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.

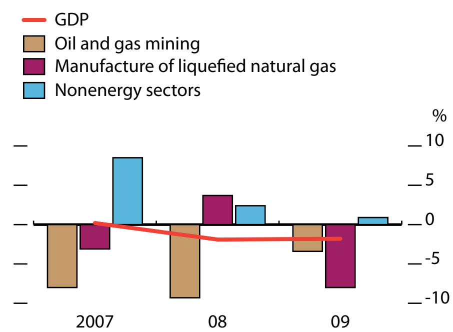
The GDP contraction in 2009 was revised to 1.8%. In that year, production of oil and gas fell by 3.4%, and LNG output by 8.0% (Figure 3.22.1), largely a consequence of weaker external demand and maintenance-related stoppages. Growth in the nonenergy sector in 2009 slowed to 0.9%, reflecting the impact 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).

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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).

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.

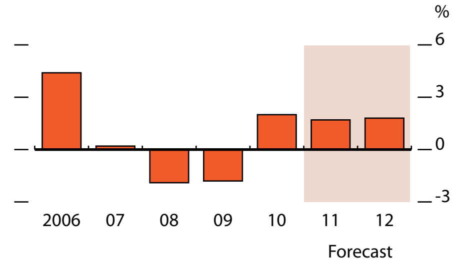
Private consumption is forecast to rise and investment to pick up this year as a result of construction projects and an improving business environment. Projects include the Pulau Muara Besar port (scheduled to be completed by end-2012), an upgrade of the international airport, and a power transmission 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.

3.22.2 GDP growth



Sources: Asian Development Outlook database; ADB estimates.

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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.

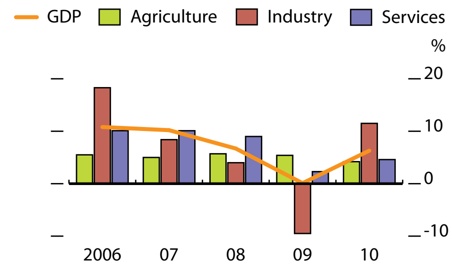
Recovery in global travel saw tourist arrivals rise by about 16% to 2.5 million, and tourism receipts by 14.5% to $1.78 billion (Figure 3.23.2). The sharpest gains were in arrivals from Asia, including Viet Nam (up 48% to 466,700), the Republic of Korea (up 47% to 289,700), and the People's Republic 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.

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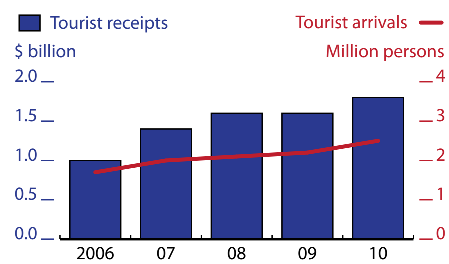
3.23.2 Tourism indicators



Source: Ministry of Tourism.

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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.

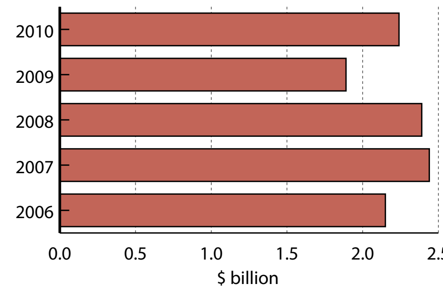
Latest available data show that 30% of the population lived in poverty in 2007, with the majority of the poor and vulnerable in rural areas. There are indications that poverty has increased since 2007 as a result of sharply higher food prices in 2008 and the economic slowdown in 2009. In response, the 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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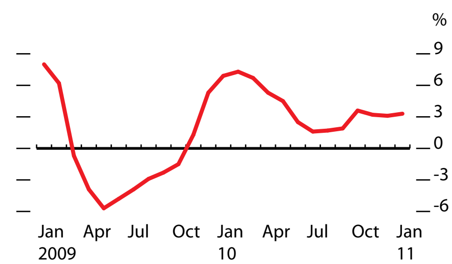
3.23.4 Inflation



Source: National Institute of Statistics.

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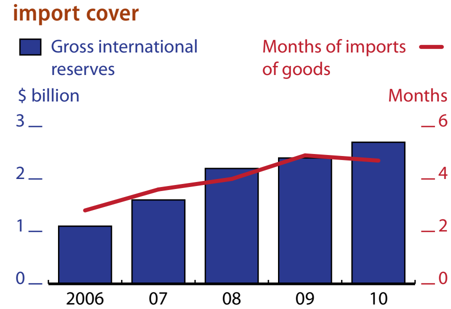
3.23.5 Gross international reserves and import cover



Source: National Bank of Cambodia.

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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.

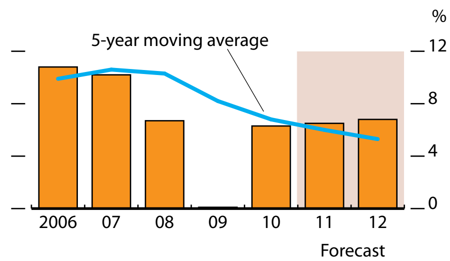
Growth in services looks set to pick up to about 5% this year. Tourist arrivals rose by 18% in January 2011 from the prior-year period, while trade and transport and communications are likely to continue expanding, as domestic consumption and the business outlook improve. Agricultural production is seen 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.

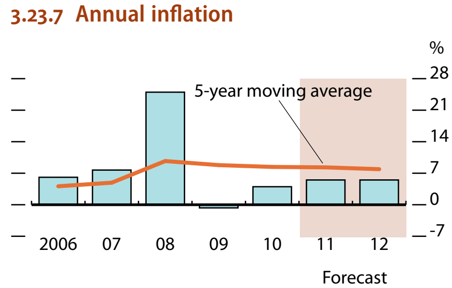
Click here for figure data

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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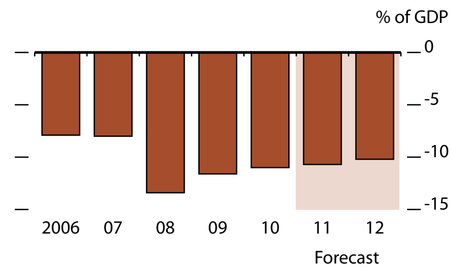
The trade deficit is expected to remain substantial, in part a result of the higher cost of imported oil in 2011. On the positive side, a rise in tourism receipts will contribute to a surplus in services trade. The current account deficit (excluding official transfers) is forecast at 10.7% in 2011 and 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.

