Economic trends and prospects in developing Asia

3

Central Asia

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

Armenia's recovery continued in 2011, bolstered by buoyant growth in industry and agriculture. Prudent fiscal and monetary policies helped control inflation and lower the budget deficit, although public debt remained high in 2011, leaving little room for fiscal maneuver. The external accounts generally improved. Economic growth will continue in 2012 and 2013—but with downside risks—and over the medium term, continued and faster structural reforms are needed to support growth.

Economic performance

After modest growth of 2.1% in 2010, economic recovery continued in 2011, with growth estimated at 4.5%. On the supply side, industry, agriculture, and services were responsible for the stronger performance, as construction declined (Figure 3.1.1).

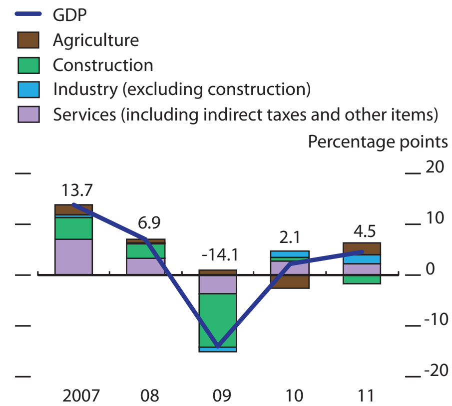
Industry (excluding construction) was the driving force, growing by an estimated 12.3%, including 12.2% in mining and quarrying and more than 16% in food processing. Agriculture expanded by an estimated 12.6%, rebounding from a 15.7% decline in 2010 that greatly impeded the country's recovery from the 2009 recession. Agriculture was a major focus of government policy and benefited from interest rate subsidies and free seed distribution programs. Construction, largely household-financed and that had been the main driver before the crisis, remained weak, contracting by about 10% despite a recovery in remittances. As overall activity accelerated, services expanded by 5.8%, with the fastest growth in health and social work activities, entertainment and recreation.

On the demand side, net exports and consumption underpinned the recovery, while total investment detracted from growth. Net exports improved by 17%, reflecting the favorable external environment, and private consumption rose by an estimated 2.3%, on higher domestic bank lending and sustained remittance inflows. Total investment fell by 4.1%, marking sluggish private investment and restraints on public capital spending.

Average annual inflation decreased to 7.7% from 8.2% in 2010 (Figure 3.1.2). Monetary tightening and a slowdown in nonfood prices offset rapid increases in food prices, helping bring inflation closer to the central bank's target band of 4% +/-1.5%. In December 2011, year-on-year inflation was 4.7%, half the previous year's rate. The central bank raised the refinancing rate by 125 basis points in three steps in February–April to 8.5% and kept it steady until September, when it was cut by 50 basis points to 8.0%, owing to diminishing inflation pressures.

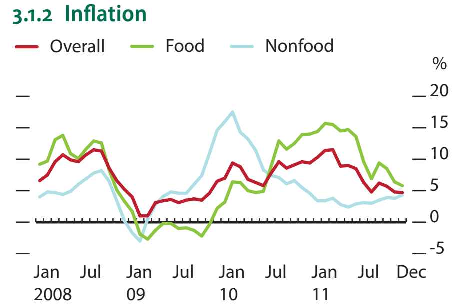
Propelled by increased credit activity and a continued buildup in net domestic assets, broad money (M2X) growth doubled to 23.7% in 2011. However, net foreign assets declined, reflecting the central bank's sales

3.1.1 Contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 15 March 2012).

3.1.2 Inflation



Sources: CEIC Data Company; National Statistical Service of the Republic of Armenia. http://www.armstat.am (both accessed 15 March 2012).

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

of foreign exchange in an attempt to limit depreciation and to smooth large fluctuations.

In 2011, the government continued to pursue a prudent fiscal policy, with the aim of gradually reducing the budget deficit and achieving macroeconomic stability. The overall budget deficit is estimated to have narrowed to 3.3% of GDP from 5.0% in 2010, surpassing the official target of 3.9% (Figure 3.1.3). Fiscal consolidation efforts, combined with the impact on revenues of economic expansion and some improvements in tax and customs administration, raised general government revenue to 23.6% of GDP from 22.3% in 2010. Restrained capital spending enabled total outlays to fall to 26.9% of GDP from 27.3% in 2010.

The ratio of central government debt to GDP rose slightly to an estimated 43% at end-2011 from 39.2% the previous year, still within the 50% ceiling stipulated by the Public Debt Law. About 86% of all public debt is external, with domestic debt held mainly by banks.

The balance of payments generally improved, and the current account deficit narrowed to an estimated 12.4% of GDP from 14.7% in 2010 (Figure 3.1.4). Exports surged by an estimated 20.0% to $1.4 billion, benefitting from generally favorable global commodity prices that boosted export values of copper, molybdenum, and other metal concentrates from mining. Imports climbed by an estimated 8.8% to $3.5 billion, boosted by domestic demand that reflected a gradual recovery in foreign direct investment (FDI) and a rebound in remittances.

The large current account gap was financed primarily by donor inflows and FDI. Remittances from workers abroad rose by 20% to $1.3 billion, slightly below their 2008 peak of $1.4 billion; most remittances came from the Russian Federation. Net FDI rose by 15.7% to an estimated $650 million, and most investments were directed to mining, telecommunications, and energy. The Russian Federation accounted for nearly half of all investment. Strong export growth, successive releases of funds from Armenia's arrangement with the International Monetary Fund (IMF) initiated in 2010, and a rise in remittances lifted foreign reserves to $1.96 billion by December, equivalent to about 5.2 months of imports.

In 2011 the nominal effective exchange rate depreciated by 1.2% and the real effective exchange rate by 2.2%, though the full potential of exports remained constrained by low competitiveness and high concentration in mining (Figure 3.1.5).

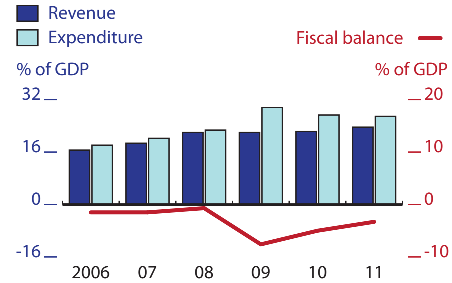
The government continued implementing economic reforms to improve the business environment, streamlining the permit process and making more use of electronic services and one-stop shops for investors. Armenia improved in five of the 10 areas in the World Bank's *Doing Business* 2012 survey and was among the top 10 reformers worldwide, rising six places to 55.

Economic outlook

Armenia's economic recovery is expected to continue in 2012 and 2013, though a shade less quickly than in 2011 (Figure 3.1.6).

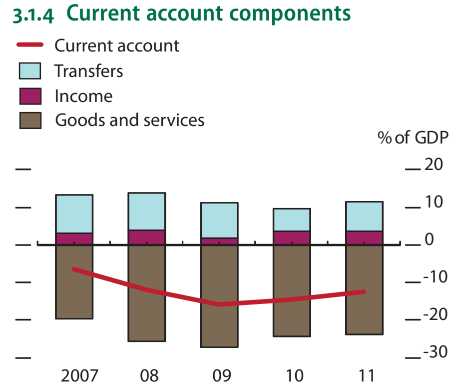
Weak economic prospects in Europe (which accounts for about 60% of Armenia's exports) and their possible spillover to the Russian Federation (80% of remittances, Figure 3.1.7) pose major risks to economic growth.

3.1.3 Fiscal balance



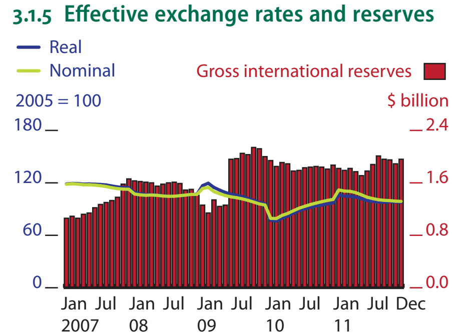
Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012).

3.1.4 Current account components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2012).

3.1.5 Effective exchange rates and reserves



Source: Central Bank of Armenia. http://www.cba.am (both accessed 15 March 2012).

However, structural policy reforms under way, such as an electronic listing of properties and property values as well as electronic facilities to issue construction permits, will help improve the investment climate.

On the supply side, agriculture is expected to continue to grow, but moderately, mainly reflecting government support and assuming continued normal weather conditions. The forecast increases in mining and food processing will contribute to overall industry growth. A moderate rise in construction is foreseen, mostly owing to large infrastructure projects, but no major changes are expected in household-financed construction. On the demand side, remittance-backed consumption is expected to be the growth driver, aided by a modest recovery in public investment spending.

Planned reforms will provide additional impetus to growth and should make it less volatile. Laws on free economic zones, an export-led strategy, and a "regulatory guillotine" initiative aimed at eliminating excessive regulation—all adopted in 2011—may lay the favorable groundwork for attracting investment and diversifying the country's industrial base. Early in 2012, approving the first applications from the Russian Federation, the government authorized the creation of two economic zones, one for agricultural exports and one for high-tech goods.

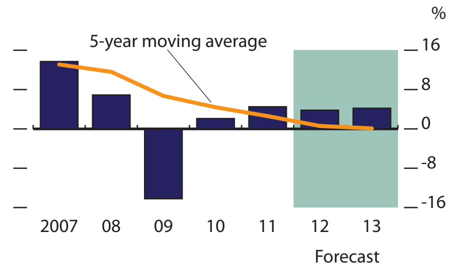
Fiscal consolidation is set to continue in 2012 and 2013, given concerns about the buildup of public and external debt. The government's medium-term fiscal objective is to reduce the budget deficit to 3.1% of GDP in 2012 and 2.0% in 2013. Although a pronounced global slowdown could reduce revenue, sustained reforms in tax, customs, and economic competition are expected to raise the tax-to-GDP ratio. They include a strong tax package adopted in 2011 that raised excises on liquor, luxury vehicles, and engine oil, the marginal rate on high-income taxpayers, and higher tax rates on gambling facilities and restaurants. Good revenue performance would enable the government to increase social security benefits and pensions, while reducing the overall budget deficit.

Average annual inflation is forecast to diminish to 4.1% in 2012 and rise slightly to 4.5% in 2013, as continued domestic support returns agricultural production to normal patterns and global food prices moderate and then pick up a little. Tight monetary policy will also help contain inflation. The 12-month (December–December) rate is expected to remain in the target band in the forecast period.

The external public debt-to-GDP ratio is set to rise in the forecast period (Figure 3.1.8), limiting the space for new borrowing. Still, the IMF, in its latest (December 2011) debt sustainability analysis, viewed external public debt as sustainable and the risk of debt distress as low, even after applying stress tests. The IMF judged that the 3% structural deficit target would maintain the debt ratio at current levels past 2016 without large shocks (although history suggests considerable likelihood of shocks occurring).

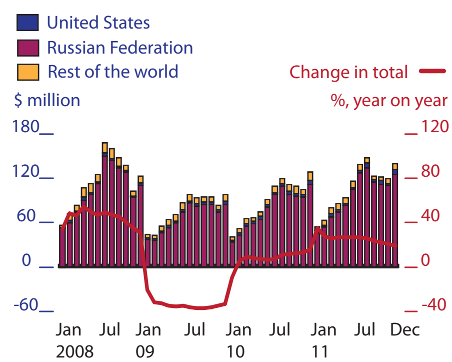
Lower world demand and a fall in prices for key commodity exports, such as copper and other metals, could harm export earnings. However, given the expected outcomes of the government's export diversification strategy—approved in 2011 and targeted at developing 11 industrial branches with export potential, including pharmaceuticals, engineering, and brandy production—exports are projected to expand by 8.0% in 2012 and by about 11.0% in 2013 on top of the large growth

3.1.6 GDP growth



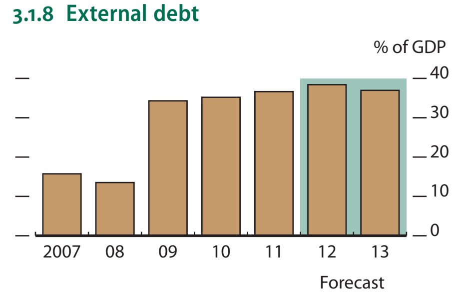
Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 15 March 2012); ADB estimates.

3.1.7 Sources of remittances



Source: Central Bank of Armenia. http://www.cba.am (accessed 16 March 2012).

3.1.8 External debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012).

in 2011. Given recent trends in remittances and investments, imports are likely to continue to grow by about 4.5% in 2012 and 6.0% in 2013. The large infrastructure projects will likely boost domestic demand for imports. The recently adopted mining code, which reset mining royalties consistent with international best practices, is expected to attract further investment in the sector.

The current account deficit is forecast to widen to 11.2% of GDP in 2012 and then shrink to 10.0% of GDP in 2013, reflecting projections for gradual export diversification and continued strong remittances. Loan inflows and a modest rise in FDI are expected to help finance the current account deficit (Figure 3.1.9).

3.1.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.8	4.2
Inflation	4.1	4.5
Current account balance (share of GDP)	-11.2	-10.0

Source: ADB estimates.

Policy challenge highlights

Continued reforms in tax and customs and in the business environment are needed to sustain economic growth and diversify the economic base from traditional overreliance on mining and construction, although the impact of reforms may take a considerable time.

The government has committed to accelerate these reforms. Despite the toughening of antitrust legislation, conditions for competitiveness remain unequal across firms of different sizes. Monopolistic practices of producers and importers of certain products distort prices and contribute to inflation. Corruption and inefficient state governance are still serious obstacles to reform.

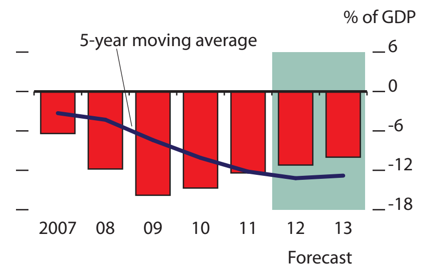
Further improvements to the business environment, especially in paying taxes, enforcing contracts, and trading across borders, are a priority for the government. Moreover, slow progress in legal reform has hindered the effectiveness of new laws. Thus the government is implementing an action plan on doing business that encompasses some 50 activities, including reducing the cost of company registration and the steps to resolve contractual disputes, and, for small and medium-sized enterprises, simplifying tax payments and allowing electronic payment of customs duties.

More effort to strengthen governance will likewise be important to improve social policy, improve the distribution of resources, and reduce the recent crisis-related increase in poverty. Private sector development, especially through promoting small and medium-sized enterprises outside the capital, is critical in reducing the gap in living standards between the capital and the regions.

Despite the monetary tightening and the central bank's policies to contain dollarization of the economy, foreign currency loans and deposits continue to be dominant (60% and 70%, respectively), increasing the country's vulnerability to exchange rate shocks and making monetary policy less effective.

Additional spending on roads, urban infrastructure, and water services is crucial for inclusive growth over the longer term. Financing such spending without increasing the already high public debt-to-GDP ratio will require further increases in the tax-to-GDP ratio and reductions in public debt. Closer public–private partnership in infrastructure could also help reduce the burden on government finances and meet burgeoning infrastructure needs.

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012); ADB estimates.

Azerbaijan

Growth was virtually nil in 2011, as safety concerns caused a stoppage in oil production at one of the main platforms for much of the year, offsetting gains from government-financed investment in other sectors. With expected more normal oil production, growth should strengthen in 2012 and 2013. Diversifying the economy will be important to maintain growth over the longer term.

Economic performance

Overall GDP grew by a mere 0.1% in 2011, as a 9.3% contraction in the oil sector largely offset a 9.4% expansion in non-oil activity, which was largely driven by public investment in infrastructure. Crude oil production fell by 10.5%, as a review and strengthening of safety procedures halted output at the Azeri-Chirag-Gunashli oil platform for much of the year. Natural gas production declined by 2.2%, as Turkey, the country's major importer, reduced imports of Azeri gas and no other countries made offsetting purchases.

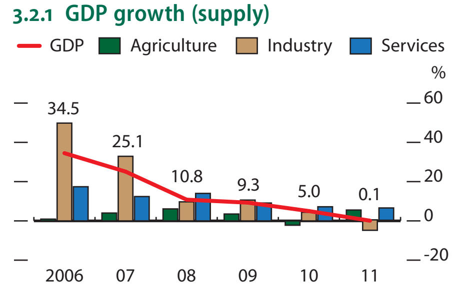
The non-oil sector recorded growth in agriculture, construction, and services (Figure 3.2.1). Agriculture grew by 5.8%, mainly from higher crops and livestock production, reflecting expanded cultivation and the impact of government tax credits and lending programs for improving access to modern farm equipment. Construction climbed by 20%, lifted by non-oil government projects and foreign investment in tourism. Industry contracted by 4.3% because of the lower oil output. Services rose by 6.5%, led by 10.3% growth in the wholesale and retail sector and some expansion of communications and tourism.

On the demand side, investment—mainly non-oil and largely financed from domestic resources—surged by 27.3%, with machinery and equipment manufacturing, communications, and chemical production receiving most of it. Private consumption grew by 9.9%, fueled in part by a 14.2% salary increase for civil servants introduced in September–November.

Average annual inflation moved up to 7.9%, largely reflecting higher food prices early in the year as a result of crop damage late in 2010 and price increases for imported foodstuffs, as well as inflation in trading partner countries. Monthly inflation spiked in the first half as food stocks declined, and then moderated in the second half with the new harvest (Figure 3.2.2).

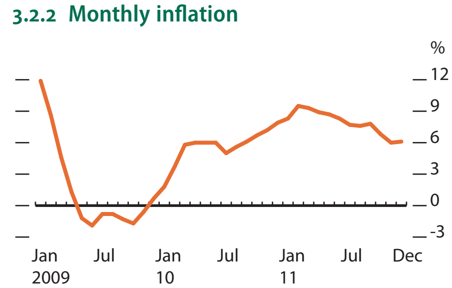
Fiscal policy is driven largely by oil income, which accumulates in the State Oil Fund of Azerbaijan (SOFAZ), from where transfers are made to the budget to finance state spending. In 2011 such transfers constituted 57% of total government revenue (versus 52% in 2010); they helped finance

3.2.1 GDP growth (supply)



Source: State Statistical Committee of the Republic of Azerbaijan.

