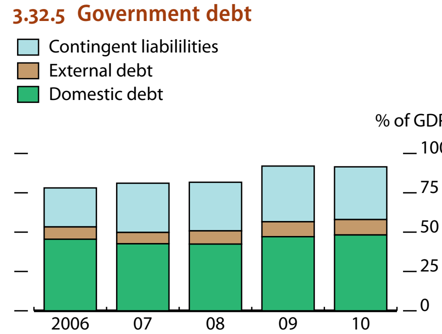
3.32.5 Government debt



Source: Ministry of Finance. *Economic and Fiscal Update. Supplement to the 2011 Budget Address.*

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14.4%, partly reflecting transfers to Fiji Sugar Corporation for operating expenses and mill repairs. The budget also assumes that GDP growth will quicken to 1.3% in 2011. Failure to meet this target would dent projected revenue and probably require spending cuts to be prolonged.

Ample liquidity is expected in the banking system in 2011, but growth in credit to the private sector will likely remain slow in view of forecast low investment levels. The Reserve Bank of Fiji lowered the overnight policy rate in February 2011, to 2.0% from 2.5%, to support growth in light of what it described as "still very weak domestic economic conditions."

Inflation rose to 5.9% in January 2011, from 5.0% in December 2010, mainly reflecting the increase in the value-added tax and higher global oil prices. For this year, inflation is projected to average 4.0% (Figure 3.32.6).

The government plans to roll over a US$150 million sovereign bond that matures in September 2011, which would delay the need to repay the bond (it represents 55% of total public external debt). Last year, the authorities discussed with the International Monetary Fund a possible stand-by credit arrangement that would bolster foreign exchange reserves, targeted primarily at debt repayment, but they put the idea of a program led by the institution on hold.

Imports will increase faster in 2011 than last year, according to official projections, while growth in exports will moderate. Foreign exchange reserves are likely to come under pressure.

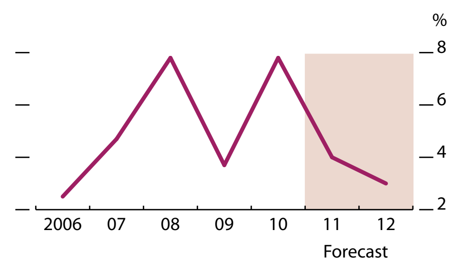
These forecasts are vulnerable to external risks, including oil prices (every US$10 a barrel increase in oil prices raises the cost of oil imports by about US$50 million, or 26% of 2010's total import bill) and weaker than anticipated earnings from tourism. Lack of progress on sugar reforms poses a domestic risk to the outlook.

3.32.1 Selected economic indicators (%)

	2011	2012
GDP growth	0.5	0.8
Inflation	4.0	3.0
Current account balance (share of GDP)	-2.2	-2.1

Source: ADB estimates.

3.32.6 Inflation



Sources: Ministry of Strategic Planning, National Development & Statistics; Reserve Bank of Fiji. *Quarterly Review.* September 2010. http://www.reservebank.gov.fj; ADB estimates.

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Development challenges

Weakness in investment confines the economy to a low-growth path. Public and private investment combined is estimated to have fallen to 14% of GDP in 2010, from an average of 18% in 2000–2005. Private investment is estimated at the low level of 3% of GDP.

The return of significant donor assistance for infrastructure and other projects, largely withheld since the 2006 coup, depends on new elections. The government is adamant, however, that it will not call them until 2014.

Investor concerns include an opaque and uncertain regulatory environment, as illustrated by foreign exchange controls, price controls, and unpredictable policy decisions. For example, a government decree in 2010 required media organizations to ensure that their directors and 90% of the beneficial shareholders are Fijian citizens permanently residing in the country, which forced a divestment by a foreign firm.

Deficiencies in infrastructure and the poor performance of government-owned enterprises also hurt the investment climate. The need to spur growth is pressing in light of rising poverty, estimated to affect 35%–40% of the population. The authorities have provided some targeted social welfare and have expanded price controls. But the sustainable remedy to poverty—job creation—is unlikely without higher rates of investment.

Papua New Guinea

Economic growth accelerated in 2010 as construction started on the country's largest resource project and incomes benefited from the recovery in global commodity prices. Growth is forecast to quicken in 2011, underpinned by investment in resources and gains in production of metals and agricultural commodities. Reforms to public financial management and the business environment should be stepped up if the full benefits of a coming surge in revenue from resources are to be realized.

Economic performance

The start of construction on a $15 billion liquefied natural gas (LNG) project and recovery in global commodity prices benefited this resource-rich economy in 2010. GDP growth was estimated at 7.1%, marking almost a decade of uninterrupted expansion averaging about 4.4%.

Industry, including minerals, grew by an estimated 9.3% and was the major contributor to GDP growth (Figure 3.33.1). This mainly reflected a construction boom in Port Moresby and Lae, and an increase in mine production, after several years of contraction in mineral output. Services expanded by an estimated 8.5%, with strong growth in telecommunications and transport. Agricultural output rose by 3.5%.

Private consumption was supported by higher incomes, partly attributable to the recovery in commodity prices (most people are farmers who produce primarily for their own consumption plus some cash crops such as cocoa, coffee, and copra).

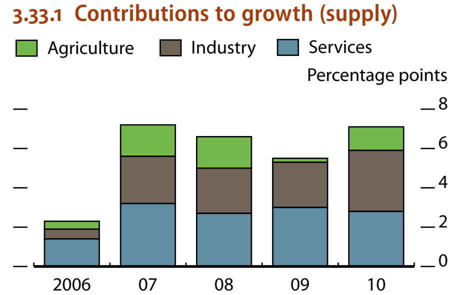
Progress on securing finance for the LNG plant and starting the construction bolstered private investment and buoyed investor sentiment. The plant is expected to begin production of LNG for export in 2014 or 2015, and full operating capacity will be 6.6 million tons a year. Strong investment helped to offset a decrease in government expenditure of 4.1% in real terms in 2010.

The rebound in commodity prices lifted the value of merchandise exports in US dollars by about 27% in 2010 (Figure 3.33.2). Mining (mainly copper and gold) and crude oil exports together climbed by about 30% in value, despite declines in export volumes of gold (4%) and oil (9%). Agricultural exports shot up in value by about 45%: palm oil 51%, coffee 20%, and copra 87%. (The increase was achieved despite a sharp fall in cocoa exports due to bad weather and disease.) The value of forestry products shipments rose, too, but fisheries and other marine exports fell.

After a highly expansionary fiscal stance in 2009, when the government drew down heavily on savings accumulated in public trust funds during past commodity boom years, the authorities reduced trust-fund drawdowns and spending in 2010. Revenue, including

This chapter was written by Dominic Mellor of the Viet Nam Resident Mission, ADB, Ha Noi.

3.33.1 Contributions to growth (supply)



Source: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies.*

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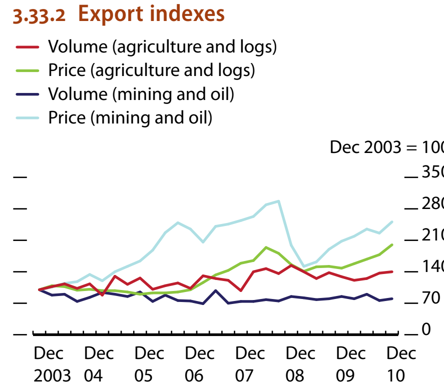
3.33.2 Export indexes



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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foreign grants, increased in real terms by 17%, mainly due to the higher commodity prices. As a result, the fiscal deficit narrowed significantly to 0.5% of GDP, including off-budget items (Figure 3.33.3). Excluding off-budget spending from trust funds, the budget again showed a near-balanced outcome.

Inflation eased for a second year to average 6.0% in 2010, in large part a result of a pullback in food-price inflation (Figure 3.33.4). However, there are concerns that the consumer price index might understate inflation because its composition is outdated. The index excludes housing costs, thus direct effects of surging rents in urban centers are not captured.