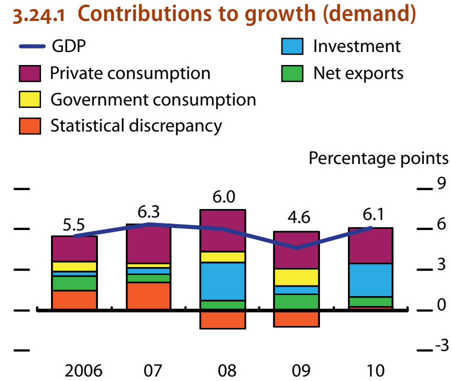
From the supply side, services again came in with the strongest expansion, at 8.4%, contributing 3.8 percentage points to GDP growth. Transport and communications recorded double-digit strengthening. Industry grew by 4.7%, reflecting a modest recovery in manufacturing, offset in part by slower growth 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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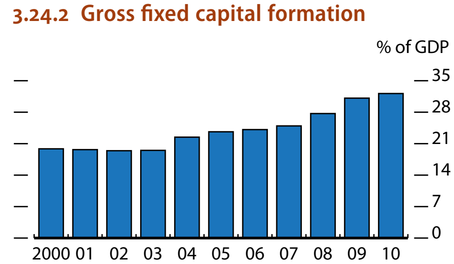
3.24.2 Gross fixed capital formation



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.

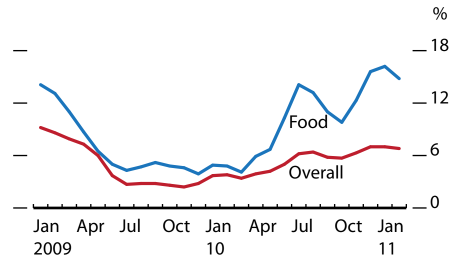
Nevertheless, the trade surplus rose to $31.1 billion in 2010 owing to a higher base for exports. The current account surplus moderated to $6.3 billion (0.9% of GDP). The transfers account recorded a marginally greater surplus, owing to growing remittances from migrant workers. However, the surplus was 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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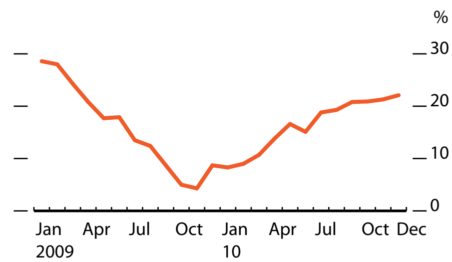
3.24.4 Credit growth



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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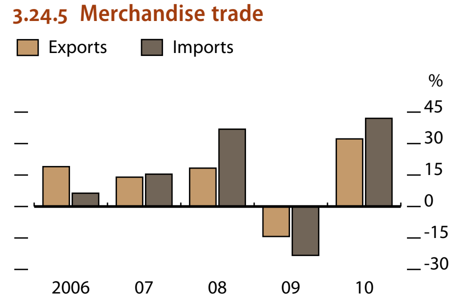
3.24.5 Merchandise trade



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 March 2011).

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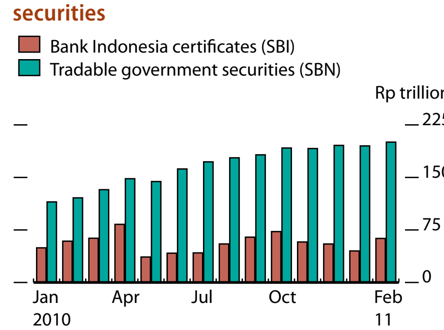
3.24.6 Foreign ownership of government securities



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

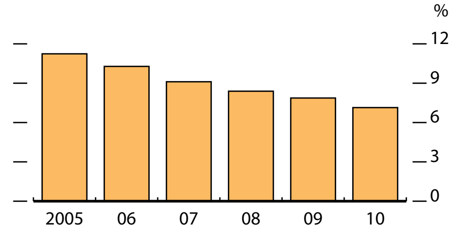
Forecasts assume that the government will continue to improve the investment environment, and that last year's bad weather (which hurt agriculture and mining) is not repeated in 2011.

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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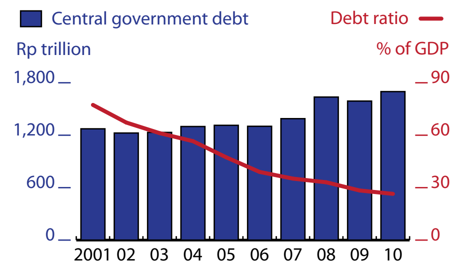
3.24.8 Government debt



Source: Directorate General of Debt Management. http://www.dmo.or.id (accessed 14 March 2011).

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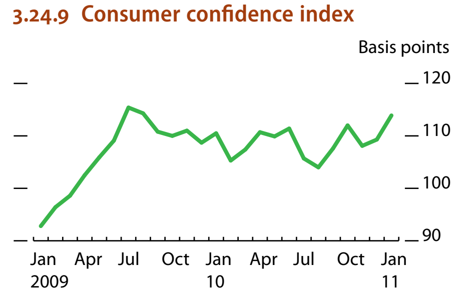
3.24.9 Consumer confidence index



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.

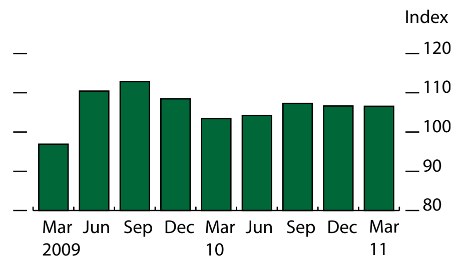
But inflation still poses a risk to the economic outlook. An unexpected sharp acceleration in prices could cloud the prospects for growth in private consumption, prompt a faster tightening of monetary policy, and raise fiscal outlays on subsidies, possibly at the expense of capital spending.