3.2.2 Monthly inflation



Sources: International Monetary Fund. International Financial Statistics online database (accessed 10 March 2012); Central Bank of the Republic of Azerbaijan.

This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku.

an expansion of government activities, in particular public investment projects in areas such as transport, energy, and water supply. The transfers allowed a surplus in the state (unconsolidated) budget of 0.6% of GDP; without them, the budget would have run a deficit of 17.3% of GDP (Figure 3.2.3).

Total government revenue, including SOFAZ transfers, was equivalent to 31.4% of GDP. Non-oil receipts grew by 22%, reflecting the strong non-oil performance, although they contributed less than half all budget receipts.

Higher oil prices enabled the government to raise its spending by 30.8%, including the steep rise of wages for civil servants, higher pensions and other social program spending, as well as building projects. Capital expenditure accounted for more than half the government's outlays.

Responding to rising inflation and concerns over capital inflows, the central bank tightened monetary policy, raising the refinancing rate in June to 5.25% and increasing reserve requirements in May from 0.5% to 2.0% on all deposits and, in July, to 3.0% on foreign currency deposits. To prevent significant real appreciation of the local currency and to create a more competitive non-oil sector, the central bank also used sterilization operations, selling $497 million to the banks (Figure 3.2.4).

The current account recorded a surplus of 28.7% of GDP, smaller than the previous year. Because of higher imports, the trade surplus declined to $16.8 billion from $19.7 billion in 2010, as higher oil prices (despite lower oil production) helped total exports to stay at around the 2010 level of $26.5 billion. Non-oil exports remained small at $1.6 billion. Growing domestic demand helped raise imports, mainly of machinery, electronics, and foodstuffs, by more than 50%.

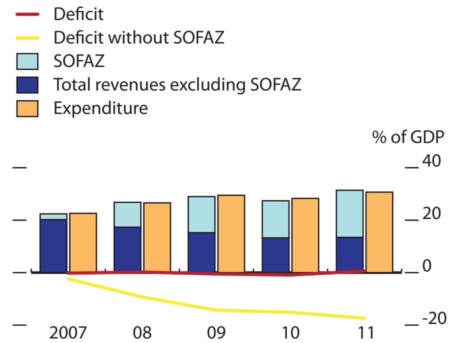
Remittances jumped by 42.7%, reflecting the revival of the Russian and Turkish economies, the main employment destinations for expatriate Azeris. Foreign direct investment remained less than 0.5% of GDP, reflecting little net private investment in either the oil or non-oil sectors. Overall reserves grew to an estimated $10.3 billion. Total external debt at end-2011 was estimated at 17.8% of GDP, including public and publicly guaranteed external debt of 8.4% of GDP.

Economic prospects

GDP growth is projected to accelerate to 4.1% in 2012 but to moderate to 3.5% in 2013, mirroring higher oil output and continued expansion in the non-oil sector (Figure 3.2.5). Oil output is forecast to pick up moderately in 2012 after completion of upgrades on the three main oil platforms, while the expected opening of new gas platforms may increase gas production if demand also increases (Figure 3.2.6). Continued recession in the eurozone will, however, likely limit demand for petroleum and thus the rise in oil production. Similarly, a steep fall in prices might lead the government to curb output.

Growth in the oil sector will affect transport, communications, and wholesale and retail trade, particularly the development of new rail and sea transport links for petroleum. Current road projects will stimulate transport, while agricultural projects and subsidies for imported seeds should help boost agricultural output. These measures will also encourage farmers to shift more into cash crops.

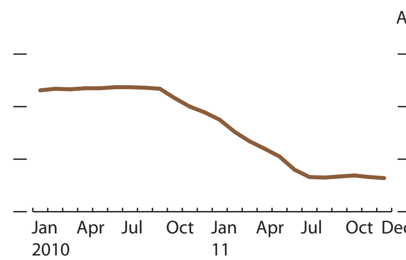
3.2.3 Fiscal indicators



SOFAZ = State Oil Fund of Azerbaijan.

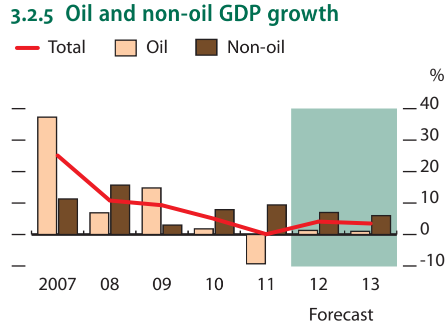
Source: Ministry of Finance of the Republic of Azerbaijan. http://www.finance.gov.az

3.2.4 Exchange rate



Source: Central Bank of the Republic of Azerbaijan.

3.2.5 Oil and non-oil GDP growth



Source: State Statistical Committee of the Republic of Azerbaijan.

Services are expected to stay largely driven by trade and tourism in 2012. The government's investment program should, by expanding infrastructure, support industry and construction through boosting demand for local production of cement, steel pipes, and other building materials. Although the non-oil sector will remain small, its development and an improved business environment would improve domestic employment opportunities, possibly reducing remittances over the medium term.

Despite the central bank's goal of reducing inflation to 7–7.5% in 2012 and 2013, various factors could take inflation to 9.0% in 2012 before it subsequently recedes to 8.5% in 2013 (Figure 3.2.7). Strong domestic demand fueled by oil income, rising public sector consumption (including planned government salary increases), and expanded domestic credit to the economy may heighten inflationary pressures in 2012. The completion of grain-storage and improved food-processing facilities should, however, reduce food imports, helping moderate inflation in 2013.

The budget envisages a deficit of 1.3% of GDP in 2012 (Figure 3.2.8), as total government spending is planned to rise by 10%, while revenue is forecast to grow by only 4%, based on a very conservative assumption for oil prices ($80 per barrel). Revenue, including SOFAZ transfers, is forecast at 37% of GDP in 2012, but would come in lower if petroleum prices plunged. Higher petroleum prices on the other hand could allow for even steeper increases in salaries and pensions in 2012, although a sharp fiscal expansion risks overheating the economy and stoking inflation.

The budget outlines a 22.2% expansion in social outlays in 2012. The government's investment plan aims to keep capital spending, mainly for infrastructure projects on irrigation, roads and energy, at 2011 levels.

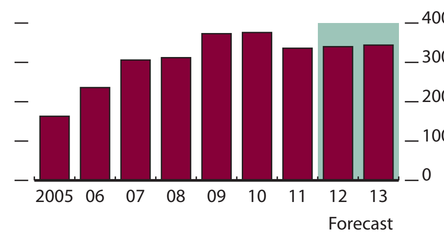
A budget deficit of 1% of GDP in 2013 is forecast, with total revenue, including SOFAZ transfers, of 32% of GDP. Because of limited non-oil sector income, the budget presumes that transfers from SOFAZ will account for 61% of total government revenue in 2012, and comparable transfers will likely be needed in 2013. Although SOFAZ balances, at close to 60% of 2010 GDP, should be sufficient to support such budget transfers over the next few years, global shocks and unexpected problems with oil production could affect the future sustainability of relying on SOFAZ transfers to fund expenditure.

Monetary policy will continue to focus on restraining inflation, so as to limit nominal interest rates and avoid a real appreciation of the local currency. The central bank plans to improve prudential and capital-adequacy control, as well as risk management, while strengthening the interbank market. Consolidating existing, small private banks and privatizing the state-owned International Bank of Azerbaijan (the country's largest bank) should foster a more competitive environment and cut banking costs.

The current account surplus is expected to remain high, at 22.0% of GDP in 2012 and 19.0% in 2013 (Figure 3.2.9), in light of elevated oil prices and increased output. Oil-related exports are expected to remain the dominant export category, at about 90% of the total.

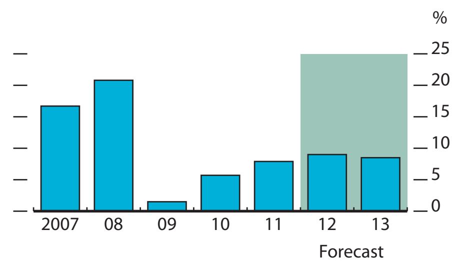
Services imports, including transport, communications, and construction, are expected to grow once oil operations are back to strength. Continued hydrocarbon development—exploration for new oil

3.2.6 Oil production



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

3.2.7 Inflation



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 14 March 2012).

3.2.8 Fiscal balance

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

3.2.1 Selected economic indicators (%)

	2012	2013
GDP growth	4.1	3.5
Inflation	9.0	8.5
Current account balance (share of GDP)	22.0	19.0

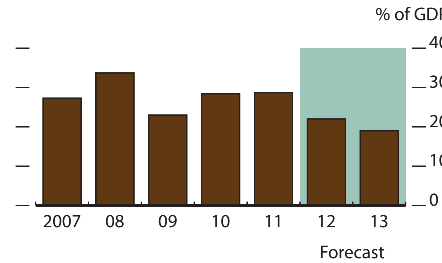
Source: ADB estimates.

wells and preparations for the second phase of the Shahdeniz (gas field) project—should sustain foreign investment.

Factors that may affect the actual outturn include rising imports of construction machinery and equipment, which may take the current account surplus below current forecasts. In addition, foreign investment could rise sharply if petroleum reserves are found in the area covered by an oil exploration agreement signed between BP and SOCAR in late 2010.

Financing for new projects is forecast to increase public and publicly guaranteed debt slightly, to about 8.7% of GDP in 2012. With international reserves of more than $40 billion (including SOFAZ assets), Azerbaijan's external position should remain comfortable over the next several years.

3.2.9 Current account balance



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 14 March 2012).

Policy challenge—diversifying from petroleum

Supporting growth in the non-oil sector and reducing dependence on oil revenue are the most pressing long-term issues for the economy. The key to maintaining long-term growth—diversifying the economy—will depend on developing a strong private sector. In turn this will require access to financing and an improved business and investment climate. Thus financial and regulatory reform making it easier to do business will be essential. Non-oil activity needs to be promoted subnationally especially, in order to reduce urban–rural income disparities.

With the country's rich natural resources, agriculture appears the most promising area for diversification, and some studies suggest that its productivity can be increased two- or threefold over the medium term. Such gains would require a stronger legal framework, output reoriented toward cash crops, and improved market access, as the relatively few produce-collection points and processing plants hold back earnings opportunities. Heavy investment is thus needed to develop agroprocessing, which requires cold-storage tanks and transport systems, sophisticated processing plants, and strong marketing.

Public investment in the non-oil sector should increasingly be financed by taxes rather than transfers from SOFAZ, to improve the sustainability of public finances. SOFAZ revenue should be used mainly to smooth out public spending and finance large, one-time infrastructure projects.

In financial sector reform, the central bank's decision to privatize the International Bank of Azerbaijan, is expected to strengthen competition among banks, while the additional capital obtained for that bank should strengthen banking generally (the bank's liquidity and capital shortages have complicated privatization, however). Proposed consolidation of small banks could also improve competition and increase efficiency, which would benefit the private sector through lower banking costs and easier access to finance.

Azerbaijan improved its ranking in the World Bank's 2012 *Doing Business* survey to 66, aided by reforms simplifying tax payments. Nevertheless, the country still rates poorly in many areas and was downgraded in several, including access to electricity and trading across borders (although current energy projects should improve the electricity ranking). Likewise, transport projects and regional cooperation programs may well encourage Azerbaijan and other member countries to streamline trading procedures and so boost cross-border trade.

Georgia

The economy maintained robust growth in 2011, following its recovery in 2010 from the global recession, while annual inflation rose slightly. The current account deficit remained large, as nominal imports grew more than exports. In 2012 a weaker global environment will likely reduce growth by constraining exports, foreign direct investment, and remittances. A key policy challenge is to achieve more inclusive growth, particularly for rural areas.

Economic performance

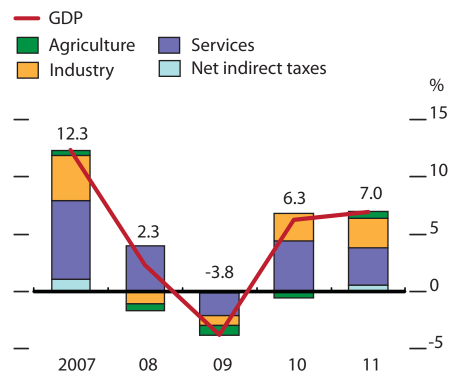
The economy continued to show robust growth, estimated by the government at 7.0% (Figure 3.3.1). Among the productive sectors, about half the growth came from services, which rose by 5.6% relative to the previous year, because of strong increases in the financial sector, tourism, and communications. Another two-fifths came from industry, which rose by 9.7% during 2011, as strong external demand and continued structural reforms boosted manufacturing, although mining declined due to reduced production of coal, lignite, and peat. The small balance came from agriculture, which, after 3 years of decline, rose by 5.5% during the year, reflecting higher crop production as a result of good weather and favorable prices.

On the demand side, private investment and private consumption are both estimated to have contributed to growth, with consumption benefiting from higher remittance inflows, aided by the Russian Federation's healthy economy. Government consumption and investment had little impact, as fiscal consolidation held back government spending, while net exports had a negative impact (real imports grew far more than real exports).

Although average inflation rose to 8.5% from 7.1% in 2010, the 12-month rate slowed to 2.0% in December, after peaking at 14.3% in May 2011 (Figure 3.3.2), as the moderation in prices of food (domestic and imported) and other imports during the second half of the year outweighed price hikes for transport and utilities stemming from price liberalization.

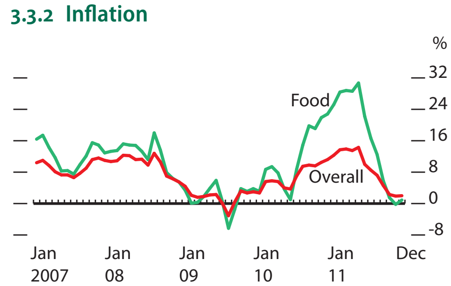
The fiscal deficit narrowed to 2.9% of GDP from 6.6% of GDP in 2010, consistent with the adjustment program supported by the International Monetary Fund. Tax revenue rose by 26.0%, reflecting a new tax code, enforcement of new revenue measures, and simplification of tax compliance and reporting requirements, all of which took effect at the start of the year. Relative to GDP, however, total revenue rose only slightly, to 28.4% from 28.3% in 2010, because of declines in grants and nontax revenue as a share of GDP.

3.3.1 Contributions to growth (supply)



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 20 March 2012).

3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 9 March 2012).

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

Spending growth was kept to 4.7%, reflecting compression in capital expenditure as well as tighter spending limits on public salaries and defense. Total expenditure fell to 31.3% of GDP from 34.9% in 2010.

Treasury securities, foreign financing, and privatization receipts all contributed to budget financing. Treasury securities—funding 28.4% of the budget deficit in 2011—have emerged in recent years as an important source of deficit coverage, and successful issues of treasury notes of up to 10 years' maturity have become an important step for developing the secondary market for tradable domestic debt. In addition, the successful issue of a second sovereign Eurobond (the first was in 2008) reduced the rollover risk from external liabilities falling due in 2012 and 2013. Total government debt was estimated at 36.8% of GDP at end-2011.

M3 broad money grew by 17.2% (Figure 3.3.3), reflecting a 19.5% rise in bank credit to the private sector. The central bank's switch to a more accommodative monetary policy in July lowered the policy rate in steps from 7.5% to 6.5% by January 2012, although heavy dollarization of the banking system limits monetary policy effectiveness. Interest rates declined on long-term loans, despite strong growth in lari-denominated loans and higher credit risk premiums, although the lending rate remained high at 19.2%. Deposit interest rates rose slightly to 9.4%, as banks moved to increase deposits by offering competitive interest rates (Figure 3.3.4).

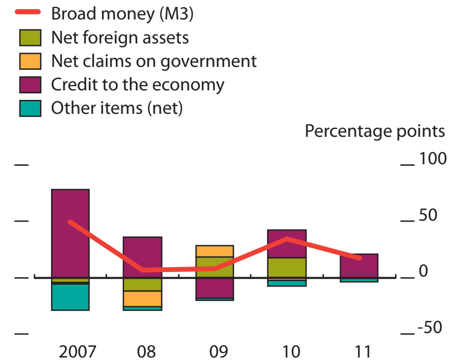
Banking stability improved, reflecting a near doubling of banks' returns on assets and on equity in light of wider profit margins and a continued high capital-adequacy ratio of about 17%. The ratio of nonperforming loans to total loans decreased to 8.6%, partly due to rising credit volumes.

The current account deficit worsened to an estimated 13.3% of GDP from 11.5% in 2010. The trade deficit widened by an estimated 25% to $3.6 billion (Figure 3.3.5). Exports shot up by 42.3%, reflecting rapid growth in vehicle reexports to Kazakhstan (in advance of higher customs duties, as Kazakhstan—a traditional major market—entered a customs union with Belarus and the Russian Federation in January 2012) and a near doubling of sales of nitric fertilizers due to heavier global demand associated with high food prices. Imports surged by 39.8% (from a larger base than exports), mainly reflecting increased imports of intermediate goods and petroleum products.

Strong remittances and continued surpluses in services—mainly from tourism (which rose by nearly 39% to $2.5 billion) and transport—offset some of the deterioration in the trade balance. A 21% rise in foreign direct investment (FDI) inflows to an estimated $981 million helped finance the larger current account deficit. Gross international reserves climbed by 23.5% to $2.8 billion, equivalent to around 4 months of imports. Total external debt, including private debt, fell to an estimated 57.5% of GDP at end-2011 from 61.6% the previous year.