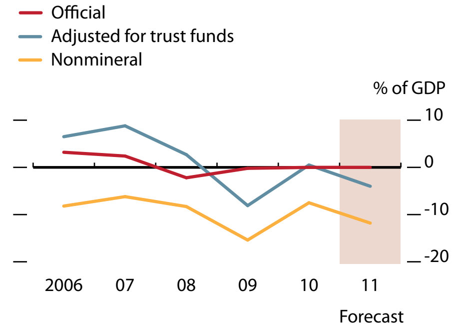
Growth in private sector credit slowed to a still high 17% in 2010 and broad money supply growth subsided to 12.5%. The Bank of Papua New Guinea raised the cash-reserve requirement for commercial banks in October 2010 to 4.0% from 3.0% to reduce excess liquidity, but kept its policy interest rate steady at 7.0% throughout the year. The kina exchange rate depreciated by 8% in 2010 against a trade-weighted basket of currencies, mainly due to the strength of the Australian dollar.

A surge in imports of equipment for the LNG plant, mainly funded by foreign direct investment, more than offset higher export receipts in 2010. The merchandise trade deficit widened to about 11% of GDP and the current account deficit to an estimated 27% of GDP. An increase in gross foreign exchange reserves to $2.6 billion (equivalent to 15.3 months of nonmineral imports of goods and services) was attributable to inflows of foreign direct investment.

The government in 2010 decided to move new public trust accounts to the central bank, a move that should give the monetary authorities better control over banking sector liquidity. Existing trust fund balances, however, remain in the commercial banking system.

In another important policy development, the government established a working group, chaired by the Treasury, to oversee establishment of a sovereign wealth fund. The plan is to manage revenue from resources through the offshore fund, with drawdowns to be channeled through the budget. This should help to shield the economy and the budget from the impact of swings in global commodity prices.

3.33.3 Budget balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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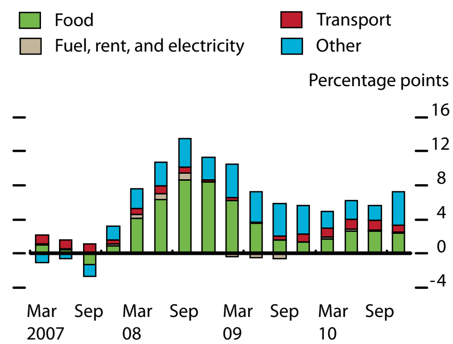
3.33.4 Contributions to inflation



Source: National Statistical Office.

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Economic prospects

Plans have been disclosed for a second LNG project, to cost $4 billion, and its developers have said construction could start late this year. Given uncertainty about the construction timetable, the outlook does not factor in any direct impact from this proposal.

Construction of the first LNG plant will accelerate this year (it faced some delays in 2010 owing to land access and compensation issues), thereby increasing activity in the construction and transport industries in particular. Still, the government estimates that only 4.5% of project investment will be retained in the domestic economy because most of the outlays are for imported goods and services.

The $1.4 billion Ramu nickel–cobalt mine, delayed last year over environmental concerns, is assumed to start production in 2011. Output from some operating mines is projected to rise, too. However, crude oil extraction rates will continue to fall as fields mature.

3.33.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	6.5
Inflation	8.0	7.5
Current account balance (share of GDP)	-35.9	-34.2

Source: ADB estimates.

High global prices for agricultural commodities will likely stimulate their production in 2011. Cocoa output is expected to rebound after it suffered from disease in 2010, and coffee production will rise, weather permitting.

On the balance of these factors, GDP growth is forecast to step up to 8.5% in 2011 (Figure 3.33.5), then ease to about 6.5% in 2012 when construction of the first LNG plant starts to taper off.

Price pressures will intensify this year in view of the demands on labor and resources from the first LNG plant. Supply-side constraints are apparent in construction and transport, the property markets in Port Moresby and Lae, and in skilled labor.

Higher global food and oil prices, coupled with last year's depreciation of the kina (against the Australian dollar especially) will fuel inflation, which is projected to accelerate to average about 8.0% this year and be near this rate in 2012. The central bank is expected to tighten monetary policy as inflation pressure builds.

The 2011 budget targets a balanced position, excluding trust fund expenditure. Nevertheless, there may be pressures on the government to spend more from trust funds ahead of elections expected in 2012. Further, a large portion of previous years' trust fund withdrawals may yet be spent. Such expenditure would result in a fiscal deficit and add to inflation pressures.

A buildup in net foreign assets has partially offset the impact of a reduction in net domestic assets on growth in money supply (Figure 3.33.6). This could add to inflation if the trend continues in 2011.

In the external accounts, higher levels of imports for resource projects will continue to widen the current account deficit, to around 35% of GDP in 2011 and 2012 (Figure 3.33.7). This gap will be largely financed by foreign direct investment. Foreign reserves are expected to remain adequate in terms of import cover.

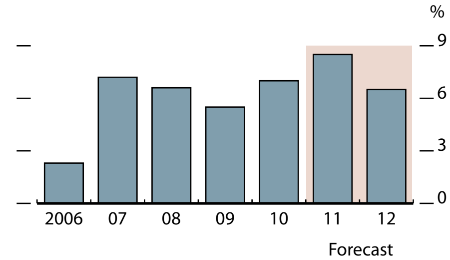
Risks to the forecasts on the upside would come from an early start to work on the second LNG plant or from higher than expected prices for export commodities. The main downside risk is seen in further delays to large resource projects from disputes over land and compensation for landowners.

In the medium term, production from the first LNG plant will underpin growth in GDP, but the likelihood of more such plants is uncertain. There are also uncertainties over mineral production: several large mines are forecast to close sometime in 2012–2015. It will be important that the authorities are cautious about committing to any substantial increases in expenditure, given that they will not receive significant revenue from the first LNG plant until 2018 and that receipts from mining depend on global prices and the life of the mines.

Development challenges

Although the economy has experienced sustained economic growth, driven primarily by development of minerals, the direct contribution of minerals to reducing poverty is limited. Few of the poor depend directly on mining and the links between mining and the rest of the economy are weak. There is currently no official measure of poverty but social

3.33.5 GDP growth



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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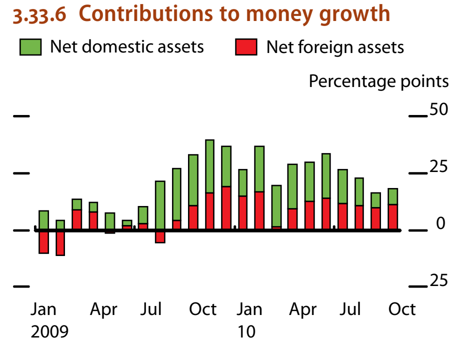
3.33.6 Contributions to money growth



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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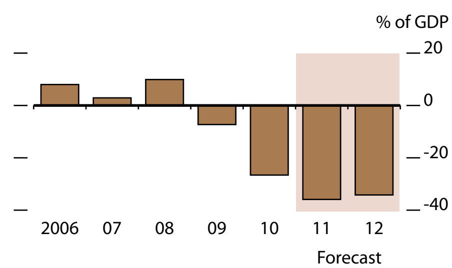
3.33.7 Current account balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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indicators are below those of other countries with similar per capita incomes. Indeed, Papua New Guinea is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 137 out of 169 countries in the 2010 human development index compiled by the United Nations Development Programme.

The government will have an opportunity to improve living standards by rehabilitating infrastructure and upgrading basic services when substantial revenue starts to flow to the budget from LNG projects. It will also have funds to meet adjustment costs of structural reforms to open business sectors controlled by state-owned enterprises, such as ports and electricity, to private competition.