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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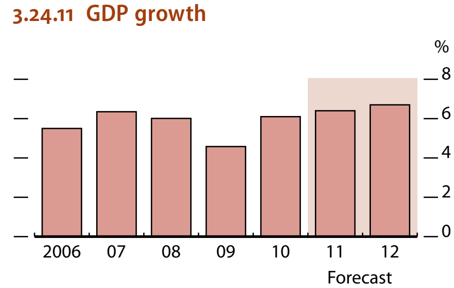
3.24.11 GDP growth



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

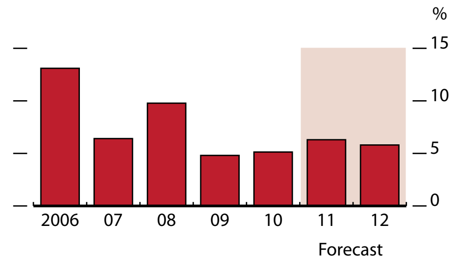
Although economic growth averaged 5.2% in the past decade, it remains below the 7%–8% rate recorded before the Asian financial crisis. This slowing of growth since the mid-1990s has been accompanied by lower growth in employment (Figure 3.24.13). The contribution of investment to growth has declined: 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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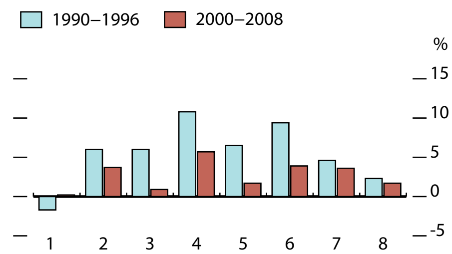
3.24.13 Employment growth by sector



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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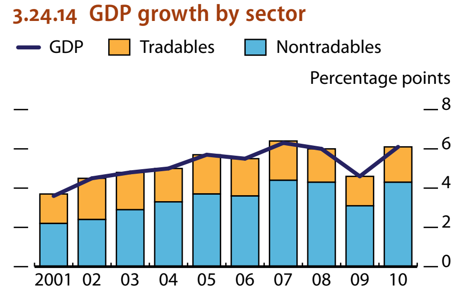
3.24.14 GDP growth by sector



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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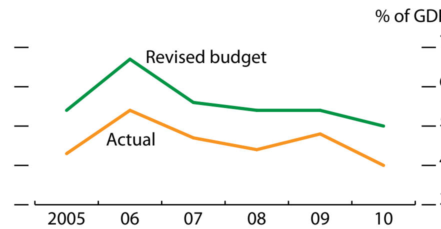
reducing public debt, at the same time as reorienting spending toward education and poverty reduction, the government needs to create greater budget resources (after accounting for essential spending) to lift infrastructure investment. Such space in the budget in the past 5 years has been low, at the 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.

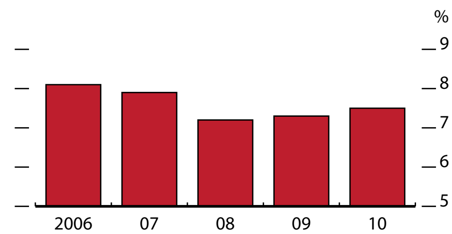
Construction activity benefited from expansionary fiscal and monetary policies.

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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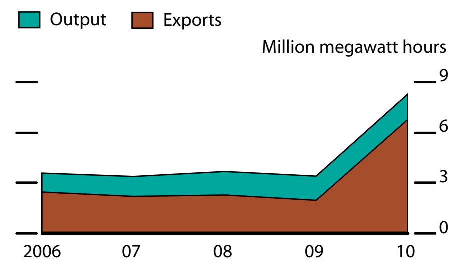
3.25.2 Electricity indicators



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.

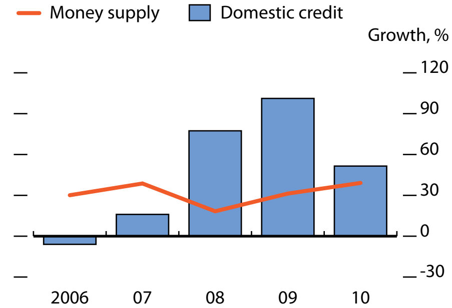
As part of a more than decade-long effort to join the World Trade Organization, the government made progress in bringing foreign exchange, investment, tax, and trade regulations into line with the organization's requirements, and completed bilateral goods and services agreements with the People's Republic 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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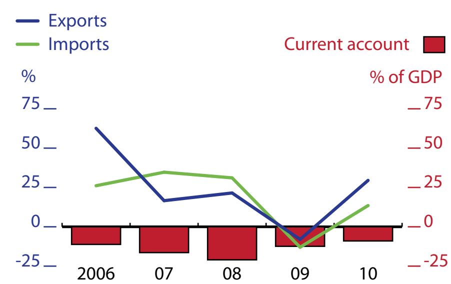
3.25.4 Current account indicators



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%).

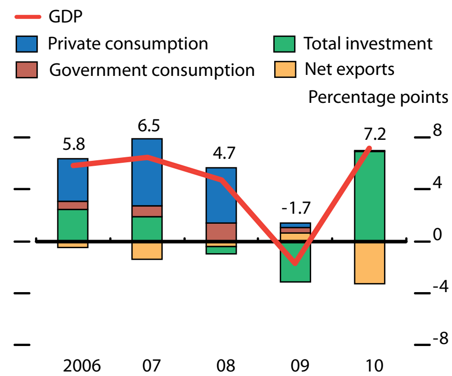
On the supply side, growth was supported by a relatively strong recovery in manufacturing output (11.4%) and by robust growth in services (6.8%) and construction (5.2%) (Figure 3.26.2). The recovery in manufacturing, which accounts for just over a quarter of total output, was driven by the strong growth 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

This chapter was written by Eric Sidgwick of the Southeast Asia Department, ADB, Manila.