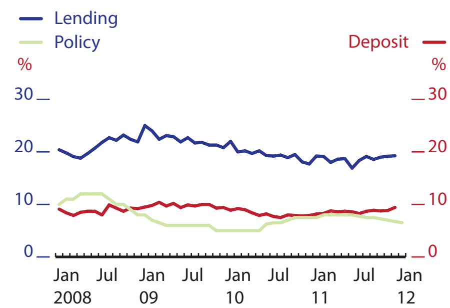
The flexible exchange rate regime continued to provide relative stability for the external sector. The lari appreciated by 12.2% in nominal effective terms and by 8.4% in real effective terms during 2011 (Figure 3.3.6).

3.3.3 Contributions to money supply (M3) growth



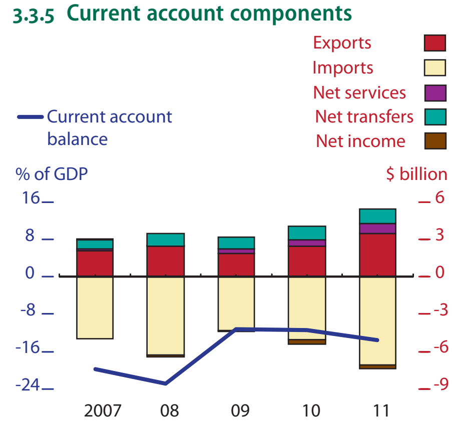
Source: International Monetary Fund. International Financial Statistics online database. http://www.imf.org/external/data.htm (accessed 15 March 2012).

3.3.4 Interest rates



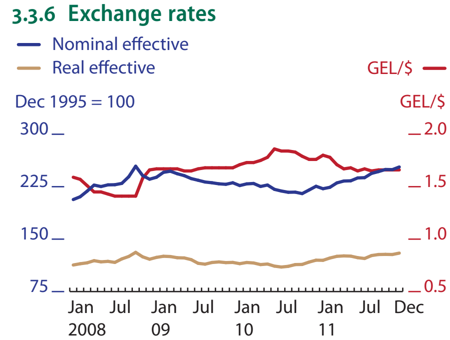
Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 9 March 2012).

3.3.5 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 9 March 2012).

3.3.6 Exchange rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 15 March 2012).

Economic prospects

For a small economy that relies heavily on trade and remittances, economic prospects will depend heavily on the external economic environment, in particular developments in the European Union (EU) and neighboring countries such as Azerbaijan, Kazakhstan, the Russian Federation, and Turkey. The expected slowdown in the eurozone and the Russian Federation will likely limit exports, FDI, and remittances, while continued fiscal restraint will curtail the government's ability to augment growth. Thus growth is projected to slow to 6.0% in 2012, recovering somewhat to 6.3% in 2013 with the assumed improvement in the world economy.

Year-average inflation is projected to slow to 4.8% in 2012, reflecting the expected moderation in global food prices. A return to modest increases in global commodity prices should cause only a slight rise in inflation to 6.2% in 2013, predicated on limited supply-side pressures and the absence of wage-price spirals.

The high level of dollarization will continue limiting the scope for monetary policy such that the authorities will need time to push through with their desired move to inflation targeting. Consistent with its adjustment program, the government aims to reduce the budget deficit further to 3.3% in 2012 and to 2.9% in 2013 (Figure 3.3.7). Fiscal consolidation will include both current and capital expenditure, with a careful review of subsidies. Total government debt is forecast to nudge up to 38.0% of GDP at end-2012 and to 38.2% the following year (Figure 3.3.8).

The current account deficit is projected to narrow to 12.5% of GDP in 2012, with slowing growth expected to reduce imports more than exports. Both sides of the trade account are, however, expected to rise in 2013 with a recovery in the world and domestic economies. As nominal GDP is forecast to grow more than the current account deficit, the current account deficit as a share of GDP will narrow further in 2013, to about 12.0%.

Negotiations for a long-awaited free trade agreement with the EU were launched in early 2012. An agreement would give Georgia extended access to the EU's single market, which should improve trade and investment.

While sound macro-prudential policies and fiscal restraint have reduced the chances of overheating and speculative bubbles, downside risks remain. These include a continuing large current account deficit; a limited export base with high import content and FDI focused more on the nontradable sector than on exports; heavy dependence on foreign aid and borrowing (despite high levels of official borrowing at concessional rates); and low private savings.

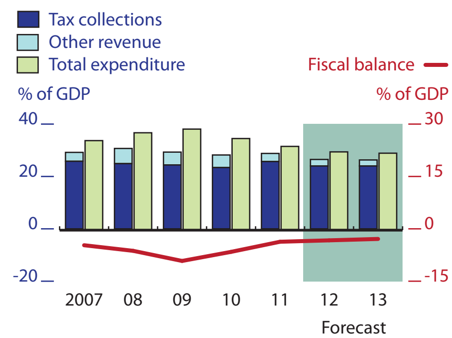
Policy therefore needs to promote capital inflows toward productive investment, particularly in the export sector. Similarly, the government needs to better leverage the country's investment resources and to maximize the efficiency and effectiveness of public spending. These measures are even more essential given current risks in the international financial markets, which may hinder availability of private investment and concessional financing from development partners.

3.3.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.0	6.3
Inflation	4.8	6.2
Current account balance (share of GDP)	-12.5	-12.0

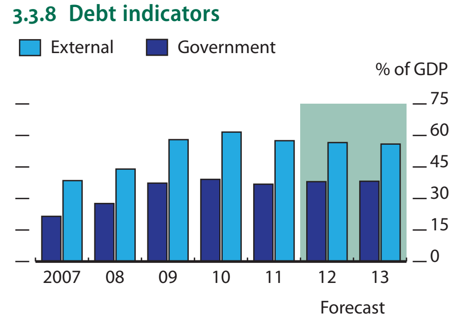
Source: ADB estimates.

3.3.7 Fiscal indicators



Sources: International Monetary Fund. 2010. *Country Report No. 10/219*. July; 2011. *Country Report No. 11/146*. June. www.imf.org; Ministry of Finance of Georgia, www.mof.ge (accessed 15 March 2012).

3.3.8 Debt indicators



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Asia Pacific*. October. http://www.imf.org; ADB estimates.

Policy challenge—securing inclusive growth

A major challenge over the medium to long run is to ensure economic growth that is more inclusive, with more equal access to economic opportunities and social welfare. One indication of income disparities is Georgia's relatively high Gini coefficient of 0.41, well above 0.31 for Armenia and 0.34 for Azerbaijan.

The government needs to step up its efforts to address structural unemployment, which stems from a mismatch between existing human capital and available jobs and which represents an important supply-side constraint. While skill inadequacies are an important part of the problem, so too is the limited range of well-paying jobs, in turn reflecting the small size of the tradable goods sector. Structural reforms to promote investment, particularly in export-oriented industries, could help create greater demand for employment while providing a way to reduce the chronic current account deficit in the medium term. At the same time, addressing high youth unemployment (35%) by improving skills through more vocational education, progress in secondary education, and on-the-job training (including the use of new technology) will help create a supply of employable workers to fill new jobs.

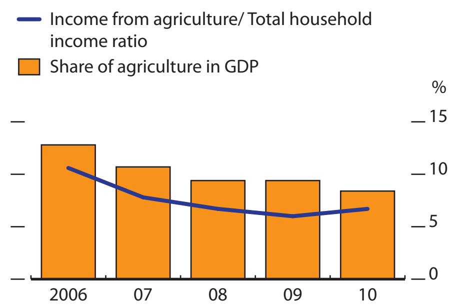
As job creation in the past was primarily skills-based and concentrated in finance and services, investing more in labor-intensive sectors such as industry and agriculture would enhance the inclusiveness of economic growth. About half the workforce is employed in agriculture, which contributes less than 10% of GDP (Figure 3.3.9). Surplus labor in urban areas, however, with low levels of labor absorption in agriculture, has made it extremely hard for the rural unemployed to move into other sectors.

The narrow base of the formal economy in rural areas, where self-employment is associated with subsistence income and low productivity in agriculture, contributes to rural poverty. Moreover, the prevalence of subsistence income limits the demand of the rural population for outputs from other sectors, constraining sectoral diversification of the economy and hindering development spillovers between agricultural and nonagricultural activity.

To help narrow differences between urban and rural development, the government has proposed a strategy to promote rural growth. This includes increasing investment in, among others, manufacturing, agriculture and renewable energy, in part through public–private partnerships. Well-designed public investment in infrastructure—whether in roads, power, water supply, or irrigation—would support private investment in agroprocessing and other industries, bolstering rural employment and reducing a persistent urban bias against agriculture. It would also promote the development of a more export-oriented agricultural sector, to draw on Georgia's favorable climate and natural resources.

Structural reforms, too, should focus on areas that could improve Georgia's attractiveness as a place to do business. Although the country has improved its standing in the 2012 Doing Business report from the World Bank—to 16 out of 183 countries (better than Malaysia, Thailand, Germany, and Japan)—it could still benefit by addressing issues in resolving insolvency, enforcing contracts, and trading across borders. In addition, improving governance and transparency in business would promote productivity and create greater job opportunities.

3.3.9 Agricultural indicators



Source: National Statistics Office of Georgia. http://www.geostat.ge

Kazakhstan

Good oil sector performance and sizable public investment contributed to robust expansion and a strong balance of payments in 2011. Growth is forecast to moderate in 2012, reflecting the slowdown expected in Europe and the Russian Federation, before recovering somewhat in 2013 as the world economy strengthens. Structurally, the economy remains dependent on oil production and constrained by financial sector weakness. Over time growth will depend on the success of the government's diversification efforts, largely funded by oil earnings.

Economic performance

Growth since independence has turned largely on strong oil and gas exports. Much of the proceeds have been saved in the National Fund for the Republic of Kazakhstan (NFRK), with portions transferred to the budget to fund public investment.

Global recovery helped growth rebound to 7.0% in 2010, and then to an estimated 7.5% in 2011, reflecting a surge in agricultural production, a strong upturn in services, and continued government investment in some industries (Figure 3.4.1). Agriculture, hit by a severe drought in 2010, was aided in 2011 by particularly favorable weather, which helped it grow by 26.7%. Grain production more than doubled, achieving record yields.

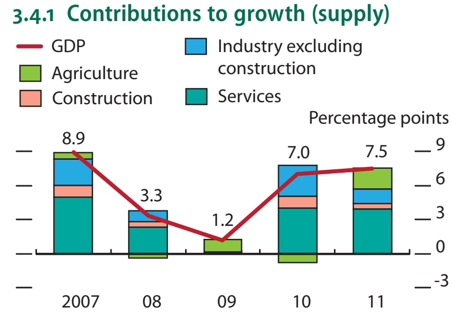
Industrial output (excluding construction) rose by 3.5%, driven mainly by a 6.2% increase in manufacturing, due to rapid growth in chemicals, metallurgy, and machinery and vehicles. Mining picked up by about 1.3%. Oil output fell by 0.5%, affected by social unrest in a key production area, although gas condensate and natural gas output climbed by 6.1% and 5.2%, respectively. Construction expanded by 2.7%, reflecting government stimulus and investment in infrastructure.

Services rose by 7.7%, driven by strong growth in wholesale and retail trade (14.5%), transport and warehousing (6.8%), and communications (18.7%). Financial services and insurance contracted by 4.5%, although the credit market expanded for the first time since the global financial crisis. Real estate activity slowed to 1.4% from 3.5% in 2010, despite continued support from the government for residential construction.

On the demand side, based on 9 months' data, total consumption is estimated to have risen by almost 11%, driven by nearly 18% growth in government consumption and a 9% rise in private consumption, as higher household income strongly boosted retail trade (Figure 3.4.2).

Gross fixed capital formation moved up by an estimated 4.5%, underpinned by higher investment in manufacturing, transport and warehousing, information and communication, and real estate. Much of this investment involved government support under the Accelerated

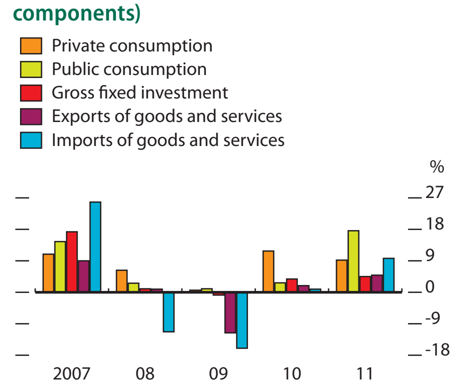
3.4.1 Contributions to growth (supply)



Note: Data in 2011 are not directly comparable to earlier years because of a break in the series.

Source: Agency of Statistics of the Republic of Kazakhstan.

3.4.2 Growth of GDP (demand-side components)



Note: Data for 2011 are for 9 months only.

Source: ADB estimates based on data from Agency of Statistics of the Republic of Kazakhstan.

This chapter was written by Christopher Hnanguie and Manshuk Nurseitova of the Kazakhstan Resident Mission, ADB, Astana.

Program of Industrial and Innovative Development, which aims to promote economic diversification and greater competitiveness through its more than 600 government-led projects, many implemented by the government's National Welfare Fund, Samruk-Kazyna (SK). Net exports rose by about 5%, reflecting higher oil prices.

Average annual inflation rose to 8.3%, slightly above the target of 6–8% set by the National Bank of Kazakhstan (NBK) (Figure 3.4.3). The acceleration reflected double-digit increases in food and fuel prices, despite stringent price regulation and efforts to contain fuel prices by having the national oil and gas company sell imported fuel products at a loss. Inflation accelerated during the first 8 months of the year, as food prices surged, and then slowed toward year-end. In the year through December, inflation was 7.4%.

The fiscal deficit narrowed slightly to 2.1% of GDP, from 2.4% of GDP in 2010, as revenue growth outpaced the rise in expenditure. Thanks to notable increases in both tax and nontax receipts—reflecting strong economic growth, higher export duties for oil products and larger receipts from the Russian Federation under the Customs Union agreement, and increased nontax income (penalties, fines, and dividends)—revenue rose by 35.6%. Total revenue, including transfers from the NFRK, remained at 19.7% of GDP.

Reductions in the number of government employees and more careful monitoring of government spending helped limit expenditure to 21.7% of GDP. Spending for education, health care, and social assistance remained at about the same share of GDP as in 2010. Public sector wages were increased by 18–24% through November, while pensions and social allowances were raised by 30% and 9%, respectively.

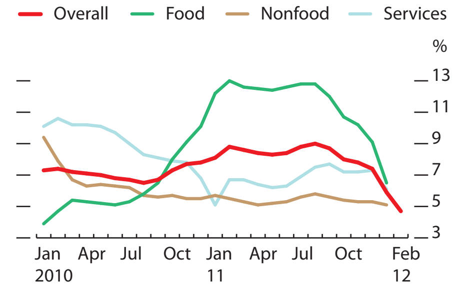
Broad money expanded by 15.0% and reserve money by 10.3% owing to higher net foreign assets at the NBK and commercial banks. The NBK, reversing the easing carried out during the crisis, raised the refinancing rate from 7.0% to 7.5% in March 2011 in response to higher inflation and maintained it through year-end.

With the foreign exchange market supporting the tenge (the national currency), the NBK returned to a managed float regime in March 2011 with limited intervention, buying in the first half of the year and selling in the second half, to minimize exchange rate fluctuations (Figure 3.4.4). In nominal terms, the tenge remained largely stable against major currencies and depreciated slightly against its currency basket. The real exchange rate, however, appreciated by 5.7% against the dollar and by 1.0% against the euro because of relative inflation rates, but depreciated by 2.8% against the Russian ruble toward end-2011, after appreciating between August and mid-December.

Positive trends in the economy led Standard & Poor's and Fitch to raise their sovereign ratings by one notch each, to BBB+ and BBB, respectively, in November. But the banking sector remains weak, and about one-third of loans are nonperforming.

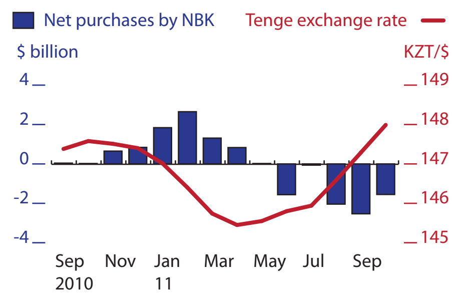
In April the NBK's role expanded to include financial supervision. Reserve requirements for banks were increased in May, from 1.5% to 2.5% on internal liabilities and from 2.5% to 4.5% on other liabilities, to address the high level of nonperforming loans (NPLs). Legal amendments were approved to prolong the guarantee of individual deposits up to T5 million

3.4.3 Inflation



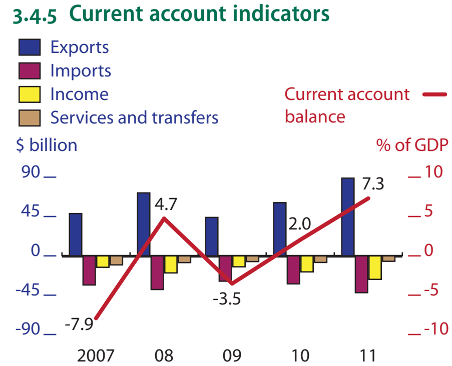
Sources: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 23 March 2012). Agency Statistics of Kazakhstan.

3.4.4 Foreign exchange market and NBK interventions



Source: National Bank of Kazakhstan. Financial Stability. http://www.nationalbank.kz (accessed 23 March 2012).

3.4.5 Current account indicators



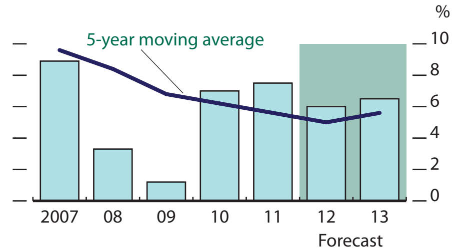
Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 22 March 2012).

(a little less than $34,000) and to make the write-off of bad loans tax deductible. The NBK will also establish a distressed assets fund to deal with the banks' bad loans.