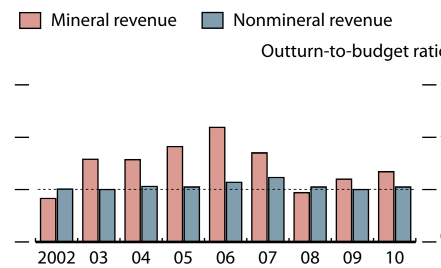
The government's medium-term development plan for 2011–2015 recognizes these challenges and paves the way for a stronger effort to address them. It puts more emphasis on policy achievements and results-based monitoring of the public service. Government commitment to the plan will be critical if agencies are to be held accountable for underperformance. Further, realizing the plan's goals will require marked improvements in the public service and public financial management.

Managing volatile flows of revenue from resources is a continuing challenge. The government has usually erred on the side of caution, under-forecasting commodity prices so that mineral revenue has tended to exceed budget targets (Figure 3.33.8). This generates large windfall revenue that has been directed to discretionary capital spending in supplementary budgets.

It would, though, be helpful if the supplementary budget process was more flexible, to allow some of these funds to be spent on rehabilitation and maintenance of public infrastructure. The plan to manage resource revenue through a sovereign wealth fund should help to smooth revenue flows to the budget.

Improvements to the business environment, including reforms of state-owned enterprises, are required to generate sustainable growth and employment in nonmineral sectors. The World Bank's *Doing Business 2011* report ranks Papua New Guinea 103 out of 183 countries, up from 108 in 2010. The improvement in the overall ranking stemmed from easier availability of credit (though its ranking dropped for other sub-indicators). The lack of enforcement of contracts is, in particular, a deterrent to investment.

3.33.8 Budget revenue forecasts



Note: If the ratio is greater than 1, the outturn is larger than the budget target.

Source: ADB estimates using Papua New Guinea budget documents, 2002–2010.

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Timor-Leste

Driven by increases in government expenditure, this petroleum-dependent economy grew rapidly in 2010 and is forecast to record double-digit growth in 2011 and 2012. Higher oil prices are positive overall for the country, but they have also fueled inflation. Longer-term prospects rest on using government investment to build human and physical capital and to trigger a transition to private sector–led growth.

Economic performance

Economic momentum generated by a rapid buildup in government spending has resulted in the preferred measure of GDP—excluding offshore petroleum production and the United Nations (UN) peacekeeping mission—averaging double-digit growth in 2007–2010. This measure of GDP rose by 9.5% in 2010, moderating from a very high rate in 2009.

Government expenditure, funded mainly by income from offshore petroleum production, increased steeply from about $220 million in 2006 to around $825 million in 2009, and was budgeted at $967 million for 2010 (although actual outlays probably fell short of the budget) (Figure 3.34.1).

Much of the additional government spending was on items that fed quickly into the local economy. Private consumption was boosted in 2010 by a continued rise in public sector wages and salaries, as well as cash transfers provided in rural areas through a wide-ranging social safety net. There was a further large expansion last year both in small, rural infrastructure projects and in larger public projects in the capital, Dili.

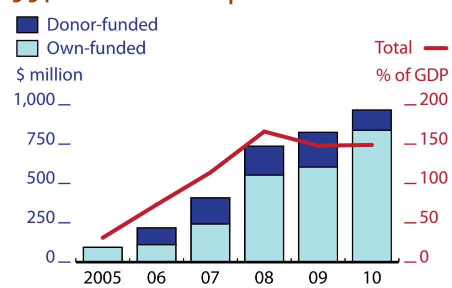
Private investment also climbed as local and overseas-owned businesses geared up to take advantage of the opportunities presented by rising public investment and buoyant consumer spending.

A high level of aggregate demand is reflected in a range of indicators, including new vehicle registrations, electricity use, and mobile phone subscribers (Figure 3.34.2), albeit with some sign of an easing in growth in 2010.

Construction expanded alongside rising investment. Agricultural output, which contributes around 30% of GDP, barely rose in 2010 because of bad weather and continuing transport problems. This followed 2 years of 13% growth in the sector, when it was bolstered by government-led distribution of better seeds and of tractors, and by the introduction of extension services. The Ministry of Agriculture estimated that rice production declined by 6.4% in 2010. Maize production, though, rose by an estimated 10.5%, and coffee exports rose from an unusually low 10,000 tons in 2009 to 25,600 tons in 2010.

Merchandise exports, mainly coffee, represent less than 10% of the

3.34.1 Government expenditure



Note: Nonpetroleum, non-UN GDP.

Source: ADB estimates based on Government of Timor-Leste. 2009. *General Budget of the State* and *State Plan for 2010*. October.

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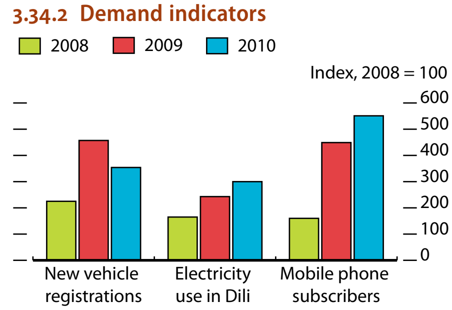
3.34.2 Demand indicators



Source: ADB estimates from Timor-Leste National Directorate of Statistics data.

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This chapter was written by Craig Sugden of the Special Office in Timor-Leste, ADB, Dili.

value of merchandise imports. The wide trade deficit, in the order of 65% of nonpetroleum, non-UN GDP, is outweighed by a surplus in the income account attributable to petroleum revenue. In 2010, such revenue rose to an estimated $2.1 billion, and provided for a current account surplus equivalent to 238% of nonpetroleum, non-UN GDP.

Growth in broad money supply slowed to a more normal 9.7% in 2010, from the exceptional 39.6% in the previous year when the banking system saw a buildup of unspent government funds. Bank lending remained constrained by a backlog of nonperforming loans and a continuing problem of securing land as collateral. Consequently, commercial bank credit to the private sector was unchanged in 2010 from 2009.

Inflation accelerated to average 6.8% in 2010 and was running at 9.2% year on year in December (Figure 3.34.3). Rising food prices were the main reason, themselves largely due to higher international prices. Inflation was lower for prices set by domestic rather than international conditions, suggesting that inflation was cost push rather than demand pull.

Economic prospects

Outlooks for the short and medium term rest heavily on developments in government expenditure. The government has budgeted to boost its own-funded spending by about 50% to $1.27 billion in 2011. Much of the increase is for a multiyear national electrification project and will not be fully spent in 2011, but a sizable increase in actual expenditure is projected for 2011. The government has foreshadowed that its own-funded spending will rise to about $1.45 billion by 2015. Total infrastructure investment over 2011–2015 is projected to exceed $3 billion.

This surge in government outlays will continue to support aggregate demand and construction. Barring disruptive shocks, economic growth is likely to remain high at around 10% over the forecast period (Figure 3.34.4).

The UN mission is phasing down toward a scheduled departure at end-2012, which will have a damping effect on growth, mainly in 2013. Until then, expansion in government expenditure will more than offset that effect.

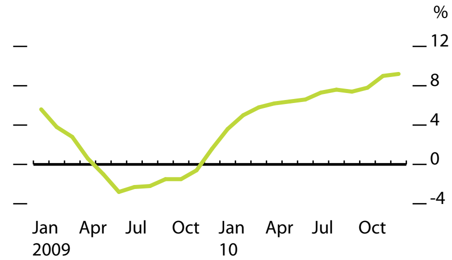
High world oil prices are boosting public saving, providing the financial resources to sustain the investment surge. The nation's Petroleum Fund held $6.9 billion in offshore investments at end-2010, and even with large withdrawals planned to finance the budget, the value of the fund is projected to rise above $14 billion by 2015.

Petroleum income exceeding $2 billion annually is likely to lead to further large budget and current account surpluses in 2011 and 2012. The budget surplus is, however, projected to decline this year as the expansion in government expenditure is expected to outweigh the additional revenue provided by higher world oil prices. From 2012, restraint in recurrent spending and a planned leveling off in public investment are seen easing the downward trend in the budget surplus (Figure 3.34.5).