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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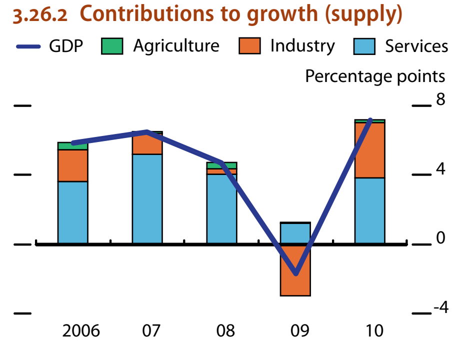
3.26.2 Contributions to growth (supply)



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).
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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.

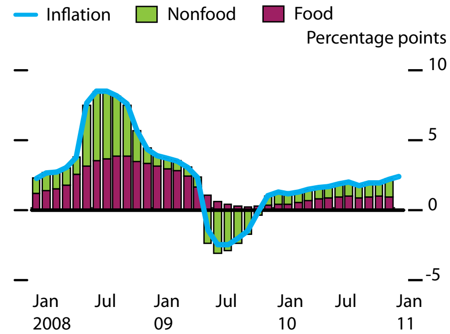
Higher payments for transport and other services linked to the initial sharp pickup in trade caused the services account to deteriorate. Deficits on the income and transfers accounts widened, the latter owing to higher remittances from foreign workers in Malaysia. As a result of these moves, the current 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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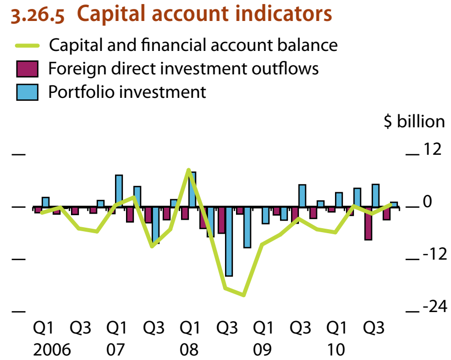
3.26.5 Capital account indicators



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

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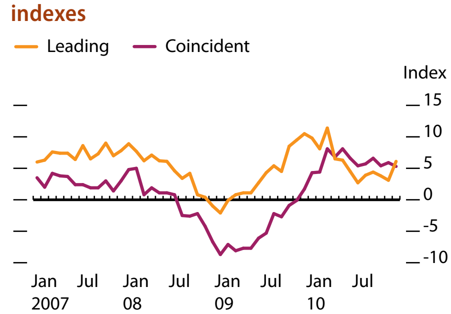
3.26.6 Growth of leading and coincident indexes



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.

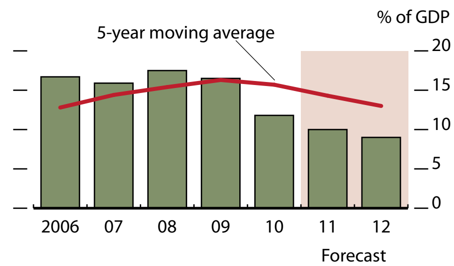
It is in this context that the government has embarked on its ambitious structural reform program (Box 3.26.1).

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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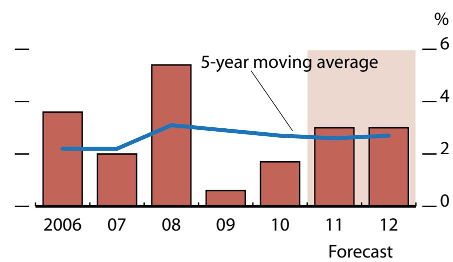
3.26.8 Annual inflation



Sources: Asian Development Outlook database; ADB estimates.

Click here for figure data

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.

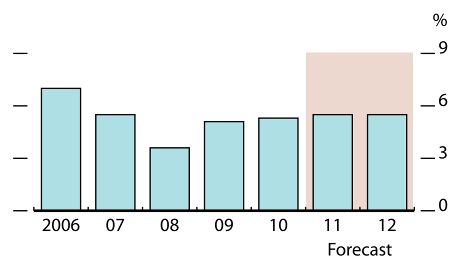
Agriculture in FY2010 was sluggish, however, a result of persistent drought in the central region and residual soil salinity in cyclone-affected areas.

(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.

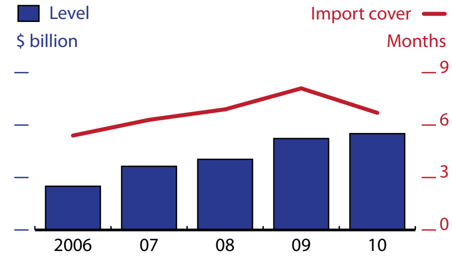
Investment is projected to rise in the forecast period, notably in construction. Projects planned or under way include new hydropower plants, gas fields, and oil and gas pipelines to the People's Republic of China, largely financed by foreign investment. A Thai company agreed last year to build a port, 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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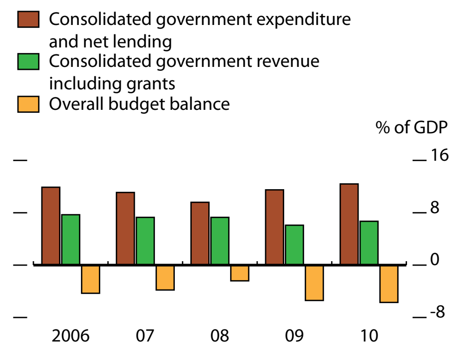
3.27.3 Fiscal indicators



Source: *Asian Development Outlook* database.

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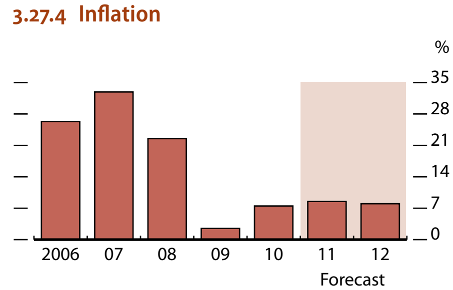
3.27.4 Inflation



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

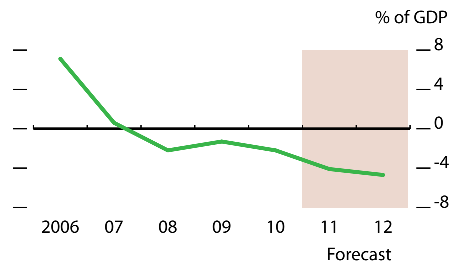
Source: ADB estimates.