The current account surplus more than tripled to an estimated 7.3% of GDP, as the trade surplus surged by 62% to $46.8 billion. Exports rose by 46.1%, reflecting high oil prices, while imports grew by 31.8%. The services account improved but still recorded a deficit of $6.1 billion. In addition, there was a $24.1 billion payment to direct investors (mostly in the oil and mineral sector) and a large outflow from net remittances, estimated at $1.3 billion, as Kazakhstan is a destination for foreign labor (Figure 3.4.5).

Net foreign direct investment tripled to about $8.8 billion. Gross official reserves of the NBK rose by $1.05 billion to $28.8 billion during the year, while the NFRK's external assets rose by 43% to $43.7 billion. External debt fell from 79.8% of GDP at end-2010 to 66% at end-September, with external private sector debt estimated at 63% of GDP, half of which was intracompany debt of multinational subsidiaries operating in extractive industries. Government external debt remained very low at about 2.3% of GDP. State enterprises' debt, which is not reported as public debt, exceeds 10% of GDP, and a June 2011 report by the International Monetary Fund noted indications of growing foreign borrowing by some enterprises in which SK has holdings.

3.4.6 GDP growth



Source: Asian Development Outlook database.

Economic prospects

Economic growth is projected to slow to 6.0% in 2012, reflecting the expected slowdown in the eurozone and the Russian Federation. It should accelerate to 6.5% in 2013, as the world economy strengthens (Figure 3.4.6). Growth could turn out slower if prospects for oil and other commodities worsen, the world outlook deteriorates, or domestic demand is weaker than expected.

3.4.1 Selected economic indicators (%)

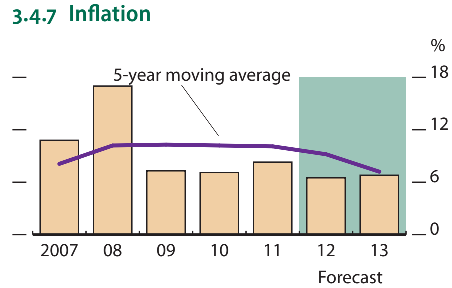
	2012	2013
GDP growth	6.0	6.5
Inflation	6.5	6.8
Current account balance (share of GDP)	1.0	1.0

Source: ADB estimates.

Sizable investments under the Accelerated Program should boost manufacturing and construction, while an expected resurgence of mineral prices and minimal decline in oil prices is seen encouraging growth in petroleum and mining. Implementation of the Accelerated Program, supplemented by other programs aimed at improving infrastructure and productivity, and at promoting industrial and social modernization, are likely to support growth by easing bottlenecks and boosting domestic producers' competitiveness.

Integration into the Common Economic Space (CES) with Belarus and the Russian Federation stands to expand trade, particularly if other countries also join. Inflation is projected to decline to 6.5% in 2012 due to lower food prices, and then rise slightly to 6.8% in 2013 as food price inflation resumes (Figure 3.4.7). The 20% rise in the producer price index during 2011 and the need to harmonize tariffs and prices under the CES to higher Russian prices will contribute to inflationary pressures in 2012. However, the authorities are expected to continue using price regulation, subsidies, and bans on individual products to keep observed inflation within the 6–8% target range.

3.4.7 Inflation



Source: Asian Development Outlook database.

Fiscal policy envisages an increase in the overall budget deficit to about 2.5% of GDP in 2012, as revenue is forecast to decline to about 19% of GDP, while expenditure as a share of GDP is forecast to fall by less than revenue (Figure 3.4.8). The authorities aim to reduce the deficit to 1.5% of GDP in 2013 through further tax administration reform (by more extensive auditing, registering the remaining small sellers for tax payments, and moving toward universal tax declarations), better procurement methods, and a moratorium on government hiring. Nevertheless, pensions, social assistance, and wages for the social sector will grow in real terms.

In January 2012, the President announced a policy change to broaden the NFRK's objectives with a new investment function. Part of the NFRK's assets will be invested internally to fund government development programs. The NFRK will, for example, lend $4 billion (nearly 2% of GDP) to the national oil and gas company Kazmunaigas in two tranches, in 2013 and 2015, to accelerate production at the Kashagan oil field, the world's largest field discovered in recent decades.

In 2012 and 2013, annual transfers from the NFRK, which are budgeted at a fixed amount of around $8 billion, will be topped up with T180 billion (about $1.2 billion or 0.6% of GDP) to allow more flexibility in meeting or expanding social expenditure without exceeding budget deficit targets. In addition, $300 million–500 million (roughly 0.2–0.3% of GDP) in revenue is expected from sales of shares in state enterprises to the population and pension funds through the proposed launch of the People's Initial Public Offering Program in 2012. Total government debt (excluding state enterprises' debt) is not expected to exceed 15% of GDP in 2012 and 2013, a very low rate by international standards.

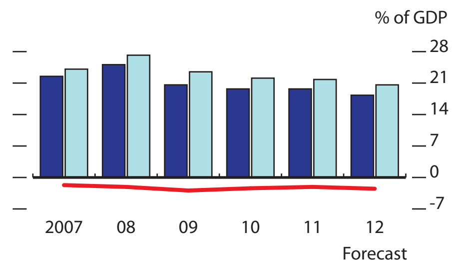
In January 2012, 12-month inflation fell to 5.9%, the lowest in many years. In mid-February, the NBK reduced the refinancing rate by 0.5% and is considering another decrease in April if inflation remains low. Thus interest rates generally may also decline moderately. As for the exchange rate, in the first 2 months of 2012 the tenge remained stable, slightly above 148/$1, and strengthened somewhat after February.

Despite government support to the financial sector, a persistent high level of NPLs is a major concern and a key constraint to economic growth. At end-2011, banking sector performance was worse (in terms of credit-to-GDP and asset-to-GDP ratios, share of NPLs, return on assets, and return on equity) than at end-2010. In addition, the large BTA Bank, which was recapitalized and restructured in 2009–2010, remains in difficulty and in January 2012 requested approval for a second restructuring. In this situation, SK—a major shareholder—may be forced to bail out the bank using public money. Over the medium term, NPLs may also rise as a result of financial assistance provided through interest-rate subsidies and partial credit guarantees under the government's Roadmap of Business 2020 program, which helped increase bank lending in 2011.

The poor performance of the state pension funds also presents a macroeconomic risk, given the aging population. Between losses on external assets and poor returns on the more than 40% of their funds invested in low-interest-rate government securities, the funds have lost over 20% of their real value during the past 6–8 years and could be hard hit if another crisis occurs.

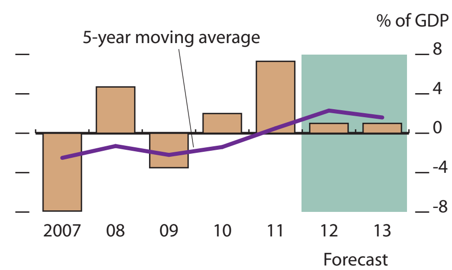
The current account is forecast to record surpluses of about 1.0–1.5% of GDP in 2012 and 2013 (Figure 3.4.9). Surpluses of at least 20% of GDP are projected for the trade balance, supported by high prices for oil

3.4.8 Fiscal indicators



Sources: Ministry of Finance of the Republic of Kazakhstan. National Budget 2012–2013.

3.4.9 Current account



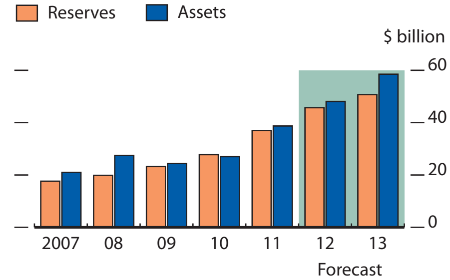
Source: Asian Development Outlook database.

and other commodities and easier access to the Russian transport and communications network, including oil pipelines, under the CES. The services account is set to improve, with completion of the infrastructure development around the Kashagan project and transition to the production phase. Income-related outflows may also increase, however, as continued mineral earnings generate higher payments to foreign investors.

Capital inflows should average about $4 billion in 2012 and 2013, while gross reserves are forecast to reach $32 billion and $35 billion at the close of 2012 and 2013. The NFRK's assets will grow more slowly than during 2011, given the government's intention to invest NFRK resources extensively in the economy, but they will likely exceed $50 billion at end-2012, offering substantial resources for future development (Figure 3.4.10).

Total external debt is forecast to remain at 65–70% of GDP at the end of this year and next (Figure 3.4.11). The share of intracompany debt will remain unchanged and public external debt (excluding state enterprises' debt) will maintain its traditionally low level.

3.4.10 Gross official reserves and assets of the National Oil Fund



Sources: National Bank of Kazahkstan. http://www.nationalbank.kz (accessed 23 March 2012). International Monetary Fund. 2011. *Country Report No. 11/150*. June.

Policy challenge—diversifying the economy

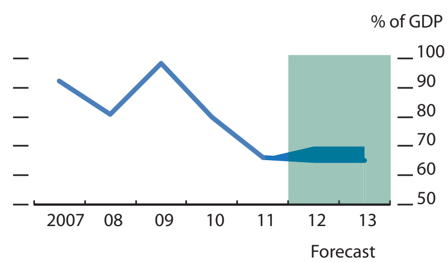
Kazakhstan's dependence on petroleum and mining makes it vulnerable to swings in international prices. And it is hard to establish a more inclusive growth model, as jobs in petroleum are limited, involving either low-skill employment or a few highly paid, specialized positions. Thus some energy earnings should be spent on developing new, competitive industries that can support a shift away from oil dependence, especially as entry into the CES provides access to much broader markets.

To help diversify its economy, Kazakhstan needs to expand its current efforts to develop competitive projects under the Accelerated Program based on its comparative advantages (mainly in agriculture, construction materials, oil and gas refining and infrastructure, metallurgy, chemicals, pharmaceuticals, defense, and energy development). Such expansion will likely require it to modernize and renovate infrastructure, which may create investment opportunities for specialized private investors in public–private partnerships, including non-oil multinational companies. Investment in infrastructure is needed to attract new technology, both to address a growing electricity deficit and to modernize transport, water supply, and sanitation in order to cut costs and expand services.

The careful use of government policy instruments—tax incentives, subsidies, regulations, and expenditure for activities that support industry—can assist private ventures with good potential, particularly in exporting. The experience of Asia's newly industrialized economies suggests that successful industrial programs are those that have the government serving as a facilitator and regulator rather than lead implementer, leaving that function to the market.

At the same time, scarce resources must not be used to aid poorly performing firms or to help vested interests seeking support for unprofitable activities. State support should be limited in time, supportive of competition, and terminated when projects fail. In addition, government funding should accompany—and not replace—broader reforms in governance and regulation, as well as efforts to build human capital by strengthening education and training.

3.4.11 External debt



Note: Data for 2011 are as of September only.

Sources: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 23 March 2012). ADB estimates.

Kyrgyz Republic

The economy is still recovering from the political crisis of April 2010. A new government has been set up, public confidence is slowly returning, and all sectors have seen growth. Improved tax administration and high gold prices increased government revenue, but higher civil service wages and social spending, alongside continuing reconstruction in the south, strained overall finances. Integration into the customs union with the Russian Federation, Belarus, and Kazakhstan may be a challenge, with risks of inflation pressures, unemployment, and trade disruptions.

Economic performance

Following a sluggish first quarter, real growth picked up as the year progressed, reaching 5.7% for 2011 (Figure 3.5.1). All sectors showed robust gains, reflecting improved security and sustained public confidence after the events of April 2010, which saw the ouster of the president and ethnic violence in the south.

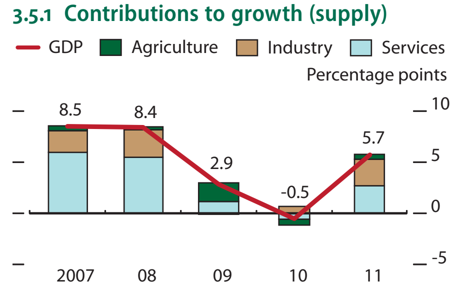
Agriculture showed a modest bounceback to 2.3% growth, following its 2.6% contraction in 2010. Land under cultivation increased by 9%, because shortages of fuel and financing were less severe than in 2010, although a drought in the south kept grain production stagnant.

Industry expanded by 8.8%, with growth in nearly all major subsectors (Figure 3.5.2). Manufacturing grew by 9.8%, or 18.8% excluding gold production, which declined slightly year on year due to low gold concentration in ore extracted during the year. Textile and chemical industries grew especially fast, reflecting the resumption of trade with the Russian Federation and Kazakhstan (disrupted by the crisis). However, food processing declined, reflecting the previous year's fall in agricultural production and the weak recovery in 2011. Also within industry, construction declined by 3.9%—adding to the 18.5% fall in 2010—reflecting a slow recovery of private sector confidence and the continuing postponement of several large projects that were put on hold in 2010.

The services sector, which fell sharply in 2010 following the political events, rebounded by 5.2%, reflecting improved consumer sentiment and the reopening of borders with Kazakhstan and Uzbekistan. (The borders were closed periodically after April 2010. By October that year the border with Kazakhstan was largely reopened, and in October 2011 Uzbekistan reopened an important border crossing.) Most of its subsectors saw growth, including trade, hotels and restaurants, and transport and communications, although real estate contracted by 1.7% on continuing fears of socioeconomic turbulence.

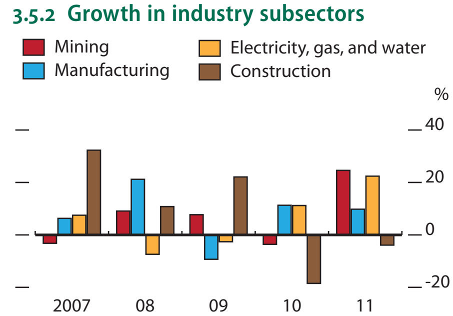
On the demand side, private consumption is estimated to have grown by 4.5%, reflecting a notable rise in retail sales, despite a small increase

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 15 March 2012).

3.5.2 Growth in industry subsectors



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 15 March 2012).

This chapter was written by Gulkayr Tentieva of the Kyrgyz Resident Mission, ADB, Bishkek.

in unemployment. The growth in consumption was driven largely by returning consumer confidence and an increase in remittances to $1.4 billion, equivalent to 25% of GDP, reflecting more Kyrgyz migrants working in the Russian Federation in 2011.

Private investment is estimated to have fallen by a further 16%, after a 23% decline in 2010. By contrast, the growth rate of government investment roughly doubled to an estimated 16%, reflecting continued spending to rehabilitate damaged infrastructure in the south.

Consumer prices rose by 16.6% on a year-average basis, mainly because of rapid price increases during the first half of the year. Inflation slowed during the second half, and the 12-month (December over December) rise in the consumer price index was only 5.6% (Figure 3.5.3).

Food prices, which rose by 25.9%, were the main driver of inflation; nonfood prices rose by 10.3%. The slowdown in inflation during the second half of the year largely reflected good harvests in the Russian Federation and Kazakhstan, which lowered the cost of imported food, along with the impact of tighter monetary policy.

The overall budget deficit rose slightly, to 7.6% of GDP, as increases in tax revenue offset higher social—but not capital—spending (Figure 3.5.4).

Government revenue rose by around 30%, reflecting strong economic growth, high gold prices, and reforms in tax policy and administration, including improved customs valuation, higher excise tax yields, a stronger large taxpayer unit, and more effective audit procedures. Total revenue and grants reached 32.2% of GDP.

Government spending rose by 34%, reflecting higher government grants, wages, and social outlays to raise pensions toward the national subsistence level. Total expenditure reached 39.7% of GDP, and total public and publicly guaranteed debt—external and domestic—declined to 52% of GDP at end-2011.

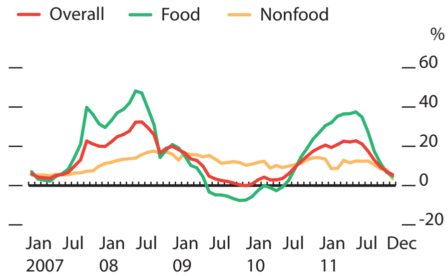
Extensive dollarization of the economy and a shallow financial sector limit the impact of monetary policy in the country. Still, in 2011 the National Bank of the Kyrgyz Republic raised its policy rate steadily over the year, from 5.5% to 13.5%. Credit growth in the broad financial system accelerated to 19.2% from 18.2% in 2010, reflecting in part the lagged impact of earlier expansionary policy and the low reserve requirement set by the central bank in 2010. Commercial banks were responsible for most of the increased lending. The ratio of nonperforming loans to total credit portfolio declined, from 13.8% to 9.8%. Higher nominal interest rates contributed to the local currency's appreciation from March to August.

The current account deficit narrowed slightly to 6.8% of GDP from 8.0% in 2010, despite higher imports, reflecting a less negative income balance and stronger remittances, which reached 25% of GDP (Figure 3.5.5).

Trade rebounded strongly, after the fall in 2010 due to the border closures. Exports are estimated to have grown by 31.1%, with gold remaining the largest item. Imports grew by an estimated 34.4%, mainly reflecting higher imports of gasoline and diesel fuel. The Commonwealth of Independent States countries remained the largest trading partners, with 64% of trade volume.

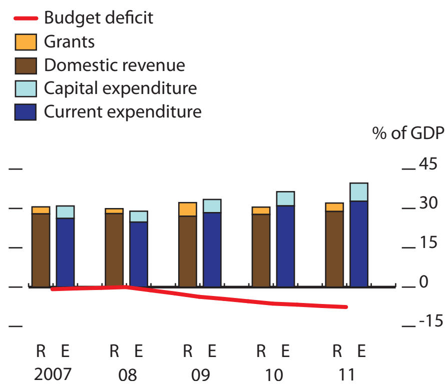
Foreign direct investment fell by 14% reflecting continued weak investor confidence. Nevertheless, net international reserves rose by 7% to $1.8 billion.

3.5.3 Monthly inflation



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 15 March 2012).