Inflation is forecast to average 7.5% in 2011, before decelerating in 2012 as upward pressure on commodity prices eases.

While the rise in oil prices is a positive factor overall for this economy, the government needs to carefully manage the resultant

3.34.3 Year-on-year inflation



Source: Timor-Leste National Statistics Directorate. Consumer Price Index. http://dne.mof.gov.tl (accessed 25 February 2011).

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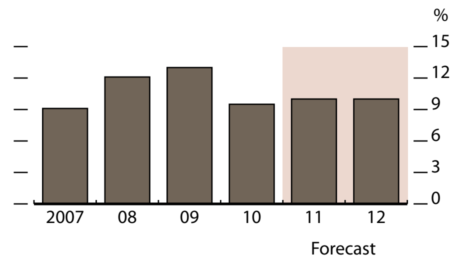
3.34.4 GDP growth



Note: Nonpetroleum, non-UN GDP, annual growth.

Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.

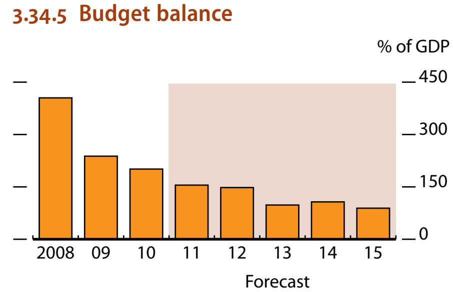
Click here for figure data

3.34.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	10.0
Inflation	7.5	5.3
Current account balance (share of GDP)	233.7	205.8

Source: ADB estimates.

3.34.5 Budget balance



Note: Ratio to nonpetroleum, non-UN GDP.

Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.

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inflation. It should avoid continually adjusting public sector wages to compensate for the higher cost of living, which could result in a wage–price spiral. That would have the potential to turn what is largely a problem of imported inflation into a deeper risk to macroeconomic stability.

The high rate of economic growth projected for the medium term will see further inroads into poverty. Average household incomes rose by about 20% in 2007–2009, helping to reduce the incidence of poverty from an estimated 50% to a still high 41%. The rate of progress in poverty reduction will rest on success in continuing to expand basic public services and in providing economic opportunities in rural areas.

Development challenges

Development is being fast-tracked through the conversion of petroleum wealth into physical and human capital. The surge in government expenditure funded from petroleum revenue is enabling a rapid expansion in public services and has provided a public social safety net for many. After ranking 150 of 159 countries in the United Nations Development Programme's 2005 human development index, Timor-Leste's position improved to 120 of 162 in the 2010 index.

Still, development challenges are daunting. Income from petroleum lifted Timor-Leste to lower-middle-income country status in 2007, but other indicators of development generally remain those of a low-income country. Of the 21 measurable Millennium Development Goals, about half are unlikely to be met by the target date of 2015, notably those relating to poverty and nutrition. The coverage of electricity, water, and telecommunications infrastructure has expanded, but access and service quality are below potential. Most of the road network is in poor condition.

Public investment needs are likely to stay high over the next decade and beyond (Box 3.34.1). Fiscal constraints will, however, ultimately limit public investment's ability to support the economy. Sustaining a high rate of economic growth will rest on a transition from public to private sector–led investment. As the domestic private sector is still emerging and not yet ready for major investments, there is likely to be a gap that will need to be filled by foreign inflows. The country's success in establishing itself as one of developing Asia's investment destinations will therefore be pivotal to its growth path.

Ideally the level of public investment will be responsive to the returns that it generates. The fundamental rule of public investment is that it should generate an economic return—broadly defined to capture the full range of factors that determine community welfare—at least as high as the economic cost of funding. Most public investment will need to be funded by withdrawals from the Petroleum Fund. Such investment should aim for a return that exceeds the cost of withdrawals, being the financial return that would have been earned if savings had remained in the fund.

The government has flagged the prospect of borrowing on concessional terms to fund public investment. Similarly, any public investment funded from borrowing should aim for a return higher than the interest rate paid, plus any other costs. Borrowing makes sense if it allows savings to be kept in the Petroleum Fund to earn a return higher than the cost of the debt.

3.34.1 How much investment does Timor-Leste need?

An economy's longer-term investment needs can be understood through growth accounting, which decomposes growth into its components: the accumulation of capital and labor, and productivity improvements.

For Timor-Leste, projections prepared in this way highlight the economy's potential to grow robustly over the next two decades. Factors in Timor-Leste's favor include a growing labor force, an ability to fund a high rate of public investment from petroleum revenue, and the potential for a quick catch-up in education and technology.

A continuation of recent double-digit rates of economic growth would probably require investment rising above $1 billion annually within 5 years and above $1.5 billion within 10 years (in 2010 prices). This would be a very large increase on the 2010 investment level of about $300 million.

Projections made using the growth accounting framework show that lower, but still internationally high, rates of economic growth could be achieved if investment was around half these levels. This lower estimate of annual investment—at least $500 million and $750 million—sets a minimum target.

Source: C. Sugden. Forthcoming. *Timor-Leste: Economic Growth to 2030.* Asian Development Bank, Manila.

Small Pacific countries

Seven of the 11 small Pacific economies grew in 2010, albeit slightly, and GDP was estimated to be flat in three. GDP fell in one (Tonga), in contrast to 2009 when the global recession contributed to contraction in seven economies.

The pickup in global travel in 2010 helped some countries. Government infrastructure projects, mostly donor financed, also supported economic activity, notably in the Cook Islands, the Marshall Islands, and the Federated States of Micronesia. Export receipts remained weak, however (except for Solomon Islands). Inflation decelerated from 2009 levels for most economies.

The economic outlook is more positive for 2011 on the back of continued global recovery. This will contribute to increased tourism earnings, export receipts, and remittances. Several economies will benefit from greater spending on public infrastructure. Growth is forecast to pick up in eight countries this year and, and for about half of them, edge still higher in 2012.

Inflation is projected to increase in all 11 countries this year, primarily owing to higher global food and fuel prices for these import-dependent economies, before price pressures ease for most of them in 2012.

Cook Islands

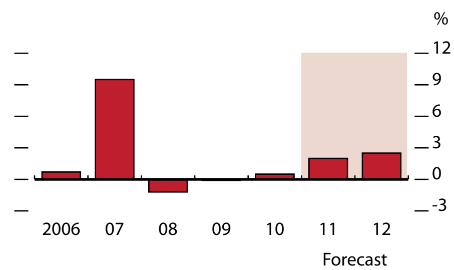
After 2 years of contraction, this economy grew by 0.5% in FY2010 (ended 30 June 2010), supported by expansion of tourism and fisheries, as well as the start of construction on some donor-financed infrastructure projects.

Visitor arrivals and expenditure rose by 2.7% and 2.6%, respectively. Exports of fish (54% of total exports) increased by 15.9%. These performances offset a 10.1% decline in pearl exports caused by a shortage of skilled pearl-seeding technicians.

Growth is projected to pick up to 2.0% in FY2011 (Figure 3.35.1), as infrastructure projects, including development of Avatiu port, gain momentum. However, tourism is subdued because of softness in consumer spending in New Zealand, the main source of visitors. Growth prospects are more positive for FY2012, on the expectation that tourism will pick up and infrastructure investment will increase. GDP growth is forecast to rise to 2.5% that year.

Inflation moderated to 3.5% in FY2010, but will likely quicken to average 4.0% in FY2011. Higher prices for imported oil and commodities, coupled with increased construction activity, have pushed up prices for food, housing-related costs (including electricity), and transport.

3.35.1 GDP growth, Cook Islands



Sources: Ministry of Finance and Economic Management. *Budget Estimates 2010/11: Part 1 Appropriation Bill Appropriations and Commentary*. http://www.mfem.gov.ck; ADB estimates.