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.

3.27.5 Current account



Source: Asian Development Outlook database.
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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.

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%).

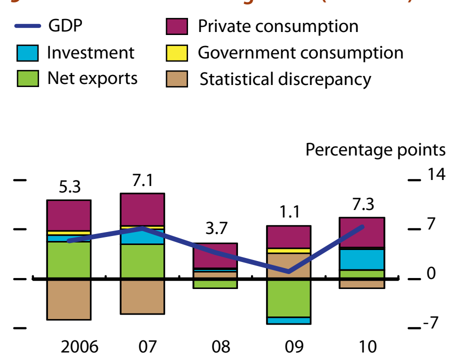
Investment contributed about 40% of total growth, the highest proportion in 10 years. Fixed capital outlays climbed by 17.1%, with equipment investment surging by 25.7%. Double-digit growth was recorded for investment in a broad range of equipment, including that for agriculture, construction, mining, 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.

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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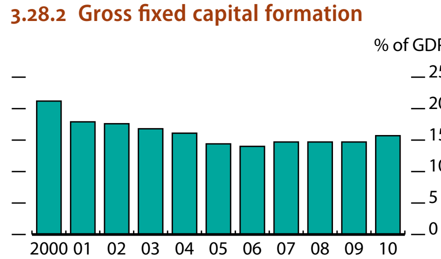
3.28.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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This chapter was written by Teresa Mendoza and Norio Usui of the Philippines Country Office, ADB, Manila.

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.

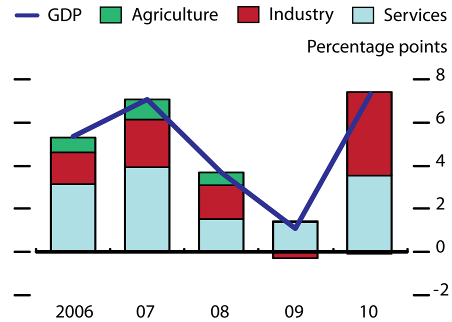
Merchandise exports shot up by 34.8% to $50.7 billion in 2010 (an increase of $13.1 billion over 2009), recovering from a 22% plunge in 2009 (Figure 3.28.5). Electronic products including semiconductors (three-fifths of total exports) surged by 40% as global demand bounced back. Shipments to the People's 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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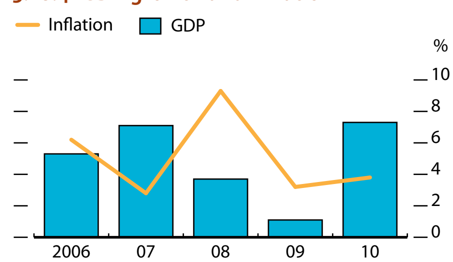
3.28.4 GDP growth and inflation



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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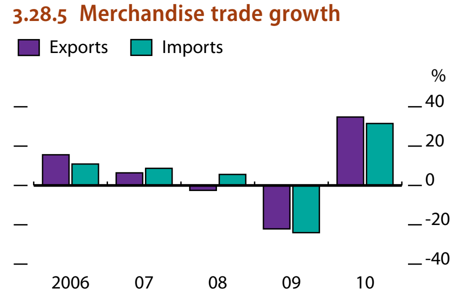
3.28.5 Merchandise trade growth



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).

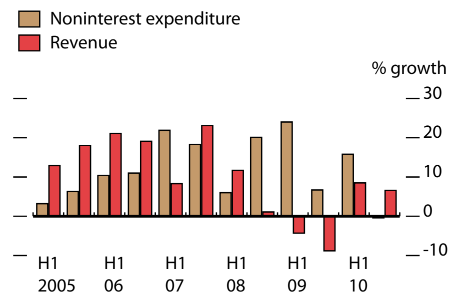
Click here for figure data

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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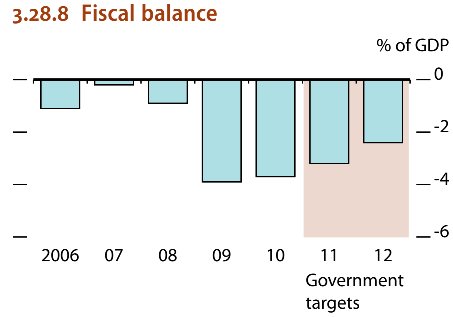
3.28.8 Fiscal balance



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.

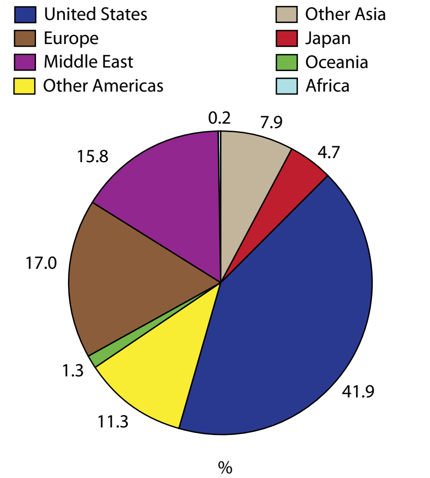
Inflation is forecast to rise to 4.9% in 2011 (it was 3.9% in the first 2 months). This projection reflects, besides higher prices for imported oil, hikes for utility charges and public transport fares. Higher global food prices will also put upward pressure on inflation, although this is cushioned by 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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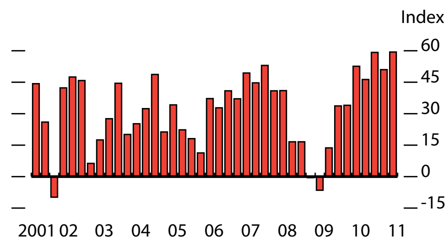
3.28.10 Business expectations index



Notes: Represents index for the next quarter. 2001 data is for June.

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

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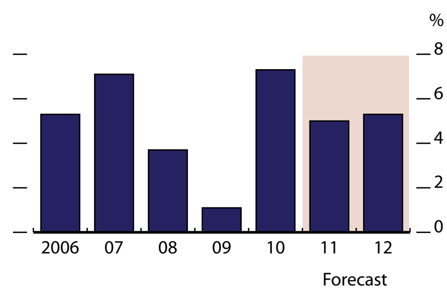
3.28.11 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 11 March 2011).