3.5.4 Budget indicators

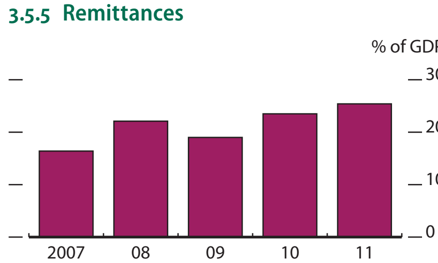


R = Revenue; E = Expenditure.

Note: Domestic revenue includes capital receipts.

Sources: International Monetary Fund. 2009. *Country Report No. 09/209*. July; 2010. *Country Report No. 10/336*. October; 2011. *Country Report No. 11-354*. December. http://www.imf.org; Ministry of Finance.

3.5.5 Remittances



Source: ADB estimates based on data from National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 15 March 2012).

Economic prospects

GDP growth is expected to slow to 5.0% in 2012 and then rise to 5.5% in 2013 (Figure 3.5.6). With the restoration of public confidence and political stability, higher domestic demand and stronger investor confidence are expected to spur private sector activity in the non-gold sectors. Against this, the adverse impact of the eurozone recession on Kazakhstan and the Russian Federation—key trading partners and sources of worker remittances—will inhibit growth. Private transfers are expected to stay around 20–25% of GDP, however.

Growth is expected to be driven by the industry and services sectors. Government plans to provide subsidized loans to farmers in 2012 are expected to promote growth in agriculture.

Large investment projects in infrastructure will drive construction, such as rehabilitating major road networks and building new power grids. Many other projects, including additional power grids and hydropower plants, remain under negotiation.

Private consumption growth is forecast at 5.9% and 5.1%, respectively, in 2012 and 2013, although continuing tensions in the south could jeopardize these increases. Net exports are likely to show little growth, as slower growth in the country's main trading partners—the People's Republic of China, Kazakhstan, the Russian Federation, and the eurozone, point to only modest prospects for exports.

Year-average inflation is expected to continue decelerating, to 5.0% in 2012, reflecting tighter fiscal and monetary policies and likely moderation in the prices for imported food (Figure 3.5.7). Inflation is forecast to rise to 5.5% in 2013, on expected price increases for imported food.

The government aims to reduce the fiscal deficit to 7.3% of GDP or less in the next 2 years, in order to improve debt sustainability and contain inflation pressures. These lower deficits would likely maintain the ratio of total public debt to GDP at 52–53% in the forecast period.

Recent government announcements signal plans to continue improving tax administration and customs collection. Revenue is targeted to reach 32–33% of GDP over the forecast period.

On the spending side, cuts for operations, along with a planned 20% reduction in the civil service headcount this year, are forecast to offset the impact of higher pensions and other socially oriented expenditures. Total expenditure is forecast at 39.6% of GDP in 2012 and 38.7% in 2013.

Monetary policy should remain conservative, reflecting central bank support of fiscal policy to mitigate inflation pressures. Nominal interest rates are likely to stay within the 13–15% band, contributing to further appreciation of the local currency this year.

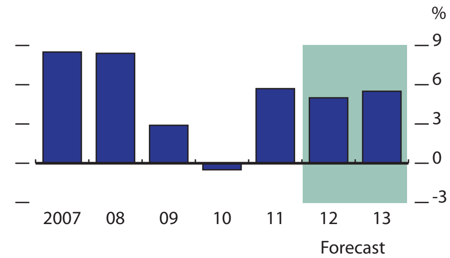
The current account balance is projected to improve somewhat to a deficit of 6.6% of GDP in 2012 before returning to and 6.8% in 2013 (Figure 3.5.8). Following the sharp recovery in 2011, export growth is forecast to moderate to 11.8% and then to 7.7% in 2013, as predicted slower growth in Kazakhstan and the Russian Federation weaken demand for the country's exports. Import growth is forecast to ease to 10.4% and 9.2%, respectively, reflecting increasing domestic production of foodstuffs, continuing but slower remittance growth, and moderating imported food prices in 2012.

3.5.1 Selected economic indicators (%)

	2012	2013
GDP growth	5.0	5.5
Inflation	5.0	5.5
Current account balance (share of GDP)	-6.6	-6.8

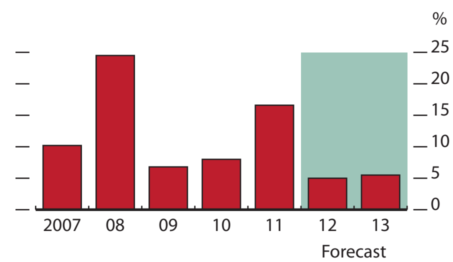
Source: ADB estimates.

3.5.6 GDP growth



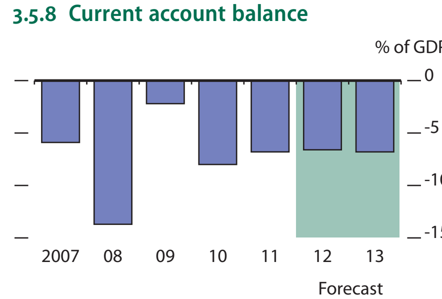
Sources: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 1 March 2012); ADB estimates.

3.5.7 Inflation



Sources: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 15 March 2012); ADB estimates.

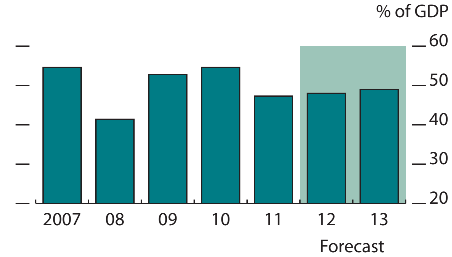
3.5.8 Current account balance



Sources: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 15 March 2012); ADB estimates.

Foreign direct investment inflows will largely depend on the government pushing through with its proposed structural reforms, which include a reduction in business licenses as part of a broader effort to reduce regulatory burdens on activity. The ratio of total external debt to GDP is expected to remain relatively stable at around 48–49% in the forecast period (Figure 3.5.9).

3.5.9 External debt



Sources: The Ministry of Finance; National Statistics Committee. http://www.stat.kg; National Bank of the Kyrgyz Republic. http://www.nbkr.kg (both accessed 15 March 2012); ADB estimates.

Policy challenge—joining the customs union

Although economic activity is recovering after the crisis of 2010, political stability and investor confidence still need strengthening. As investments have been falling, the government is considering providing new tax incentives to investors. Unless substantial new investment is generated, this move could raise the fiscal deficit and increase the debt-to-GDP ratio.

Over the longer term, the planned accession of the Kyrgyz Republic into the customs union that Belarus, Kazakhstan, and the Russian Federation inaugurated in January 2012 poses major challenges to the economy. Entry into the customs union would make the country subject to new common external tariffs, which are generally higher than those now in force in the Kyrgyz Republic. These new tariffs would raise the price, and reduce the volume, of "shuttle trade" products, which consist largely of textiles reexported from the People's Republic of China to the Russian Federation and Kazakhstan. The shuttle trade was estimated to contribute 3–4% of GDP in 2005–2009.

The terms of accession, including the common external tariffs, are being discussed. The government is concerned that premature accession may entail job losses and is seeking measures to mitigate the possible negative economic effects. Conflicts between customs union arrangements and the country's obligations as a World Trade Organization member also need to be resolved.

Tajikistan

Underpinned by record-high remittance inflows and supported by expansion in agriculture, services, and industry, growth accelerated in 2011, continuing the recovery to precrisis levels. Inflation remained high for most of 2011 but gradually eased toward year-end. In the short and medium term, continued moderate growth is forecast, but heavy reliance on remittances and public investment as drivers of demand-driven growth alongside extremely low private investment may not be sustainable.

Economic performance

GDP growth accelerated to 7.4% (from 6.5% in 2010), reflecting strong domestic demand and expanding agriculture, services, and industry, despite limited electricity supply and disruptions to rail transit through neighboring countries that held back output in the first half (Figure 3.6.1).

Driven by record remittances, services were the main driver of growth, expanding by 13.5%. Agriculture grew by 7.9%, despite difficult climatic conditions. Cotton production shot up by 34%, reflecting a 30% rise in the area devoted to cotton, as high international prices encouraged additional planting. Other crops, particularly fruits and vegetables, also showed double-digit growth.

Industry grew by 5.9%, encompassing a wide variation between a more than 38% increase in mining and extraction industries and a 16% contraction in aluminum output caused by disruptions to alumina imports and reduced electricity generation in the early part of the year.

Consumption, reflecting higher imports, was the main source of growth on the demand side. Private investment showed little expansion, and its share in GDP remained extremely low at about 3%. Domestic investment was dominated by the government through state-owned enterprises.

Rising global food and fuel prices and higher remittances (which boosted domestic demand for imports) nearly doubled year-average inflation to 12.5% from 6.5% in 2010, although core inflation (excluding food and fuel) remained moderate at 5.7%.

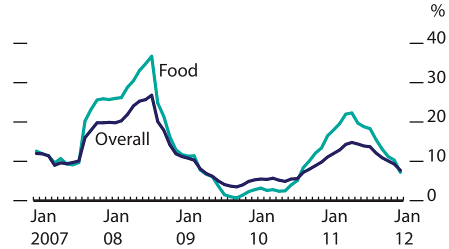
Increases in export duties for oil products imposed by Tajikistan's main supplier, the Russian Federation, in the first half of 2011 raised fuel prices by 59%. Food price inflation peaked in that half in response to rising world prices (Figure 3.6.2), with staple foods rising by an average of 32%, before slowing in the second. Massive public expenditure on infrastructure and special projects to commemorate the 20th anniversary of Tajikistan's independence added to inflationary pressures.

The overall budget deficit widened to 3.1% of GDP, although the more narrowly defined fiscal deficit (excluding foreign-financed public investment projects) was less than 1% of GDP (Figure 3.6.3).

3.6.1 GDP growth by sector

Sources: International Monetary Fund; Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2012).

3.6.2 Monthly inflation



Source: Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2012).

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

Revenue receipts exceeded the budget target, with tax collection surging by 30% from 2010, reflecting high prices for key exports and increased imports. Nevertheless, a narrow tax base and heavy dependence on import-based taxes contributed to a fragile fiscal position. Total revenue equaled 24.4% of GDP.

Government expenditure, in particular capital spending on infrastructure, rose by close to 30%, reflecting strong revenue and heavy foreign financing. Government investment surged by 41%, with increased spending focused on energy and transport infrastructure projects, including rehabilitation of the massive Roghun hydropower plant. Spending for social insurance and social protection grew by about 7%, as the state budget focused on capital outlays. Total expenditure amounted to 27.6% of GDP.

Although the stock of public and publicly-guaranteed debt climbed, rapid GDP growth reduced the ratio of public and publicly-guaranteed debt to GDP to 33.3% from 36.5% in 2010 (Figure 3.6.4). Potential contingent liabilities for state enterprises and the financial sector continued to raise questions about fiscal sustainability over the medium term.

Although high dollarization and an underdeveloped financial market undermined such moves' effectiveness, the National Bank of Tajikistan (NBT) pursued contractionary monetary policy during much of the year to curb inflation, raising its refinancing rate from 8.25% to 9.0% in February and again to 10.0% in October 2011. Yet reserve money still grew by more than 27% during the year, reflecting the recovery of private sector credit and considerable liquidity support from the central bank to commercial banks.

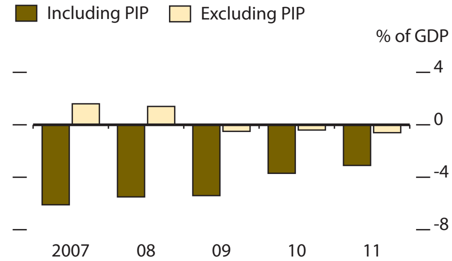
Since late December, with inflation slowing, the NBT has relaxed policy somewhat, lowering the refinancing rate in two steps to 9.0% by February 2012, to stimulate the economy.

Although financial sector indicators improved somewhat, more than 15% of loans remained nonperforming. The sector is constrained by limited private investment, few deposits, and exposure to risky agricultural loans. The exchange rate of the somoni, the local currency, depreciated by more than 8% against the US dollar and Russian ruble and 10% against the euro in 2011 (Figure 3.6.5).

The current account switched to a 4.1% of GDP deficit, after a 2.1% surplus in 2010. High remittances helped boost imports by about 20%, but exports picked up by only 5.2%, widening the trade deficit to over $2 billion. The limited production base, noncompetitive products, and a focus on a few export commodities—mainly aluminum and cotton—limited export growth. Import growth largely reflected surges in food products (38%) and textiles (27%), as well as industrial products (13%).

After hitting a trough in 2009–2010 of less than $20 million, foreign direct investment edged up to an estimated $30 million in 2011, but even this was very low. The government continued borrowing for energy and transport infrastructure projects. Gross reserves climbed to $582 million at end-2011, equivalent to 2 months of imports, from $476 million at end-2010. Public and publicly guaranteed external debt declined to 31.3% of GDP at end-2011, compared with 34.4% of GDP a year earlier.

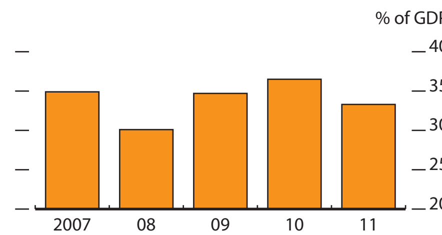
3.6.3 Fiscal balance



PIP = public investment program.

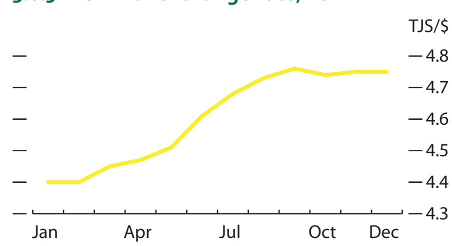
Sources: International Monetary Fund. 2010. *Country Report No. 10/374*. December; 2011. *Country Report No. 11/130*. June; 2012. *Country Report No. 12/32*. February. http://www.imf.org

3.6.4 Public and publicly guaranteed debt



Sources: International Monetary Fund. 2010. *Country Report No. 10/374*. December; 2011. *Country Report No. 11/130*. June; 2012. *Country Report No. 12/32*. February. http://www.imf.org

3.6.5 Nominal exchange rate, 2011



Source: National Bank of Tajikistan.

Economic prospects

Remittances will continue supporting aggregate demand, but GDP growth is forecast to decline to 5.5% in 2012, reflecting slower growth in the Russian Federation and other key trading partners, before recovering to 6.0% in 2013 as the world economy improves (Figure 3.6.6). Large remittances should boost consumption, maintaining sizable consumer imports and helping finance higher public investment through increased tax revenue. Although the overall outlook for exports is uncertain, construction of an international power line and the signing of an export agreement in 2011 should boost summer exports of electricity to Afghanistan in 2012 and 2013.

Output projections are less certain on the supply side. Moreover, the economy will remain prone to risks from recurrent shocks such as drought, natural disasters, and regional trade and political disputes.

Agriculture's performance will depend heavily on cotton output, which could expand further if global cotton prices stay high. Industry (including construction) and services will continue to fuel growth but at slower rates than in 2011 because of continued problems in the power sector, limited supplies of inputs, and aging production facilities, particularly in aluminum.

Inflation is forecast to stay around 8.5–9.0% in the next 2 years (Figure 3.6.7), as upward pressures on nonfood prices from higher imports and other factors offset the impact of moderating food prices. The Russian Federation is considering exempting from export duties only a fraction of oil products exported to Tajikistan, so inflation pressures from high fuel prices will persist in 2012. Additional pressure is likely to come if the government proceeds with plans to raise electricity tariffs.

Although the narrowly defined fiscal deficit is projected to remain around 0.5% of GDP, the overall deficit may widen beyond the forecast 5.5% of GDP. Slowing export growth may limit revenue. On the other hand, any increase in revenue will likely encourage a corresponding rise in expenditure, mainly for infrastructure, which would add to external borrowing under the public debt management framework.

The government plans to expand reforms in social assistance programs, which remain highly inefficient and poorly designed to the needs of the most vulnerable social groups. Tajikistan is unlikely to meet its Millennium Development Goal targets by 2015, although the government aims to focus more on investment strategies for more inclusive growth through initiatives to improve access to health care and education, including universal access to education for girls.

Continuing large consolidated deficits are expected to raise the public debt-to-GDP ratio to 37.3% by end-2012 and 37.8% a year later, which could prove risky in view of the possible recurrence of shocks to the economy.

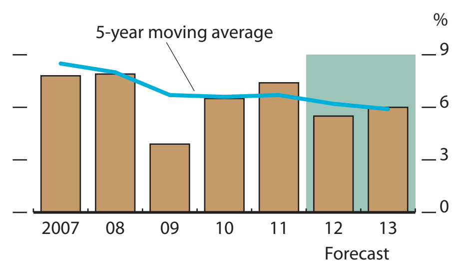
Despite persisting inflation, monetary policy may need to reflect more of a balance between supporting economic recovery and ensuring price stability, given the expected slowdown in growth and the limited volume of loanable funds for the economy. Slowing inflation has already led the central bank to reduce the refinancing rate from 9.8% in December 2011 to 9.0% in February 2012, and it may follow with further steps to more expansionary monetary policy. Weak external performance is expected to put further downward pressure on the national currency.

3.6.1 Selected economic indicators (%)

	2012	2013
GDP growth	5.5	6.0
Inflation	8.5	9.0
Current account balance (share of GDP)	-7.0	-6.5

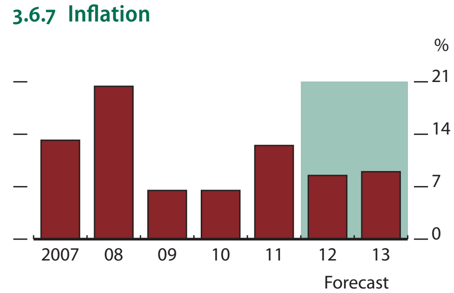
Source: ADB estimates.

3.6.6 GDP growth



Sources: International Monetary Fund; Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2012); ADB estimates.