Click here for figure data

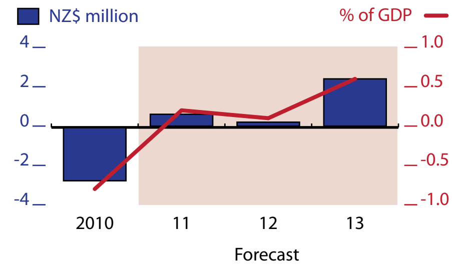
This chapter was written by Stephen Pollard and Elbe Aguba of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Rommel Rabanal, consultant.

Merchandise exports fell by 21% in FY2010, largely owing to the problems with pearl production, while imports rose by 42%. The trade deficit widened, and is expected to worsen as import growth, driven mainly by materials for projects that donors are financing, outpaces exports.

Government revenue exceeded budget estimates by 4.3% in FY2010, a result of better than expected receipts from company tax and one-time revenue from fines for illegal fishing. Expenditure was 9.6% over budget, partly on account of supplementary appropriations to cover cyclone recovery expenses and subsidies for Air New Zealand flights from Rarotonga to Sydney and Los Angeles. Still, the budget deficit of NZ$2.7 million (0.8% of GDP) narrowed sharply from 11.7% in FY2009.

The FY2011 budget projects an operating surplus of 0.2% of GDP (Figure 3.35.2), but this was framed against an earlier backdrop of a more positive tourism outlook. Consequently, revenue collections will need to be revised down. The government is aiming to trim expenditure by 1.5% relative to FY2010. Public debt is projected to fall by NZ$30 million to NZ$114.8 million in FY2011 (equivalent to 34% of GDP), mainly due to movements in exchange rates.

3.35.2 Fiscal balance, Cook Islands



Source: Ministry of Finance and Economic Management. 2010. *The Cook Islands Half Year Economic and Fiscal Update for the Financial Year 2010/2011*. December. http://www.mfem.gov.ck

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Kiribati

This economy, too, performed better in 2010, following 2 years of contraction (Figure 3.35.3). Estimated GDP growth of 0.5% was attributable mainly to additional spending by the public sector and to some pickup in private sector activity, especially in construction and retailing. This performance offset a fall in remittances and copra production.

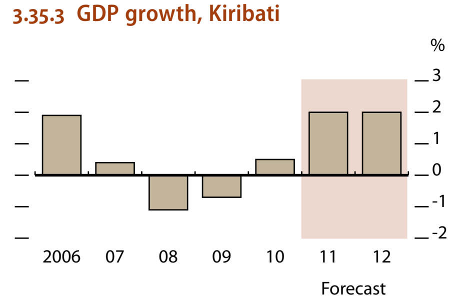
Remittances from the country's seafarers, which account for about 7% of GDP, fell by an estimated 13% in 2010 because of weakening demand for the country's seafarers and greater supply of such workers from other nations. Production of copra declined owing to bad weather.

Wage increases for the public service and higher subsidies for copra production were major factors in widening the budget deficit to an estimated 15% of GDP in 2010. The 2011 budget projects a further rise in public service wages, and in infrastructure investment, pushing the deficit out to 19% of GDP. The gap is to be financed from the country's wealth fund and short-term loans.

The value of the wealth fund—the main source of deficit financing—declined from A$637 million (420% of GDP) in 2007 to A$571 million (350% of GDP) in 2009, primarily due to losses on investments, as well as drawdowns that averaged around 19% of GDP annually from 2007 to 2010. Although the fund's investments recovered marginally last year, concerns remain about its sustainability. The International Monetary Fund recommends that the budget deficit be limited to 6.0% of GDP to preserve long-term financial sustainability.

Fiscal risks are likely to worsen if the government undertakes substantial external borrowing to fund capital works, and if drawdowns from the wealth fund remain high. The government has adopted a medium-term fiscal framework that should help to maintain fiscal discipline.

3.35.3 GDP growth, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.

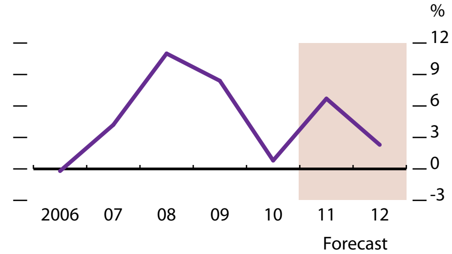
Click here for figure data

Economic growth is likely to pick up to about 2% in 2011 and 2012 as large, mostly donor-funded, capital works get under way. These include revamping the international airports in Tarawa and Kiritimati, upgrading the South Tarawa Road, and extending Betio port.

Inflation slowed to average 0.8% in 2010 (Figure 3.35.4), reflecting appreciation of the Australian dollar and the lagged pass-through from international to domestic prices. This year, though, inflation is expected to accelerate to 6.7%, driven by higher prices for imported fuel and food.

The current account deficit is set to widen from about 14% of GDP in 2010 to about 23% in 2012, in part a result of lower investment income from the wealth fund as drawdowns become smaller.

3.35.4 Inflation, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.
Click here for figure data

Marshall Islands

Supported by grant-financed increases in government spending and expansion in fish processing, the economy grew by an estimated 0.5% in FY2010 (ended 30 September 2010). This represented a turnaround after 2 years of declining GDP (Figure 3.35.5). Higher global prices of copra and coconut oil—the country's major agricultural exports—contributed to some increase in export receipts.

The fiscal balance improved, posting a surplus of about 0.3% of GDP in FY2010 (compared with a deficit the previous year), owing to improved tax collection and an increase in fishing fee income. Inflation quickened to 1.0% on higher prices for fuel, electricity, and transport.

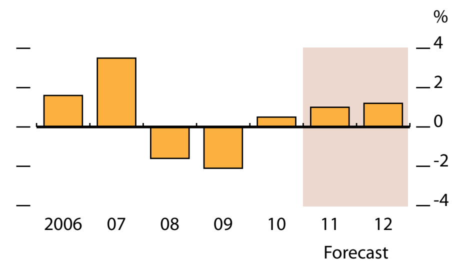
In preparation for when grants under the Compact of Free Association with the United States (US) expire, scheduled for 2024, the government is implementing tax reforms this year that aim to improve the fiscal position, including by raising revenue. It has taken some measures to trim expenditure, but needs to make more cuts for long-term fiscal sustainability. Such reductions could include allowances for civil servants and public officials and assistance to state enterprises.

Economic growth is expected to pick up marginally to 1.0% in FY2011 and 1.2% in FY2012. The outlook is supported by additional grants from Taipei,China and the European Union, which will partly offset the impact of a 5.5% cut in government spending this year. Fisheries, a key source of income, could benefit from planned subregional collaboration on managing fish-stocks.

Inflation is forecast to accelerate to about 5.0% in FY2011 on rising food and oil prices, coupled with some renewed demand-side pressures as the economy grows, before moderating to 3.8% in FY2012 as global commodity price pressures subside (Figure 3.35.6).

Risks to the outlook center on rising prices for commodities, a possible further downsizing of the US military base on Kwajalein, and the pace of phasing down compact-related grants from the US.

3.35.5 GDP growth, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.
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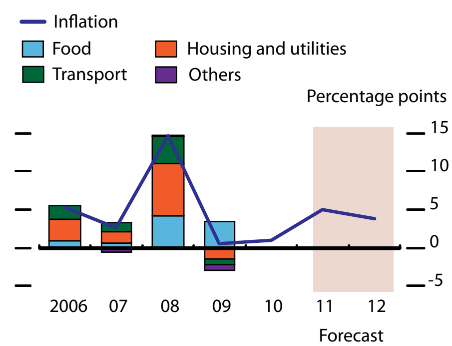
3.35.6 Contributions to inflation, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.
Click here for figure data

Federated States of Micronesia

Growth of an estimated 0.5% in FY2010 (ended 30 September 2010) followed a similar increase in GDP in FY2009 (revised from a previously estimated slight contraction).