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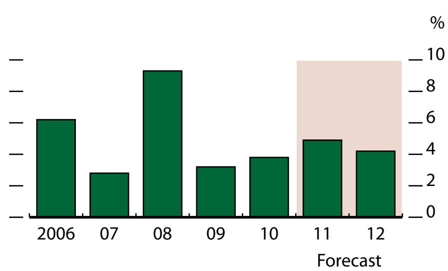
3.28.12 Inflation



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.

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.

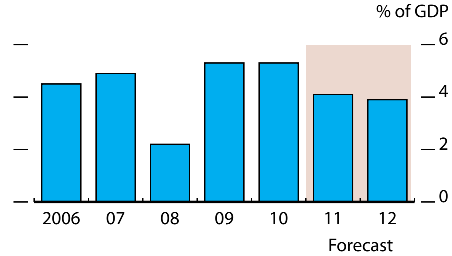
Weak employment generation and low productivity equate with slow reductions in poverty. The number of people living in poverty increased by 3.3 million to 23.1 million in the 6 years to 2009, when the incidence of poverty rose to 26.5% from 24.9%. Progress has been slower than hoped for on the Millennium 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.

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.

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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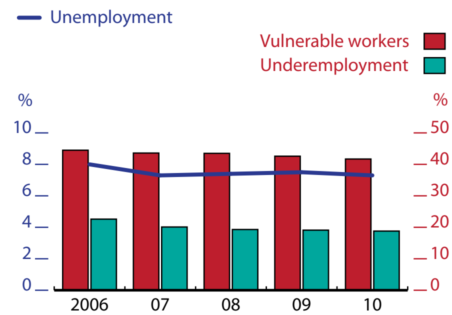
3.28.14 Labor indicators



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

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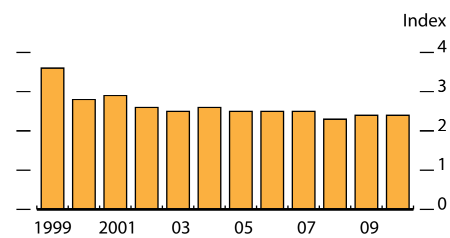
3.28.15 Transparency International's Corruption Perceptions index



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

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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).

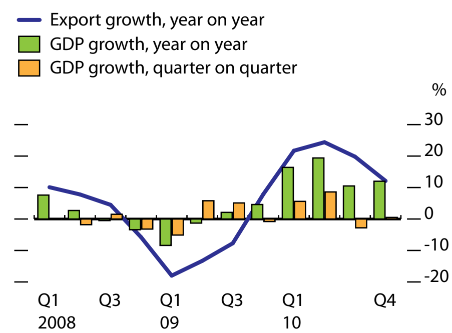
The impact of rebounding external trade and manufacturing spilled over into private consumption and investment. Private consumption increased by 4.2% in 2010, adding 1.6 percentage points to total growth. A stronger labor market lifted employment and wages. Visitor arrivals jumped by 20.2%, helping to 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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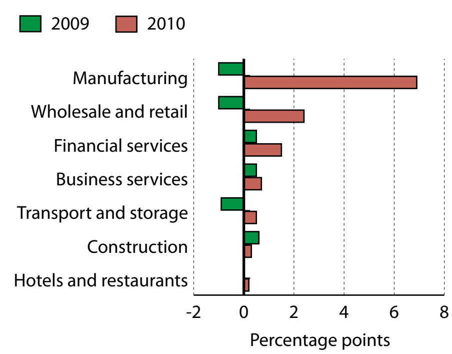
3.29.2 Contributions to growth (supply), selected sectors



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%.

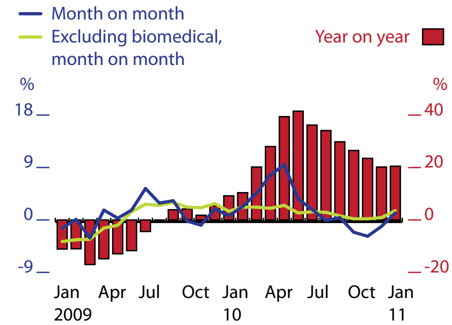
In the external accounts, a 31.1% rise in merchandise exports in 2010 outpaced a 27.6% increase in merchandise imports (both in US dollars), and the trade surplus rose to US$46.6 billion. Together with the external balances for services and income, the current account surplus climbed to the equivalent 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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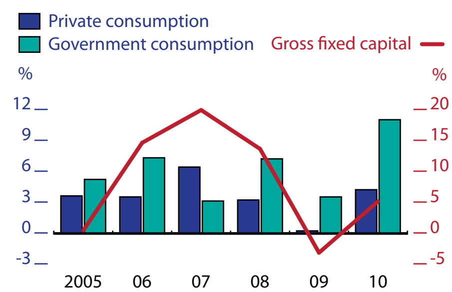
3.29.4 Growth in consumption and investment



Source: CEIC Data Company (accessed 12 March 2011).

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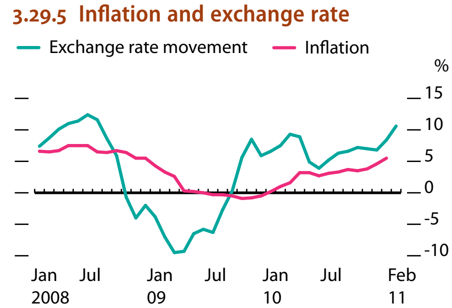
3.29.5 Inflation and exchange rate



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

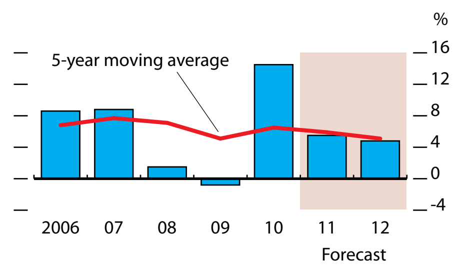
Expanding the economy's capacity is an immediate imperative. Even moderate economic growth will likely push up prices and costs of

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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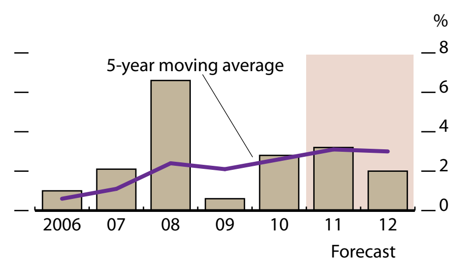
3.29.7 Inflation



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.