3.6.7 Inflation



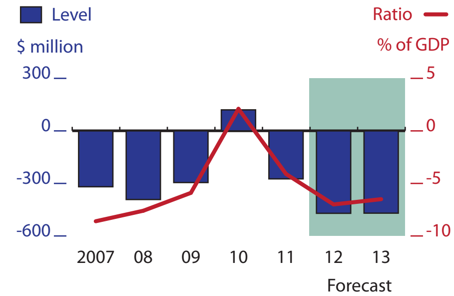
Sources: International Monetary Fund. 2011. World Economic Outlook database. September; Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2012); ADB estimates.

The current account deficit is expected to widen from 4.1% in 2011 to 7.0% in 2012 before narrowing to 6.5% in 2013 (Figure 3.6.8). Export receipts are projected to fall as a result of declining international prices for cotton and other exports. Imports, though, should remain at least at the current level because of higher remittances (Figure 3.6.9).

The government is likely to continue external borrowing to finance infrastructure projects, mainly in energy and transport. However, the above-mentioned debt management framework requires all new government borrowings to have at least a 35% grant element and to limit borrowings to priority projects. Total public debt is projected to stay below 40% of GDP over the foreseeable future.

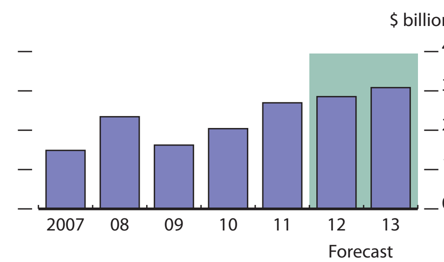
Foreign direct investment inflows are projected to continue rising gradually over the medium term, in line with current reform initiatives in tax administration and regulatory simplification. The bulk of investments will likely go to several large infrastructure projects, such as hydropower stations, toll roads, and supporting facilities for mining. Public and publicly guaranteed external debt is forecast to reach 37.2% of GDP at end-2012 and 37.5% of GDP 12 months later.

3.6.8 Current account balance



Sources: International Monetary Fund. 2010. *Country Report No. 10/374*. December; 2011. *Country Report No. 11/130*. June; 2012. *Country Report No. 12/32*. February. http://www.imf.org

3.6.9 Net remittances



Sources: International Monetary Fund. 2010. *Country Report No. 10/374*. December; 2011. *Country Report No. 11/130*. June; 2012. *Country Report No. 12/32*. February. http://www.imf.org

Policy challenge—boosting investment

A big concern remains the very limited share of private investment and foreign direct investment inflows, and more generally, a weak business environment and problems in the financial sector. The government relies extensively on public investment, an approach that may be unsustainable given the limited room for additional budget outlays. The private sector still represents less than half of GDP—and private investment less than 5%—reflecting an unfavorable business environment and lack of investor confidence. Most private enterprises are still small or of medium size and require little capital, operating in areas such as trade and services.

Serious efforts are necessary to reverse the lack of investor confidence and declining levels of private investment. Reducing risks to private investors—by providing and then enforcing property rights, for example, by reducing corruption, and by enhancing supportive infrastructure—is critical. Improving the security situation at the border with Uzbekistan, where clashes between border guards have closed an important rail line, and maintaining macroeconomic stability would also encourage private investment inflows.

Difficult business regulations also discourage private investment. Despite being among the top 10 reformers in the World Bank's 2010 and 2011 *Doing Business* reports, in the 2012 report Tajikistan still ranks 147 among 183 economies in the ease of doing business. Tax administration is complicated and time consuming, while the tax burden is high and encourages tax evasion. Limited financial intermediation and costly business financing are also major barriers. Addressing inefficiency, eliminating directed lending, and promoting competition by allowing international banks to enter the market could facilitate more lending and help cut financing costs.

Overall, understanding and eliminating key constraints to private investment, including deterrents to foreign investment, is critical to achieve sustainable economic growth in the medium term.

Turkmenistan

Growth continued at nearly double-digit levels in 2011, reflecting a sharp rise in gas exports and sizable public investment. A similar rate is expected in 2012, through planned expansion of gas pipelines, but growth may moderate in 2013. Diversifying the economy in order to reduce the country's dependence on energy exports and deepening the reform process remain key policy challenges.

Economic performance

Turkmenistan recorded strong growth in 2011, driven largely by hydrocarbon exports and an ambitious public investment program. The International Monetary Fund (IMF) put growth at 9.9% (Figure 3.7.1).

On the demand side, the government reported that gas exports—the mainstay of the economy—shot up by 75.2%, reflecting a 42.5% rise in production and the expansion of pipeline capacity to the People's Republic of China (PRC) and the Islamic Republic of Iran. Total investment under the National Program of Socio-Economic Development 2011–30, a long-term program to modernize the country's economy, rose by 23.2%, according to government estimates. The IMF estimated that gross investment reached 60% of GDP (Figure 3.7.2).

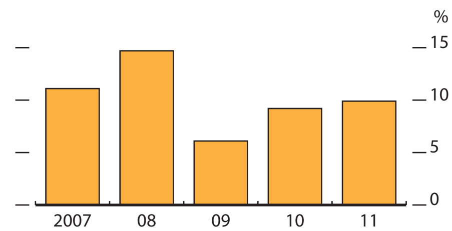
On the supply side, the government reported all sectors showing growth. Industry grew fastest (24.2%), followed by construction (12.5%), trade (8.9%), services (8.1%), and transport and communications (8.0%). Agriculture also expanded.

Expansionary fiscal policies and higher global commodity prices augmented inflationary pressures, although price controls and subsidies for basic goods and utilities, along with a stable exchange rate, kept inflation to an estimated 6.1%.

An accurate assessment of the fiscal situation is difficult because of sizable extrabudgetary operations, including funding for public investment. Nevertheless, the state budget was reported to have recorded a surplus (Figure 3.7.3). The government reported a 48% rise in revenue, reflecting the growth in gas exports, while spending was reported to have climbed by 37%, with three-fourths of budget expenditure devoted to the social sector. Control by the government over monetary policy and commercial bank activity remains significant. Banks and the government receive central bank credit at concessional interest rates, and directed lending is extensive.

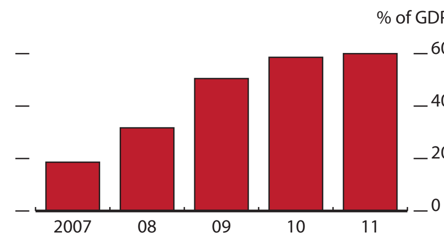
The IMF estimates that the surge in gas exports narrowed the external current account deficit to about 2.9% of GDP from an estimated 11.7% in 2010, despite a large rise in imports, particularly for public investment. Although the country accumulates substantial foreign exchange reserves, external debt is believed to have risen sharply, from 2.6% of GDP at end-2009 to 20.5% at end-2011.

3.7.1 GDP growth



Sources: International Monetary Fund. 2011. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

3.7.2 Total investment



Source: International Monetary Fund. 2011. *Public Information Notice (PIN) No. 11/161*. December. http://www.imf.org

This chapter was written by Jennet Hojanarazova of the Turkmenistan Resident Mission, ADB, Ashgabat.

Economic prospects

Hydrocarbon exports will remain the chief source of growth and development project financing. GDP growth of 10.0% is forecast in 2012, reflecting further expansion of pipeline capacity to the PRC and large public investment. Somewhat slower growth (about 9%) is anticipated in 2013.

The government intends to widen its export destinations, and a private firm's audit of gas deposits, released in October 2011, confirmed reserves of up to 26.2 trillion cubic meters, among the world's largest. Besides existing pipelines to the PRC, the Islamic Republic of Iran, and the Russian Federation, a new pipeline under construction since 2010 is intended to connect the country's eastern fields with the Caspian Sea and facilitate exports to Europe. Plans are also under way for a pipeline project from Turkmenistan to Afghanistan, Pakistan, and India agreed in December 2010, although security remains an issue.

Over time Turkmenistan will benefit from enhanced cooperation and trade with neighboring countries. The North–South railway line, scheduled for completion by 2014, will improve its access to Kazakhstan, the Gulf, the Russian Federation, and South Asia. This line could become the region's main route for transporting goods such as petroleum, minerals, agricultural products, and textiles.

The state budget for 2012 projects a small deficit—financed by transferring the 2011 surplus—caused by increased spending. Expansionary fiscal policies will likely add to inflation, which is forecast to reach 7.0% by 2013 (Figure 3.7.4). Continued growth in gas exports is expected to move the current account to a surplus of 3.4% of GDP in 2012 and 2013 (Figure 3.7.5).

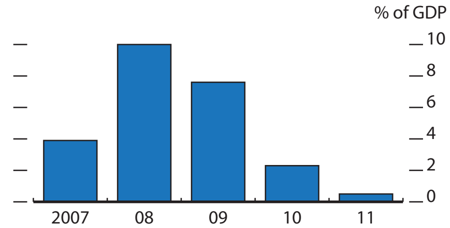
Policy challenge highlights

Hydrocarbon products account for over 90% of exports, and high specialization in energy exports entails risks for sustainable economic development. The government has already taken some steps through the National Program of Socio-Economic Development to diversify the economy, aiming to develop agriculture, food processing and other agro-industry, textiles, chemicals and petrochemicals, electricity generation, tourism, and construction materials.

Substantial diversification will require extensive supply-side reforms. Numerous structural measures will be needed to free private firms from the state planning system's disincentives. An adequate legal and regulatory framework for private businesses must be in place, along with an expanded and restructured banking sector that can provide financial capital and channel profits and savings from hydrocarbons to investment in other sectors.

Efficient resource allocation is also crucial. A long-term investment plan, with careful prioritization and sequencing of investments and cost-benefit analysis, must ensure that resource wealth is allocated to viable projects.

3.7.3 General government fiscal balance



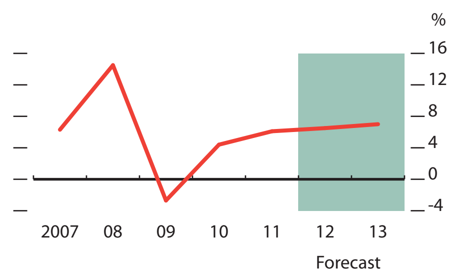
Source: International Monetary Fund. 2011. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org.

3.7.1 Selected economic indicators (%)

	2012	2013
GDP growth	10.0	9.0
Inflation	6.5	7.0
Current account balance (share of GDP)	3.4	3.4

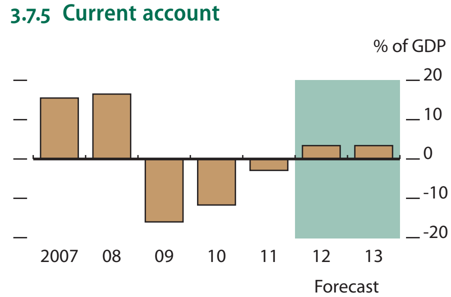
Source: ADB estimates.

3.7.4 Inflation



Sources: International Monetary Fund. 2011. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

3.7.5 Current account



Sources: International Monetary Fund. 2011. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

Uzbekistan

Growth accelerated in 2011, driven by net exports, state-led investments, and remittances. With lower non-oil commodity prices in 2012, economic growth will be sustained by public investment and increasing foreign investment. The key downside risk is a deteriorating economic environment in the euro 20 and the Russian Federation. To reduce risks from reliance on commodity exports, the economy needs to diversify beyond the natural resources sectors and expand the private sector.

Economic performance

Reflecting the favorable external environment, sustained public investment, and rising private consumption bolstered by remittances, Uzbekistan's strong economic performance continued in 2011 with GDP growth of 8.3% (Figure 3.8.1). As in previous years, industry (including construction) and services were the main contributors to GDP growth, with estimated growth rates of 6.7% and 12.7%, respectively.

Industrial growth declined to 6.7% from 8.3% in 2010, mainly due to a slowdown in the fuel subsector, where a decline in natural gas output kept growth to 0.3%. Nevertheless, all subsectors grew collectively by 11.9%, in particular machinery and equipment, chemicals and petrochemicals, construction materials, and the food industry, reflecting strong external demand for metals and petrochemicals and continued industrial development. Construction grew by 8.5%, reflecting higher public construction, which offset a slowdown in foreign investment-related construction activities.

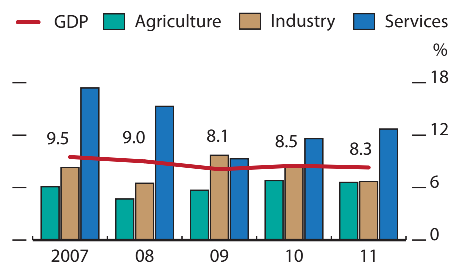
As in 2010, services were again a main source of growth, with retail trade, communications, and financial services recording a combined growth rate of 22.3%, supported by strong domestic demand, in particular, rising private consumption. The agricultural sector grew by 6.6%, supported by fruit and vegetable production and livestock breeding.

On the demand side, rising remittances, increased domestic lending, and wage and pension hikes boosted private consumption. Gross fixed capital formation increased by 11% in nominal terms, to 26% of GDP, as bank lending for investment rose by one-third (Figure 3.8.2). Most investment went to industry, for purchases of capital goods.

Estimates of inflation range from the government's 7–9% to 13.1% from the International Monetary Fund, with the latter above 2010's outturn of 9.4%. Inflation in 2011 reflected public sector and pension increases in August and December, totaling 26.5% since December 2010, with high foreign exchange inflows, rapid credit growth, local currency depreciation, and increased private and public spending.

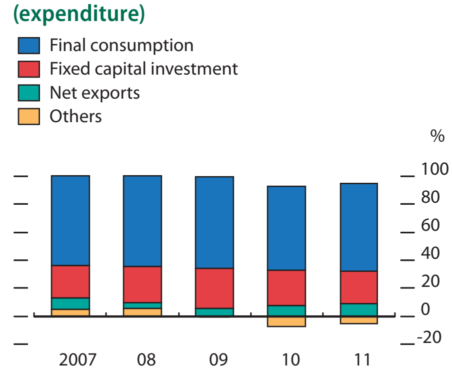
This chapter was written by Iskandar Gulamov of the Uzbekistan Resident Mission, ADB, Tashkent.

3.8.1 GDP growth (supply)



Sources: State Statistics Committee of Uzbekistan; ADB estimates.

3.8.2 Structure of nominal GDP (expenditure)



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

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

It is believed that 0.3% output growth of the fuel sector in 2011 and subsequent substantial increases in fuel costs have provided additional inflationary pressures.

The central bank attempted to curb inflation by issuing certificates of deposit (equivalent to 40% of the existing stock) in order to sterilize excess liquidity, while the government absorbed $1.6 billion of export revenues into the Fund for Reconstruction and Development, Uzbekistan's sovereign wealth fund.

The augmented budget, which comprises the official budget plus the surplus from this fund, is estimated to have recorded a surplus of 3.2% of GDP. Revenue gains from higher commodity prices and improved tax administration (taking revenue to an estimated 38.5% of GDP, from 37.1% in 2010) offset the impact on spending of wage and pension increases, higher social outlays, and the rural development program (overall expenditure climbed to 35.3% of GDP, from 34.4% in 2010).

The central bank's issuance of certificates of deposit helped reduce broad money growth from 52.4% in 2010 to a still high 27.7%. Banks benefited from heavy government injections aimed at strengthening their capital and increasing lending. Bank lending to small and medium-sized enterprises and private entrepreneurs reached $2.8 billion, a 50% increase from 2010. In August 2011, Moody's reconfirmed its rating for the banking system as stable, following an upgrade a year earlier.

The central bank continued to intervene in the foreign exchange market, with the aim of depreciating the local currency—the sum—to promote competitiveness. Depreciation of the Russian ruble and Kazakh tenge against the US dollar added downward pressure on the exchange rate. By year-end the sum depreciated by 8.6% against the dollar, more than in 2009 and 2010 (Figure 3.8.3).

An improved trade balance and higher remittances helped raise the current account surplus to 8.1% of GDP from 6.6% in 2010 (Figure 3.8.4). Exports of goods and services rose by 28.6% to $15.6 billion, as international prices for gold, cotton, copper, and natural gas reached record levels, and strong consumer demand in the Russian Federation contributed to a 25% rise in automobile exports by GM Uzbekistan.

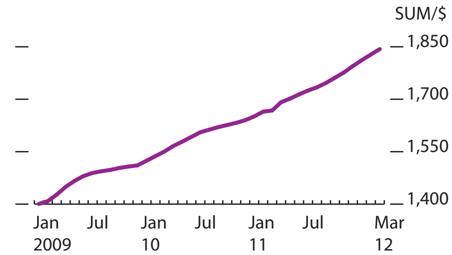
Imports of goods and services rose by 26.5% to $14.0 billion, as continued state-led public infrastructure development and industrial modernization required more imported capital goods. Remittances grew sharply, particularly from the Russian Federation, as the Russian economy improved.

The government reported foreign investment inflows of $2.9 billion, of which 79% was for foreign direct investment (FDI), mainly in the fuel, energy, petrochemical, and automobile manufacturing sectors. External debt is estimated to have risen to 17.5% of GDP from 14.7% of GDP at end-2010, as the public investment program is increasingly being financed with foreign loans (Figure 3.8.5).

Economic prospects

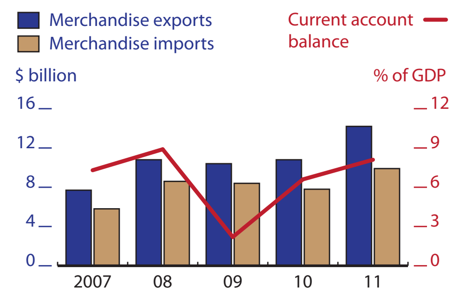
GDP is forecast to grow by 8.0% in 2012 and 7.9% in 2013, as rising state-led investments are expected to offset a decline in exports. Industry and services are expected to be the major contributors to economic

3.8.3 Exchange rate



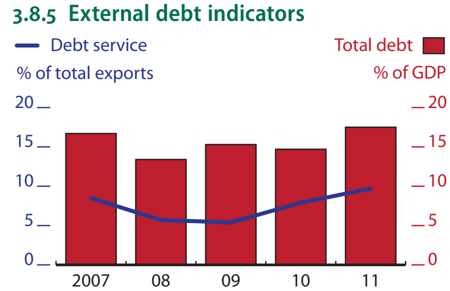
Source: Central Bank of Uzbekistan. http://www.cbu.uz/ (accessed 28 March 2012).