The modest expansion was driven by public infrastructure projects,

including extension of Pohnpei airport and the expansion of the fiber-optic communications network. The reopening of a fish-processing plant in Kosrai and an increase in small-scale agriculture stimulated by rising commodity prices helped the economy, as did some uplift in remittances and tourism receipts.

Inflation subsided to about 3.5% in FY2010, owing to lower prices for imported food and energy in the early part of the year.

Reflecting a general weakness in consumption spending, food imports from the US, the main trading partner, fell by 6.7% in value in FY2010.

The government trimmed expenditure by 3.6% in FY2010, cutting capital spending by almost 20% while raising current spending by 2.1% (for the public wage bill and subsidies). Tax revenue growth of 7.9% helped to generate a small fiscal surplus.

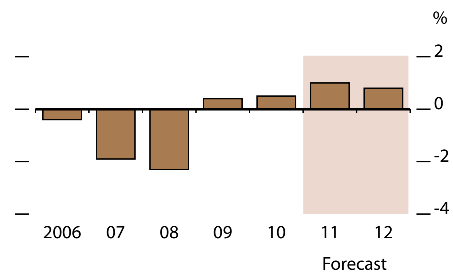
The fiscal situation has improved markedly since FY2009, in part because of efforts by state governments to raise revenue collection and cut spending. Nevertheless, much further progress is needed before FY2023, when grants expire under the Compact of Free Association with the US.

GDP growth is expected to pick up to 1.0% in FY2011 (Figure 3.35.7), based on a pipeline of infrastructure projects and the release of infrastructure funds delayed in previous years. With the Pohnpei airport extension scheduled for completion in mid-2011, improved direct flight connections could expand opportunities for tourism and exports. GDP growth is forecast at 0.8% in FY2012.

Inflation will likely inch up to 4.0% in FY2011 owing to higher global commodity prices, before easing to 3.0% in FY2012.

Sluggish development of the private sector, which is hindered by inadequate infrastructure, lack of skilled labor, and investment restrictions, remains an impediment to growth.

3.35.7 GDP growth, Federated States of Micronesia



Sources: Federated States of Micronesia Fiscal Year 2009 Economic Review; ADB estimates.

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Nauru

GDP was likely flat in FY2010 (ended 30 June 2010) (Figure 3.35.8) because storm damage to the port and weak demand restricted exports of phosphate.

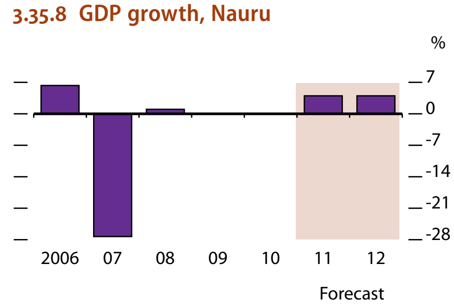
Repairs to the port, funded by the Russian Federation, with modest recovery in world phosphate demand, are expected to support a return to economic growth in FY2011 and FY2012. GDP growth of about 4% is forecast for each year.

Consumer prices declined by an estimated 0.5% in FY2010. The cost of telecommunications fell as a result of the entry of a new mobile telephone and Internet service provider. In FY2011 and FY2012, however, higher global food and fuel prices are expected to induce inflation of 2.5%.

The FY2010 budget outturn was a net cash position of A$7.7 million, with the surplus achieved after own-funded expenditure of A$20.2 million and donor-funded expenditure of A$11.2 million. This fiscal year's budget maintains the prudent fiscal management adopted since 2004. Spending in FY2011 is budgeted at A$29.0 million (excluding donor-funded projects), down by 9% from FY2010. Donor-funded expenditure is expected to total A$31.0 million. Without donor support, per capita GDP (estimated at US$2,240 in 2009) would fall by more than half.

Nauru faces an enormous debt burden as a result of poor

3.35.8 GDP growth, Nauru



Sources: Asian Development Bank. 2007. *Country Economic Report*. August; ADB estimates.

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decisions by previous governments. Total government external debt in 2010 was estimated at A$261 million. In addition, A$265 million is owed domestically by the government, mainly to depositors at the insolvent Bank of Nauru, and state-owned enterprise debts total about A$368 million. Total external debt is more than eight times GDP.

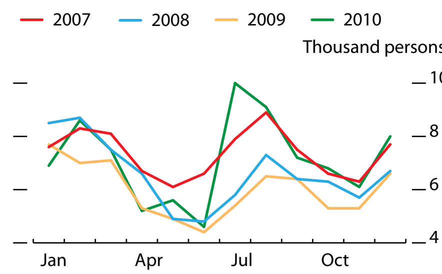
Over the medium term, the economy will remain heavily dependent on donors. Longer-term prospects depend on government reforms both to improve public financial management and the performance of state-owned enterprises, and to revitalize mining and quarrying, which now include coral aggregate used in construction (as well as phosphate). Tourism and fisheries offer untapped opportunities for greater economic self-sufficiency.

Palau

An upturn in tourism compensated for cuts in public expenditure to drive growth estimated at about 2.0% in FY2010 (ended 30 September 2010). This was the first year of growth after 4 consecutive years of contraction.

Tourism, which accounts for around half GDP, had seen visitor arrivals drop by a cumulative 16.5% over the previous 2 years. In FY2010, arrivals picked up by 11.7% as a result of the global economic recovery, new airline and charter connections to Palau, and intensified advertising and promotion. Growth was particularly strong in arrivals from Taipei,China. Arrivals from Japan, the largest source of visitors, rose sharply during the northern summer months. Total monthly arrivals recovered to 2007's levels by the second half of 2010 (Figure 3.35.9).

3.35.9 Visitor arrivals, Palau



Source: Palau Visitors Authority. http://www.visit-palau.com (accessed 16 March 2011).

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Domestic demand appears to have picked up a little last fiscal year. Consumption spending, as measured by the value of monthly food imports from the US, was just above the previous year's level. However, public investment on infrastructure projects remained low.

Inflation slowed to an estimated 3.8% on average from 5.2% in FY2009, due primarily to lagged effects of lower international prices of fuel and other commodities early in the year. Transport and household costs declined in the first quarter before climbing steadily.

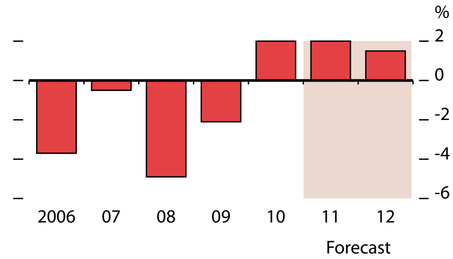
The original budget for FY2010 intended to reduce public expenditure by about 10%, as a start toward bringing outlays down to more sustainable levels. In a reversal of a recent trend of overoptimistic revenue projections, which had led to drawdowns in cash reserves and accumulation of public debt, the revenue shortfall was budgeted to narrow in FY2010.

However, a supplementary budget passed later in the year partly reversed the spending cuts and restored current expenditure to about the FY2009 level. Given the scheduled ending in FY2024 of grants from the US under the Compact of Free Association, it will be important to gradually reduce current expenditure to more sustainable levels, particularly the wages bill for the public service and purchases of goods and services. Otherwise, more severe spending cuts will be needed later. These reductions should be put through in parallel with increases in government revenue. Raising utility charges to eventually reflect the cost of service delivery would help.

Economic prospects remain largely dependent on the outlook for tourism. Visitor arrivals are projected to increase by around 7% in FY2011 (the first-quarter performance was strong), followed by another 5% gain in FY2012. Such expansion in tourism would help take GDP growth to 2% in FY2011 and 1.5% in FY2012 (Figure 3.35.10).

Inflation is projected at about 4.0% in FY2011, lifted by higher global food and fuel prices, easing to 2.5% in FY2012 as commodity price increases moderate.