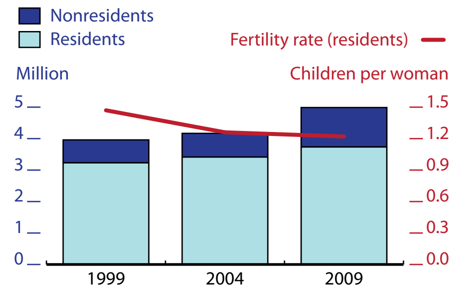
Discouraging the use of foreign workers in less productive tasks, at a time of strong economic growth, has tightened the labor market and raised operating costs, particularly for small and medium-sized businesses that employ cheap foreign labor. But as there will be a lag before the productivity gains 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.

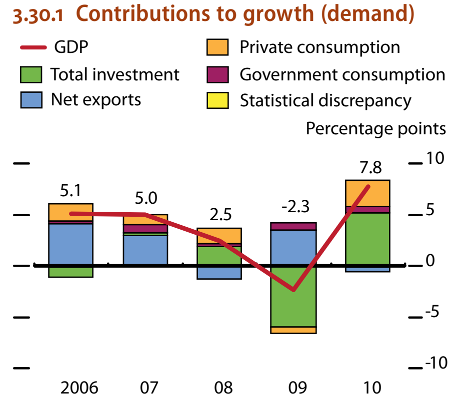
Private fixed investment grew by 13.8% in 2010, mainly in export-oriented manufacturing. As export orders picked up, higher capacity utilization in industries such as automobiles and electrical machinery prompted investment in new equipment, which rose by 14.7% for the year. Private construction expanded 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.

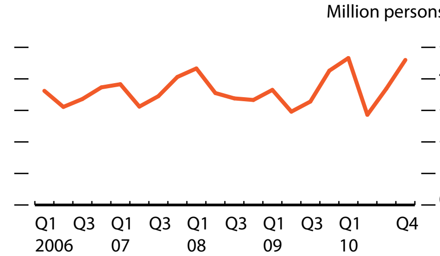
External trade rebounded (Figure 3.30.5). Merchandise exports rose by 28.5% to $193.7 billion, reflecting strong external demand for both agricultural and manufactured goods. Shipments of manufactured items, including autos and components, computers, electrical appliances, and machinery, rose by about 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.

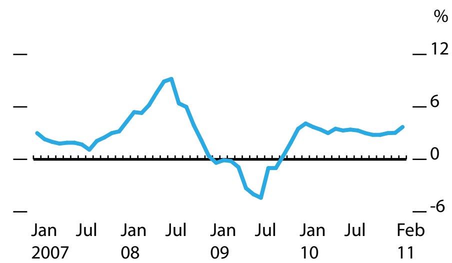
After taking into account a larger surplus in services, countered by a wider income deficit, the current account was in surplus equivalent to 4.7% of GDP. The capital and financial account recorded a net inflow of $15.6 billion.

3.30.2 Tourist arrivals



Source: Bank of Thailand, available http://www.bot.or.th (accessed 28 March 2011).
Click here for figure data

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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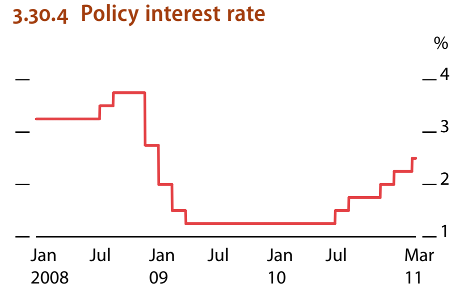
3.30.4 Policy interest rate



Source: Bloomberg (accessed 20 March 2011).
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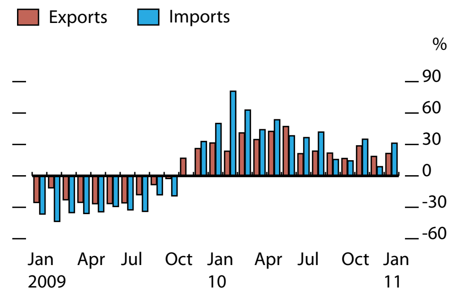
Current account surpluses and buoyant capital inflows into equity and debt securities ($55.2 billion in 2010) fueled the appreciation of the baht. To reduce that upward pressure, the Bank of Thailand liberalized restrictions on capital outflows, and the finance ministry removed a withholding tax waiver 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).

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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.

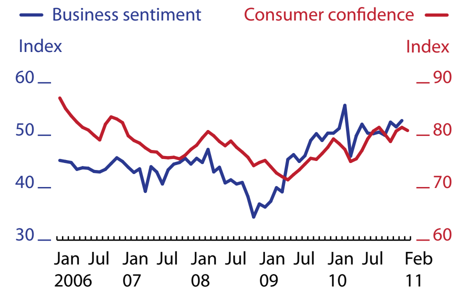
Higher prices for imported commodities and oil will likely mean that merchandise imports outpace exports in the forecast period. The trade surplus will decline slightly and the current account surplus is seen subsiding to about 2.0% of GDP in 2011 and 1.0% in 2012. Tourism, an important contributor to 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

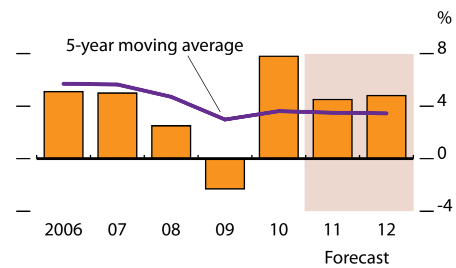


Note: A reading of less than 50 for business sentiment and less than 100 for consumer confidence denotes a deterioration.