3.8.4 Current account indicators



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

3.8.5 External debt indicators



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

growth. Industrial output will be supported by higher domestic lending and foreign investment, while services will be driven by higher domestic demand, especially from the public sector. Higher vegetable and fruit output should boost agriculture relative to 2011.

On the demand side, continued public investment should be a key driver. Gross fixed capital formation is forecast to rise by 9.3% in 2012 in nominal terms, with investment exceeding 30% of GDP. The government is implementing a $47.3 billion Industrial Modernization and Infrastructure Development Program in 2011–2015, with significant investment planned in oil and gas, electricity generation, chemicals, metallurgy, and other strategic sectors.

Domestic consumption will be supported by expected increases in public sector wages and pensions, and additional measures—probably further wage increases and welfare payments—are likely to be taken if the slowdown in the eurozone and the Russian Federation appears to be hampering growth. Nevertheless, lower remittances are expected to moderate growth in private consumption, which is forecast to rise, in nominal terms, by 8.0% in 2012 and 9.0% in 2013.

Inflation is expected to come in at about 9.5% in 2012 and 9.0% in 2013, as global commodity prices decline, although continuing currency depreciation will keep import prices high (Figure 3.8.6). The authorities are also expected to limit measured inflation through sterilization operations and domestic price controls.

The official government budget, adopted in November 2011, projects a deficit of around 1% of GDP in 2012; the augmented budget is forecast to show surpluses of 4.0% in 2012 and 3.2% in 2013 (Figure 3.8.7). The official budget envisages substantial tax reductions, with the goal of reducing the ratio of tax revenue to GDP by 0.7 percentage points in 2012, although commodity-based revenue is expected to grow strongly, and additional revenue will come from new excise taxes on imported vegetable oil and domestically produced jewelry. Augmented budget revenue is forecast at 39.0% of GDP in 2012 and 38.3% in 2013. Almost 60% of expenditures will go to social security, welfare, health care, education, and culture. Augmented budget expenditures are projected at 35.0% of GDP in 2012 and 35.1% in 2013.

Money growth is expected to accelerate to 30% in 2012 and 33.6% in 2013, as public wages and pensions rise and banks increase their lending. Further increases in official reserves (at least in 2012) and continued foreign exchange intervention to depreciate the currency will increase reserve money, offset partly by further central bank sterilization operations.

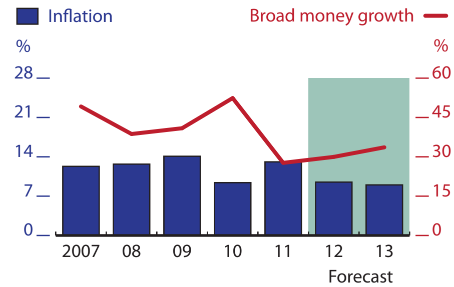
The current account surplus is forecast to decrease to 7.5% of GDP in 2012 and 6.0% of GDP in 2013, as the trade balance weakens (Figure 3.8.8). Declining international prices for the country's main exports, excluding natural gas, coupled with weaker external demand, will hamper export performance, with exports forecast to rise moderately in 2012 and decline in 2013. Recession in the European Union will likely lower growth in the Russian Federation, Uzbekistan's main trading partner, reducing exports, especially for automobiles and food, and remittances. Moreover, an expected growth slowdown in the People's Republic of China is expected to reduce key metal and cotton exports.

3.8.1 Selected economic indicators (%)

	2012	2013
GDP growth	8.0	7.9
Inflation	9.5	9.0
Current account balance (share of GDP)	7.5	6.0

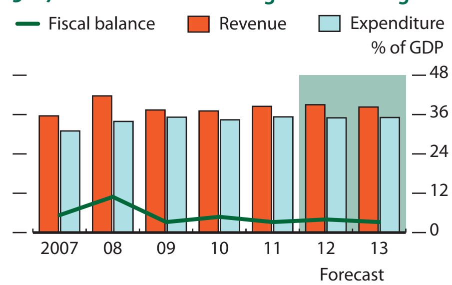
Source: ADB estimates.

3.8.6 Inflation and money supply



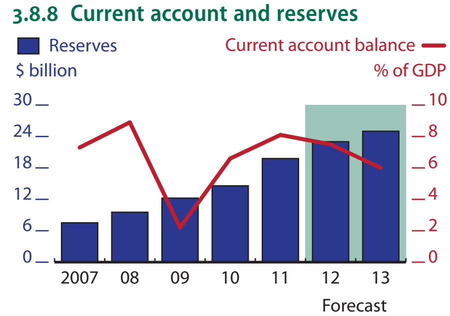
Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

3.8.7 Fiscal indicators: Augmented budget



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

3.8.8 Current account and reserves



Sources: International Monetary Fund. 2011. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

Import growth is forecast to slow to 8.3% in 2012 and 2.8% in 2013, despite infrastructure spending and the industrial modernization program, because of the projected moderation in imported food prices and tighter import controls, particularly on imported consumer goods. Gross international reserves are forecast to increase further in 2012 and 2013 (to $23.0 billion and $25 billion, respectively), according to ADB estimates, reflecting continuing current account surpluses and net capital inflows.

Reflecting increasing foreign borrowing for industrial modernization and infrastructure development, external debt is forecast to reach 20.2% of GDP at end-2012 and 22.8% a year later.

Policy challenge—developing the private sector

Uzbekistan's private sector will play a greater role in economic development as the economy moves toward middle-income status. The government has reported that small businesses accounted for 54% of GDP in 2011, which is at par with international averages, but the role of entrepreneurs in key areas of economic activity has yet to develop (Figure 3.8.9).

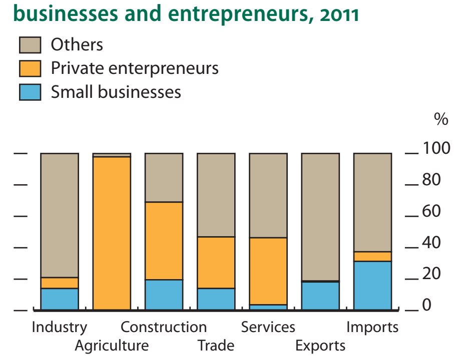
Policies and investment to improve the business climate, promote the private sector, and strengthen infrastructure and trade need to be reinforced for a more diversified and sophisticated export sector and to accelerate the economy's transformation.

Improving the business climate is urgently required to develop the private sector, especially for the many small businesses that represent the overwhelming share of legal entities and provide most national employment. A more favorable business climate would promote diversification and the growth of new firms. It would also facilitate private sector participation in the infrastructure and other strategic sectors, as these are gradually opened to private firms. (The private sector is already involved in repairing and maintaining public roads, and its share in road freight transport reached 72.2% in 2010 from 58.7% in 2005.)

Uzbekistan is ranked overall 166 out of 183 economies in the World Bank's 2012 *Doing Business* report (and lowest in the trading across borders category). Accelerating regulatory reforms to attract investors, ensuring access to finance and foreign exchange, simplifying customs procedures, and continuing the efforts to offer competitive factor prices would help transform the national economic landscape and sustain economic growth.

Other key measures include further steps to reform the tax regime, liberalize regulations for small firms, increase access to external financing in the banking and nonbank sectors, and develop the securities market. Finally, the country has taken steps toward decentralizing some activities in public administration, and further reforms in this area will multiply the benefits of economic growth.

3.8.9 Economic participation of small businesses and entrepreneurs, 2011



Sources: State Statistics Committee; ADB estimates.

East Asia

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

People's Republic of China

Domestic demand rather than exports was the driving force behind 2011's strong performance, with high investment and consumption. The outlook for 2012 and 2013, despite uncertain global prospects, is for only moderately slower growth. The economy is gradually diversifying, with imports rising rapidly and the trade surplus now much less as a percentage of economic output. Currency appreciation, rising wage rates, increasing income disparities, and environmental concerns underscore the need for modifying the country's growth model. With a strong fiscal position and declining inflation, the government is well positioned to implement the 12th Five-Year Plan, designed to further transform the economy.

Economic performance

GDP of the People's Republic of China (PRC) grew at 9.2% in 2011, despite subdued external demand for exports and the effects of domestic policy tightening. Although growth came in more than 1 percentage point less than in 2010, it far exceeded that in most other countries, further consolidating the country's status as the world's second-largest economy. The main factors continuing to drive the economy were high domestic and foreign investment, brisk government expenditure, and increased domestic consumption.

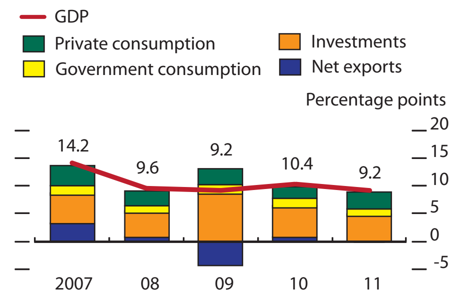
Investment and consumption accounted for all the growth in 2011 (Figure 3.9.1). Net exports were a marginally negative contributor, as real imports grew faster than real exports.

Fixed asset investment increased by almost 24%, slightly slower than in 2010 on the policy-induced slowdown in real estate investment to curb speculation (Figure 3.9.2). Local government expenditure on infrastructure also stayed strong, although again at a slower rate than in 2010.

Rising urban and rural per capita incomes (up 8.4% and 11.4% in real terms) bolstered consumption, reflecting wage and pension increases. Retail sales (a proxy for consumption) increased by 17% in nominal terms, somewhat slower than in 2010. Sales of furniture, household appliances, and audiovisual equipment registered the highest growth, while car sales grew much more slowly, showing the impacts of restricted licensing to control traffic congestion and of the end of subsidies and rebates.

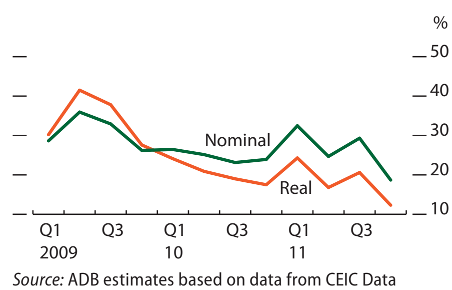
By sector, agricultural output benefited from an abundant grain harvest in the second half of the year and increased overall by 4.5%, slightly above the pace set in 2010. Slowing investment and exports caused growth of industrial output to slow to 10.6% from 12.3% the previous year; the sector was still the main contributor to growth (Figure 3.9.3). Services increased by 8.9%, slower than the 9.8% growth in 2010, driven by retail sales and financial services.

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.2 Growth in fixed asset investment



Source: ADB estimates based on data from CEIC Data Company (accessed 1 March 2012).

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

Reflecting the turmoil in global markets, the bellwether Shanghai A-share stock index dropped by more than 20% in 2011. Investors, concerned about the international outlook and earnings prospects of listed companies, exited risk assets. Total market capitalization during 2011 fell by $486 billion, or to 31% of GDP from 45% in 2010.

Inflation—measured by the consumer price index—peaked at a 3-year high of 6.5% in July, falling to 4.1% by December (Figure 3.9.4). The second-half improvement reflected monetary tightening in the first half of the year, government measures to regulate the housing market, and favorable harvests in the autumn that curbed hikes in food prices. Still, the inflation rate in 2011 was 5.4%, up from 3.3% the prior year, reflecting primarily food and fuel prices and residential housing costs. Supply shocks, such as surging pork prices and supply shortfalls as a result of poor harvests in the first half of the year, accounted for much of the food inflation. Residential housing prices started to grow more slowly or fall marginally in some areas; transactions were fewer.

Fiscal policy was expansionary. Government expenditure grew by 24.7%, revenue by 26.7%, and the government incurred a fiscal deficit equal to 1.8% of GDP (including local government debt). At 44% of GDP, total public debt remains manageable. Increased budget shares were made in support of medical reform, educational programs for migrant workers' children in urban areas, and poverty relief. The government revised the poverty line from about $0.50 to $1 a day, thereby classifying another 100 million people as poor.

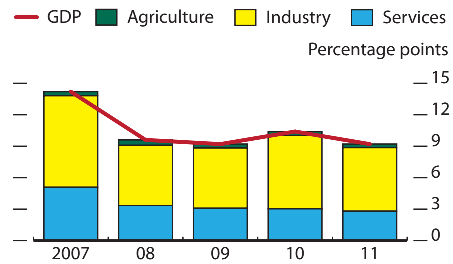
Monetary policy tightened in 2011 to dampen inflation pressures. The central bank increased the banks' reserve requirement ratio six times in the first half, to 21.5% for big lenders. It raised benchmark 1-year interest rates three times in the year, to 6.56%. As inflation pressures eased and the consumer price index fell, it started easing monetary policy first in December, by lowering the reserve requirement by 50 basis points and then by another 50 basis points in February (Figure 3.9.5). Money supply growth was 13.6% in 2011, below the government target of 16.0%. New credit amounted to CNY7.5 trillion ($1.2 trillion) in 2011, about the same increase as the year earlier.

Restricted access to credit, and persistent negative real interest rates (bank deposit rates were lower than the inflation rate), encouraged heavy off-balance sheet credit activities and informal lending. This undermined government efforts to stabilize liquidity and control inflation, prompting increased supervision by regulatory agencies. Of particular focus were macro-prudential measures to regulate rapidly expanding wealth management products.

As reported by the central bank, foreign exchange reserves increased to $3.18 trillion in 2011, compared with $2.85 trillion in 2010. In a break from the seemingly continuous increase in reserves, they declined (by $21 billion) in the fourth quarter of 2011 for the first time since 1998, due to increased repatriation of foreign capital, capital flight, and valuation losses. On the exchange rate, the yuan appreciated during 2011 by 4.7% against the United States (US) dollar, and by 7.9% against the euro.

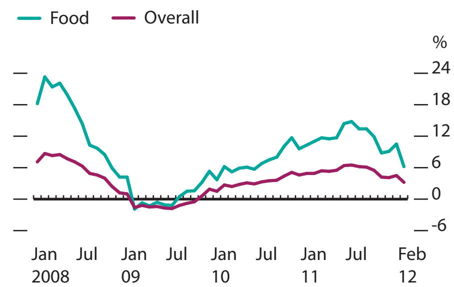
Due to the weak global economy, trade slowed: export growth decelerated to 20% from 31% and imports to 25% from 39% (Figure 3.9.6). The trade surplus on a customs basis narrowed to $158 billion from

3.9.3 Contributions to growth (supply)



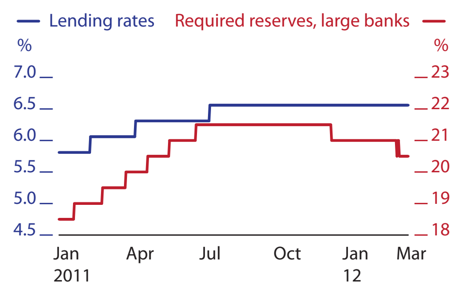
Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.4 Monthly inflation



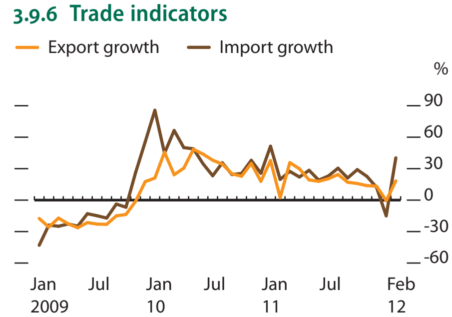
Source: CEIC Data Company (accessed 12 March 2012).

3.9.5 Interest rates and required reserves



Source: CEIC Data Company (accessed 12 March 2012).

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 1 March 2012).

$181 billion (2.2% of GDP in 2011 versus 3.1% in 2010, and down from a high of 7.5% in 2007). The current account surplus fell to 2.8% of GDP in 2011. Foreign direct investment in the PRC increased, however, from $106 billion in 2010 to a record $116 billion. Declining investment by US and European Union investors were more than offset by increased inflows from Asia.

Economic prospects

The outlook assumes that the US economy will continue its slow recovery, that the eurozone sovereign debt crisis will not worsen, and that the PRC's policy stance will remain accommodative.

During the Annual Central Economic Work Conference in December 2011—a major economic policy forum—the government announced the main policy guidelines for 2012. These include a shift in emphasis from curbing inflation to maintaining stable and relatively fast economic growth, promoting restructuring, and managing inflation expectations. These objectives will be addressed through fiscal and financial reforms supporting domestic demand as well as emerging and strategic industries, and structural reform to rebalance the sources of growth, in line with the main guidelines of the 12th Five-Year Plan (2011–2015).

Fiscal policy is expected to remain broadly expansionary in the forecast period, with higher spending on education, health care, pensions, public housing, and other social security programs (including a 40% increase in the 2012 budget allocation for poverty relief). The overall fiscal deficit is expected to be 1.7% of GDP in 2012 and 2.0% in 2013. To ease the tax burden on consumers and small and medium-sized enterprises, the government may again raise the minimum income tax exemption level and replicate nationwide the Shanghai pilot tax reform of shifting from the business tax to a value-added tax (Box 3.9.1). Plans have also been announced for improved support of small businesses, including tax relief and easier access to capital markets.

Monetary policy will accommodate a continued high rate of economic growth. Money supply (M2) is set to grow by 14% in 2012, with new lending targeted at CNY8 trillion ($1.3 trillion) and a similar target for 2013. Financial sector reform will continue, including prudential regulation of off-balance sheet credit activities that could destabilize the real economy. A cornerstone reform in this context would be a more market-based approach to setting interest rates, leading to a more effective allocation of capital and savings.