3.35.10 GDP growth, Palau



Sources: International Monetary Fund. 2010. *Country Report* No. 10/116. May; ADB estimates.

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Samoa

Declines in agriculture, tourism receipts, and remittances offset growth in construction, manufacturing, and transport and communications in FY2010 (ended 30 June 2010), leaving GDP flat.

Even though visitor arrivals rose by 3.5% to 131,300, earnings from tourism fell by 6.0% to $130 million owing to a decrease in tourist spending per head. Remittances fell by 5.3% to $148.8 million.

Merchandise exports increased by 18.8% to $12.2 million in FY2010, led by strong performances from nonu fruit and coconut oil. Merchandise imports picked up by 14.1% to $261.6 million, reflecting higher costs of petroleum and food. A wider trade deficit, coupled with reduced remittances, saw the current account deficit worsen to 8.1% of GDP.

However, the overall balance of payments was in surplus due to net disbursement of government loans for tsunami reconstruction (a tsunami hit coastal areas in September 2009). Foreign exchange reserves of $165.7 million at June 2010 were equivalent to 7.6 months of import cover.

Inflation slowed to average 1.2% in FY2010. The deceleration was a result of falling commodity prices and subdued domestic economic activity.

Fiscal policy was exceptionally expansionary in FY2010, with a budget deficit equivalent to 8.1% of GDP. Spending was boosted by measures to counter the impact of the global recession on the domestic economy, coupled with post-tsunami reconstruction. These steps were largely funded by grants and concessional borrowing. External debt levels went up to about 43% of GDP by end-FY2010 (Figure 3.35.11), exceeding the government's 40% target.

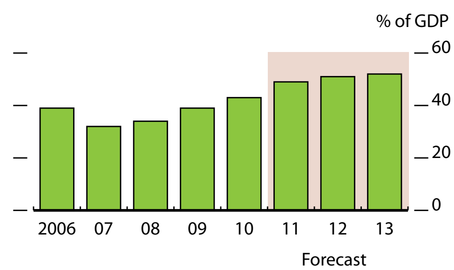
The FY2011 budget continues high levels of expenditure, reflecting the reconstruction effort and increases in public sector wages and pensions. The fiscal deficit is projected to widen to 9.3% of GDP.

The rise in government spending, and in private consumption to a lesser degree, are expected to produce a return to economic growth in FY2011, forecast at 2.1%. A stronger tourism marketing effort is likely to have some positive impact in FY2011, and private remittances should benefit from economic growth in Australia. For the first 7 months of FY2011, earnings from tourism and remittances rose by 4.0% and 1.1%, respectively.

Growth is seen rising to 3.0% in FY2012 on continued post-tsunami reconstruction and an expected increase in tourism.

Inflation is projected to increase to around 3.0% this year as domestic economic activity picks up and as a result of higher global food and fuel prices.

3.35.11 Total debt, Samoa



Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. 28 May.

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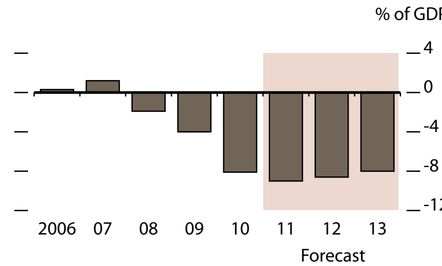
The government intends to run fiscal deficits of over 8% of GDP through FY2013 (Figure 3.35.12). Although the deficits are to be financed through concessional borrowing and grants, sustaining such a stance holds risks—the government would find it hard to adjust to any external shocks, for example.

Structural reforms to improve the commercial focus of state-owned enterprises and to increase access to, and economic use of, customary land are needed for the potential benefits of public investment to be realized.

3.35.12 Budget balance, Samoa



Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. May.
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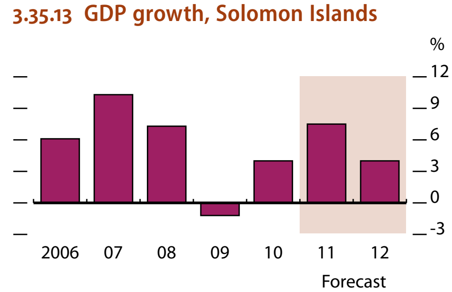
Solomon Islands

This economy recovered in 2010, growing by an estimated 4.0% after contracting by 1.2% in 2009 (Figure 3.35.13). Logging led the upturn. After a poor year in 2009, log export volumes rose by about 30% in 2010, a result of recovering demand in Asia that also helped to lift international log prices. Production of palm oil and cocoa, as well as the size of the fish catch, also increased, although copra production declined.

The services sector was sluggish in the first half of 2010, but business conditions improved in the second half according to a business expectations survey. Building activity indicators suggested expansion in construction as well.

GDP growth is forecast to accelerate to 7.5% in 2011, when the Gold Ridge mine in Guadalcanal is due to start producing and exporting gold. Logging is expected to decline during the forecast period, owing to falls in logging resources, but stronger global demand for other commodity exports, such as palm oil and copra, will bolster growth. Other positive factors include an expected rise in foreign investment in mining, including a new copper mine, and in telecommunications. Growth of about 4.0% is projected for 2012.

3.35.13 GDP growth, Solomon Islands



Sources: Central Bank of Solomon Islands. *Quarterly Review September 2010*. http://www.cbsi.com.sb; ADB estimates.
Click here for figure data

Inflation eased to average about 3.0% in 2010, largely due to a 40% fall in the price of rice caused by greater competition in food imports (rice constitutes around 18% of the consumer price index). Looking ahead, though, inflation is expected to accelerate to 4.2% this year and 6.3% in 2012, as a result of higher global prices for fuel and commodities and stronger domestic demand as the economy grows.

At an estimated 20% of GDP, the current account deficit remained wide in 2010, reflecting high levels of imports of mining and telecommunications equipment. The start of gold exports this year, coupled with growth in agricultural exports, is seen pulling back the deficit to 15% of GDP.

Despite the trade and current account deficits, foreign reserves rose to the equivalent of about 9 months of import cover, a consequence of large inflows of donor funds and the first tranche of a US$18.3 million stand-by credit facility approved by the International Monetary Fund in June 2010. Half this credit was disbursed in 2010 and the rest is scheduled for 2011. Foreign reserves are expected to remain strong in 2011, at about 6 months of import cover.

A tight fiscal situation for much of 2010 led to restrictions on expenditure until the fourth quarter and a government recruitment freeze. Budget support from donors, including large sums in the

second half of the year, together with a better than expected revenue performance, resulted in a budget surplus.

After elections in August 2010, the incoming government was unable to draft a full budget before year-end, and instead passed a supplementary appropriations bill that enabled spending to continue in the first 3 months of 2011, at no higher than in the same period of 2010.

Tonga

Weakness in remittance and tourism contributed to a 1.2% contraction in GDP in FY2010 (ended 30 June 2010). Remittances fell by 10.0% and earnings from tourism fell by 13.3% owing to slow recovery in source countries, particularly New Zealand and the US. GDP has contracted in 3 of the past 4 years (Figure 3.35.14).

Private sector credit fell by around 13% in December 2010, in part reflecting consolidation in the banking sector and the write-off of bad debts.

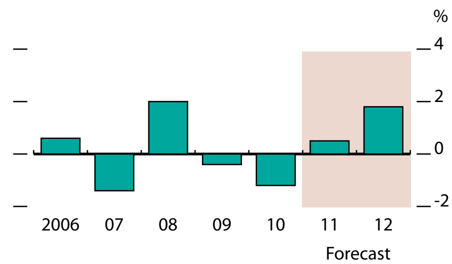
The government trimmed its nonwage operating costs and own-funded capital spending in FY2010, in response to a 4.0% decline in revenue (it fell short of the target by more than 20%). Budget support from donors limited the deficit to about 1.0% of GDP; without that support the gap would have been 2.3%.