Sources: Center for Economic and Business Forecasting; Bank of Thailand, http://www.bot.or.th (both accessed 28 March 2011).

Click here for figure data

3.30.7 GDP growth



Source: Asian Development Outlook database.

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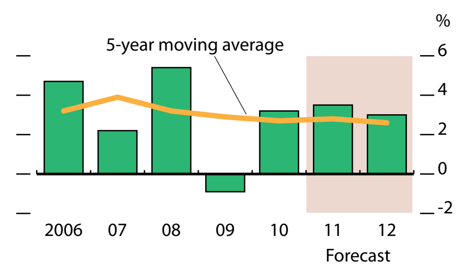
3.30.8 Annual inflation



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.

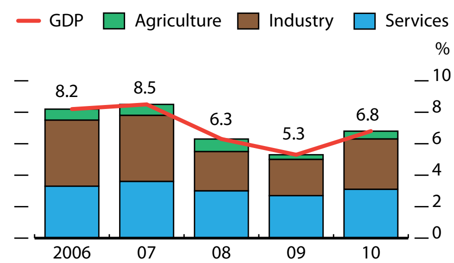
By sector, industry expanded by 7.7% and contributed 3.2 percentage points of total GDP growth. Stronger external demand spurred 8.4% growth in manufacturing, and public infrastructure investment pushed up growth of construction by 10.1%. Services grew by 7.5%, contributing 3.1 percentage points of GDP 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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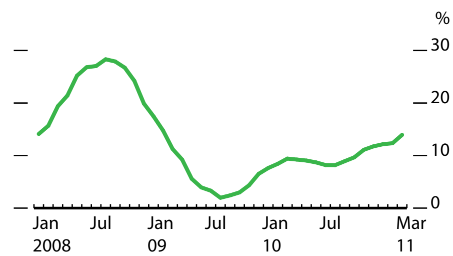
3.31.2 Inflation



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).

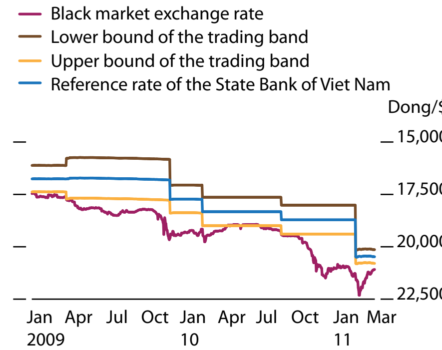
Net foreign direct investment (FDI) inflows rose by about 3% to $7.1 billion in 2010. FDI approvals at $18.6 billion missed the target, however, and were well below 2009's, likely reflecting investor uncertainties over policy direction. FDI approvals for real estate projects fell, but approvals for manufacturing 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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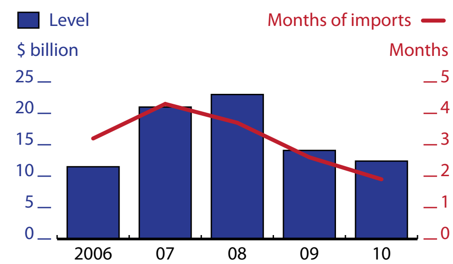
3.31.4 Gross official reserves



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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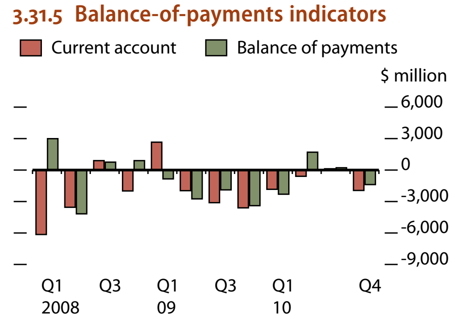
3.31.5 Balance-of-payments indicators



Source: State Bank of Viet Nam.
Click here for figure data

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.

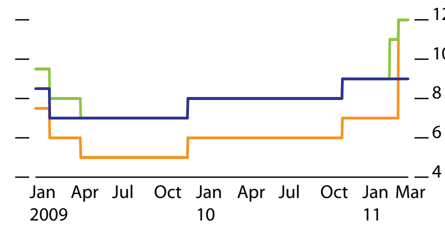
A deceleration in world trade from the rebound rates of 2010 alongside the impact of policy tightening on imports will contribute to slower growth in external trade this year. After inflows from tourism and remittances, the current account deficit is forecast at 3.8% in 2011 and 3.6% in 2012 (Figure 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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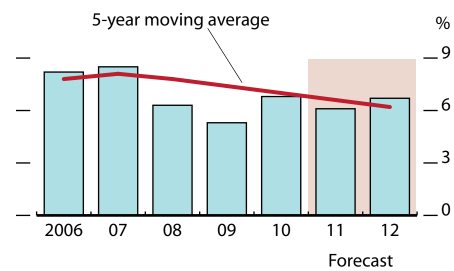
3.31.7 GDP growth



Source: Asian Development Outlook database.

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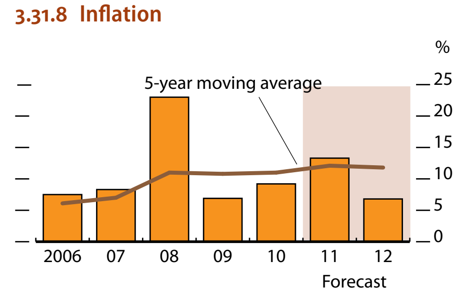
3.31.8 Inflation



Sources: General Statistics Office of Viet Nam; *Asian Development Outlook* database.

Click here for figure data

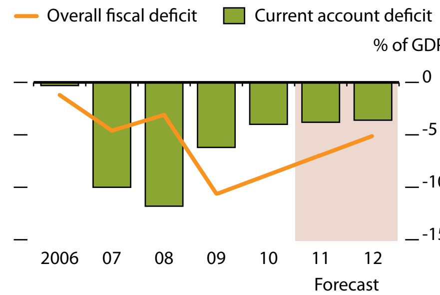
The large increase in the domestic credit stock, of about $100 billion during 2007–2010, raises concerns over banking asset quality, as does bank exposure to real estate and state-owned enterprises.

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.