In the external accounts, increased receipts from exports of sea cucumber more than made up for declines in fish and agricultural products in FY2010, so that total exports grew by 2.2%. Imports fell sharply, by 21.0%, reflecting weak domestic demand. The current account deficit narrowed to $16.6 million from $24.8 in FY2009. Official foreign reserves amounted to $98 million at end-December 2010, equivalent to 7.9 months of imports (Figure 3.35.15).

Donor-funded infrastructure activities are expected to support a return to economic growth of about 0.5% in FY2011. Government spending is budgeted to rise by 14.9%, based on commitments from donors, and will contribute to aggregate demand through higher public sector wages. Revenue, excluding grants, is to remain weak.

Inflation eased to 2.0% last year, mainly the result of better supplies and a related fall in prices for domestically produced food, as well as lower school fees. It is forecast to rise to about 3.0% in FY2011 on upward pressure from world oil prices and higher prices for imports from New Zealand, in part a result of exchange rate movements.

3.35.14 GDP growth, Tonga



Note: Fiscal year ending June.

Sources: Ministry of Finance. *Budget Statement: Review of the Tongan Economy and Outlook*. Various years. http://www.finance.gov.to; ADB estimates.

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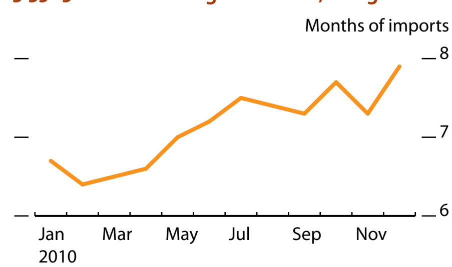
3.35.15 Official foreign reserves, Tonga



Source: National Reserve Bank of Tonga. *Official Foreign Reserves December 2010*. http://www.reservebank.to

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Tuvalu

This economy continued to feel the impact of the global recession in 2010. Even with higher government spending, GDP was estimated to be unchanged from 2009.

Seafarer employment—a significant income source for households—was weak and is likely to remain so due to subdued demand for Tuvaluan seafarers. Income from the ".tv" domain name and fisheries licenses fell as the Australian dollar (which Tuvalu uses) gained parity with the US dollar. The Australian dollar's strength also had an impact on

consumer prices: they eased from mid-2009, with the average decline in 2010 estimated at 1.9%.

The government continued to support the economy through spending. It approved three supplementary appropriation bills, together accounting for about 10% of GDP, in 2010. These were used to pay for the government's guarantee of an Air Fiji loan (Tuvalu is the biggest shareholder in the airline) and to increase capital spending by 15.7% from the original estimate.

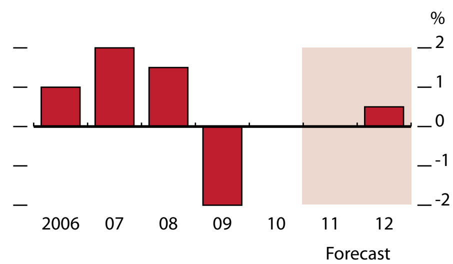
The fiscal deficit is estimated to have widened sharply to almost 30% of GDP in 2010, owing to lackluster domestic revenue and increased expenditure. Revenue is estimated to have declined by 17%, in part due to weak offshore income from all sources. Public debt (including guarantees) is about 44% of GDP, which is high for this small economy.

The value of the Tuvalu Trust Fund likely stabilized in 2010, after falling during the global recession. However, no distributions from this fund to the budget were made or are expected while international financial markets are volatile.

The economy is projected to stay flat in 2011 (Figure 3.35.16) as fiscal adjustments, mainly spending cuts, are made to ensure longer-term fiscal sustainability. Growth is expected to resume at about 0.5% in 2012 when donor-financed public works employing local workers are scheduled to start. Rising global food and fuel prices are likely to rekindle inflation, forecast at 1.5% in 2011 and 2.0% in 2012.

The number of households living in poverty has increased to about 20%, based on a 2010 household survey, from 14% in 2004. Declining remittances is the major cause. One way to ensure that funds are available to meet basic health and education needs for the poor would be selective cuts to other spending, such as medical insurance and scholarship programs, that benefit only a narrow section of the population.

3.35.16 GDP growth, Tuvalu



Sources: Central Statistics Division, Government of Tuvalu; ADB estimates.

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Vanuatu

Growth slowed to an estimated 3.0% in 2010 from an average of 5.7% in the previous 7 years. Agricultural production and construction increased, but tourism and retailing were soft.

The prolonged period of growth (8 years in a row) is attributable to increases in private investment, underpinned by policy reforms that included the opening of the aviation and telecommunications markets.

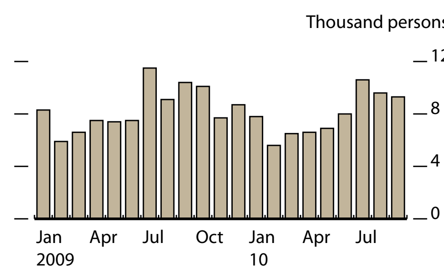
Last year, tourist arrivals declined by an estimated 2.6%, from record numbers in 2009 (Figure 3.35.17). The decline was largely due to a recovery in tourism to Fiji, which had lost market share to Vanuatu in 2009 (because of flooding and political uncertainty in Fiji).

Construction benefited from projects funded by the US Millennium Challenge Corporation as well as from some work on tourist facilities. Buoyed by higher prices for copra, coconut oil, and beef, agriculture recovered from a poor performance in 2009.

Inflation eased to average 3.4% last year. In the external accounts, the current account deficit likely widened to 2.4%, a result of lower tourism receipts.

The Reserve Bank of Vanuatu began to withdraw stimulus measures that it had implemented during the global financial crisis. It lifted

3.35.17 Visitor arrivals, Vanuatu



Source: Vanuatu National Statistics Office. *Tourism and Migration July 2010*. http://www.spc.int/prism/country/VU/stats

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the statutory reserve requirement for banks to 6% from 5% in August (still below the 8%–10% range of 1999–2008) and foreshadowed further monetary tightening as global economic conditions improve.

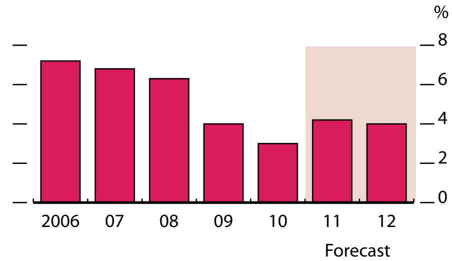
A near balanced budget was anticipated for 2010. Fiscal policy will likely remain broadly neutral in 2011, as the government is required under law to target budget surpluses.

GDP growth this year is forecast to rise to 4.2% (Figure 3.35.18), based on an expected increase in tourist arrivals—particularly from Australia—driven by robust economic conditions, a strong Australian dollar, and increased flights from that country. Agriculture is expected to pick up owing to high commodity prices. GDP growth of around 4.0% is expected in 2012, on continued gains in tourism and agriculture.

Higher food and fuel prices are forecast to raise inflation to 5.0% in 2011, before it eases to 4.0% in 2012. The current account deficit is expected to widen in 2011 and 2012 to 3.8% and 4.7% of GDP, respectively, as the pickup in domestic demand lifts imports.

Inadequate transport infrastructure and services hinder development of rural areas and outer islands, where income-generating opportunities are scarce. These areas need improved ports, wharves, and jetties, as well as more reliable and affordable shipping services. The country's road network is also inadequate: out of about 1,800 kilometers of roads, less than 100 kilometers is paved and about 400 kilometers is gravel surfaced.

3.35.18 GDP growth, Vanuatu



Sources: Reserve Bank of Vanuatu. 2010. *Quarterly Economic Review*. September. http://www.rbv.gov.vu; ADB estimates.

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