In view of exchange rate movements in 2011 and earlier, and the effects of increased labor and other domestic costs on export competitiveness, continued appreciation of the yuan against the US dollar may slow.

Fixed asset investment is projected to remain the major engine of growth, increasing by 20% or more in 2012 and 2013. Investment in infrastructure (such as railways, rural irrigation, and urban public transport) is expected to continue at a high level. As part of the current five-year plan, 7 million housing units are to be constructed in 2012, which will partly offset the slowdown in real estate investment by the private sector. Consistent with government efforts to narrow regional

3.9.1 Tax reforms

The authorities introduced new tax policies in 2011. In a step designed to improve energy efficiency and strengthen local government finances, a national resource tax system was launched in November 2011. Following a trial period in Xinjiang Uygur Autonomous region, oil and gas producers now face a 5% tax on sales value. The reform does not cover coal, however—the source of about 70% of the country's total energy.

A trial program for the services sector began in January 2012, in Shanghai, to replace the business tax (on gross revenue) with a value-added tax (VAT).

The trial will focus on selected service providers and will be extended nationwide if effective. As part of the program, the Shanghai government announced new brackets of lower VAT rates for transport and certain service industries. The reform is expected to lower the tax burden for the service sector and support development of the country's modern service industry.

To bolster development of small and medium-sized enterprises (SMEs)—which employ a large proportion of the country's work force, especially in urban centers—the government raised the minimum threshold of the VAT and business tax for SMEs.

It also abolished the stamp tax on loan contracts between financial institutions and micro and small enterprises. Government departments have been requested to allocate at least 30% of their purchasing quota to SMEs.

disparities, the central and western provinces will continue to receive the highest rate of public investment growth.

Nominal private consumption is expected to grow by almost 12% in both 2012 and 2013, boosted by continued employment and wage growth as well as increased government social expenditure. Inclusive-growth measures under the five-year plan target the rural–urban income gap (see below). Exports and imports are expected to increase by around 15% and 18% in 2012, edging up in 2013. The contribution of net exports to GDP growth is projected to remain negative, and the trade surplus to continue narrowing. The current account surplus is set to fall to 2.1% and 1.7% of GDP in 2012 and 2013 (Figure 3.9.7). Factors weighing on these trade prospects include deteriorating terms of trade and a gloomy world economic outlook, particularly for the eurozone.

In a signal that it will accommodate somewhat slower growth in order to make it more inclusive and environmentally sustainable, the government announced that it has reduced the 2012 growth target from 8.0% to 7.5%. As in previous years, though, it is expected that actual growth will exceed this target. On the above estimates, GDP growth is forecast at 8.5% in 2012 (Figure 3.9.8) driven by robust investment and private consumption, and 8.7% in 2013, supported by stronger global growth momentum.

Inflation is forecast to decline to about 4.0% (Figure 3.9.9), as indicated by the combined annual rate of 3.9% for January and February. With world economic growth expected to remain modest, global commodity prices—except for oil—will likely moderate, easing pressures from imported inflation. Continued policy restraint on property markets will help control domestic inflation pressures, although bad weather or other setbacks could disproportionately affect inflation. Other inflation risks stem from rising labor costs and possible increases in energy and utility prices, reflecting the need for stringent compliance with the environmental targets of the current five-year plan.

The main downside risk is uncertainty over external demand, including the slow recovery in the US, fiscal and debt concerns in the European Union, and Japan's economic setbacks—among the country's largest trading partners. Nevertheless, progress in diversifying its export markets, and in rebalancing the sources of growth toward domestic demand, should help maintain economic momentum.

Potential increases in nonperforming loans of local government could be a domestic risk, stemming from large debt issues during implementation of the stimulus program introduced in 2009 to counter the effects of the global financial crisis. The concern relates to the mismatch between short- and medium-term maturity (over 50% of debt will mature within the next 3 years) and the long-term nature and limited profitability of most of the infrastructure projects undertaken as part of the stimulus program. However, this risk is unlikely to cause major disturbances to the economy given the overall soundness of the financial sector.

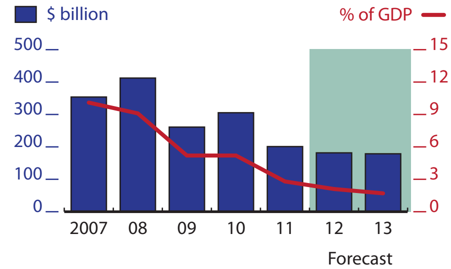
In October 2011, the Ministry of Finance announced a trial program to allow four local authorities—including the city governments of Shanghai and Shenzhen—to sell bonds directly, a move to help local governments repay loans of more than $1 trillion.

3.9.1 Selected economic indicators (%)

	2012	2013
GDP growth	8.5	8.7
Inflation	4.0	4.0
Current account balance (share of GDP)	2.1	1.7

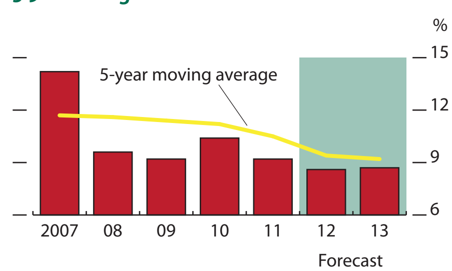
Source: ADB estimates.

3.9.7 Current account balance



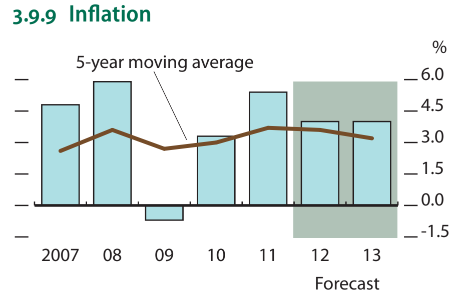
Sources: CEIC Data Company (accessed 5 March 2012); ADB estimates.

3.9.8 GDP growth



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

3.9.9 Inflation



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn/english/ (accessed 1 March 2012); ADB estimates.

Another domestic consideration is the transition to a new generation of political leaders. The 12th plan focus on deemphasizing exports in favor of domestic demand will require strong leadership and consensus. Further, new impetus is needed for inclusive growth and environmental sustainability.

Policy challenge—tackling income inequality

In the transition to a more market-based economy, 3 decades of rapid growth have lifted hundreds of millions out of poverty, but more than a hundred million are still severely poor, and income inequality has sharply widened. As acknowledged in the 12th plan, such inequality will hinder future growth as it undermines consumption, constrains development in poorer regions, and generates social tensions.

Different measures show how much income inequality has risen. The widely used Gini coefficient worsened (on a scale of 0–100) from around 25 in the mid-1980s to 41 in 2000, the last year the government published findings. Since then, several independent PRC scholars, using various methods and data, have placed the coefficient in a range of 45 to more than 50—among the highest in the world.

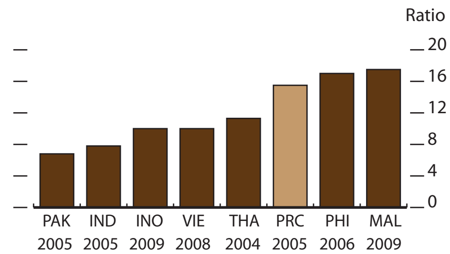
Other research suggests that the income of the top 10% of households relative to the bottom 10% in 2005 was 15.5 times, against 7.3 times in 1998. In contrast, the ratio was 10 or less for Indonesia, India, Pakistan, and Viet Nam in 2005 or more recent years (Figure 3.9.10).

Urban–rural income differences are very large: urban households' incomes are on average almost three and a half times as high than rural households' (Figure 3.9.11). The gap persists for two main reasons. First, rural areas have much less investment in physical and human capital. Second, the return on investment and assets is typically much lower in rural areas. Other overlapping factors include special economic zones concentrated in coastal areas, decentralization of public services provision to local government without a corresponding increase in fiscal resources, and regressive taxes. Further, the social support network was set up initially for urban households—a rural pension system only started in 2009. Finally, fiscal disparities are steep: per capita public spending in the richest county is 48 times that in the poorest.

The first reason is the dominating factor in the PRC. The consequences of underinvestment in rural areas are strikingly illustrated in the returns to education. In 1988, education and individual characteristics (other than age) explained little of the variation in income among workers. Some 20 years later, household and individual characteristics accounted for 50% of the urban–rural income gap, and education alone for about 25% of that gap. Urban–rural income disparities are likely to further widen.

Income redistribution and social security thus need to be strengthened for inclusive and sustainable growth. A comprehensive social security system would help reduce income inequality. Although the PRC's social policies have made great strides in recent years—including the long-awaited Social Insurance Law in July 2011—further social security reform is vital. The social security framework is still segmented, operating through a complex system of insufficiently coordinated schemes

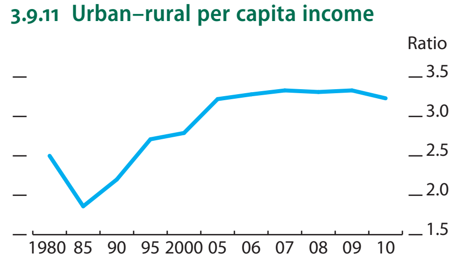
3.9.10 Income share, top 10% to bottom 10%



IND = India; INO = Indonesia; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; PRC = People's Republic of China; VIE = Viet Nam; THA = Thailand.

Source: ADB estimates based on data from World Bank, World Development Indicators online database (accessed 14 February 2012).

3.9.11 Urban–rural per capita income



Source: ADB estimates using data from *China Statistical Yearbook 2011* (Table 10.2, p.330).

that result in inadequate coverage of benefits and beneficiaries. Further, its dual nature—parallel rural and urban programs—resulting from the household registration system or hukou, is no longer suitable. A much more unified system, as envisaged under the Social Insurance Law, is required to address the needs arising from increased labor mobility (including those of migrant workers), the challenges of accelerated urbanization, and the implications of a rapidly aging population.

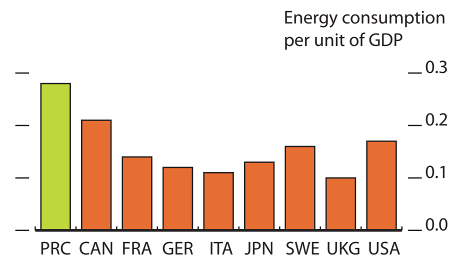
Central–local fiscal arrangements must also be strengthened. Although transfer payments from the central government have been increased, the capacity of local governments to provide public services has not improved in tandem. Equally, revenue sharing and expenditure responsibilities between the central and local governments need to be better aligned.

Beyond challenges of inclusive growth and income inequality are many others, notably water resource management and energy use. The country needs to manage its water better, as water scarcity and pollution are threatening the agricultural base. (The 12th plan aims to reduce water consumption per unit of industrial value added by 30%.)

The PRC is now the world's biggest energy consumer and since 2007 the largest source of energy-related greenhouse gas emissions; its energy intensity (energy consumption per unit of GDP) is nearly double the average of countries in the Organisation for Economic Co-operation and Development (Figure 3.9.12). (The 12th plan has set a target of cutting energy intensity by 17%.)

As the world's second-largest economy, the PRC will increasingly influence the rate and manner of world economic growth. Global interdependence requires the eurozone crisis to be resolved, a repeat recession in industrial countries to be avoided, trade protectionism to be rejected, and international consensus to be secured on actions on climate change and other issues. The PRC's growth in 2012 and 2013 is heavily dependent on the global context, as are its longer-term prospects.

3.9.12 Energy intensity



CAN = Canada; FRA = France; GER = Germany; ITA = Italy; JPN = Japan; PRC = People's Republic of China; SWE = Sweden; UKG = United Kingdom; USA = United States.

Source: Enerdata. *Global Energy Statistical Yearbook*. http://yearbook.enerdata.net (accessed 5 March 2012).

Hong Kong, China

The economy's sensitivity to a downturn in global trade and financial markets, as during 2008–2009, was again in evidence in 2011 when it slipped from robustness to worrying signs of another slowdown. Although 2012 began with a lift in the world outlook, Hong Kong, China's merchandise exports are expected to languish and its overall growth to slow sharply. Provided overseas markets pick up, however, a rebound should be experienced in 2013.

Economic performance

This economy had a mixed year of *yin* and *yang*. While it slowed to 5.0% for the full year (from 7.0% in 2010), growth momentum of 7.6% at the start of the year moderated progressively to only 3% by the end. Further, moderating growth in the People's Republic of China (PRC) was a concern, compounded by the reemergence of the eurozone sovereign debt crisis and faltering demand in advanced economies.

The dominant source of growth for Hong Kong, China was domestic demand. Private consumption expenditure increased by 8.6%, buoyed by strong employment and rising real incomes (Figure 3.10.1). Retail sales and visitor spending went up by 18% and 25%, powered by a jump in tourist arrivals.

The other potential sources of growth—government consumption, investment, and net exports—made little impact. Government consumption increased by 2% and investment by only 1%. Investment actually fell in the first quarter but recovered during later quarters, led by machinery and equipment acquisition and public sector works. Merchandise exports rose much less rapidly than in 2010 and slightly less than merchandise imports, such that net exports subtracted from growth in 2011. This outcome was in marked contrast to the first quarter, when the net export position was strongly positive.

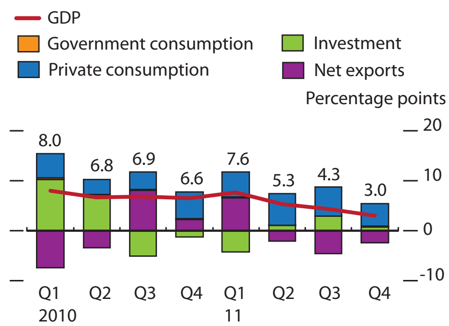
Accounting for nearly 90% of output, services set the pace for the economy as a whole. Professional and business services grew strongly, as did services related to tourism and cross-border commercial and financial services. Trade-related and transport services, however, slipped with the slowdown in merchandise trade.

Full employment characterized much of the economy. Unemployment fell to 3.3% by year-end, underemployment was less than 2%, and job vacancies surged. Wages and earnings scored their biggest gains since the mid-1990s, boosted by the tightness in the labor market and the introduction of a statutory minimum wage (Figure 3.10.2).

Inflation climbed sharply, to 5.3% from 2.3% in 2010, due to domestic cost pressures and imported inflation (notably for food and

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

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk/ (accessed 14 March 2012).

3.10.2 Unemployment and earnings

Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 28 March 2012).

oil) (Figure 3.10.3). Housing prices stabilized in the second half but showed steep appreciation (7.2%) for the year as a whole. Government interventions, such as increased land supply and restrictions to mortgage availability, helped cool the property market (Figure 3.10.4).

Macroeconomic policy focused on investing in the future, as well as fighting inflation and the risk of an asset bubble. Fiscal policy helped low-income groups deal with the rising cost of living, especially food and housing-related costs, as these account for two-thirds of such groups' overall spending. Measures to moderate the cost of living included electricity subsidies and rate concessions on property taxes and public housing rentals. Netting out the effects of the government's one-time measures, underlying inflation rose at the same rate as headline inflation.

Fiscal policy for FY2011 (1 April–31 March 2012) was consolidative. Expenditure was up 22% and revenue 15%, with the result that the budget surplus narrowed to 3.5% of GDP (from 4.5% in FY2010).

Monetary policy reflected the pegged exchange rate to the United States (US) dollar and the accommodative policy of the US Federal Reserve, including low interest rates that helped maintain strong domestic demand. Similar to the US dollar, the nominal trade-weighted effective exchange rate index of the Hong Kong dollar depreciated by 2.4% in December from a year earlier.

Trade activity was deflated by the eurozone crisis, the sluggish US economy, and disruptions to global supply chains resulting from Japan's earthquake in March. Merchandise exports rose (in nominal terms) by only 11.2%, or less than half the rate of the previous year. Although the PRC accounts for over half of Hong Kong, China's exports and reexports of goods, slackening demand in the advanced markets became increasingly evident in Asian markets (Figure 3.10.5).

Services exports increased by 14%, a sharp deceleration from the gain of 23% the previous year. Tourism boomed but transport and trade-related services weakened appreciably. Despite the 20% slump in the Hang Seng index during 2011, the economy retained its rank as the world's top initial public offering center.

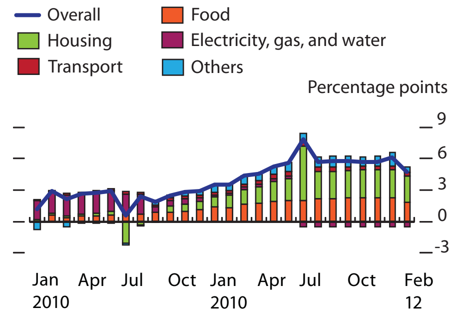
Merchandise imports climbed by 12%, again around half the rate of 2010. Retained imports, which account for one-fourth of total imports, increased by 16%, reflecting strong domestic demand and tourist spending.

Hong Kong, China continued to have a large current account surplus, equivalent to 5.1% of GDP. The positive balance for trade in services more than offset the deficit in trade in goods. The capital account was negative, with heavy portfolio investment outflows. Net foreign direct investment was substantially positive, despite outflows in the latter part of the year. Official reserves increased by US$16.7 billion to US$285.4 billion.

Economic prospects

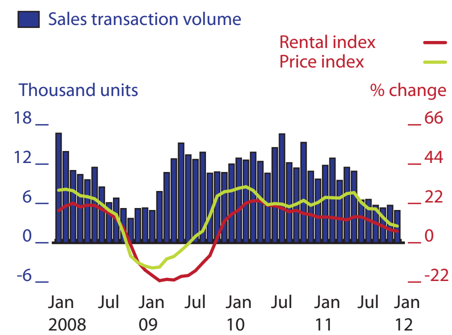
The economy is highly open and trade dependent, hence growth is critically dependent on conditions of its major economic partners. The business outlook is uncertain and growth of only 3.0% is forecast for Hong Kong, China in 2012, well below the 5-year average before the global financial crisis. The forecast for 2013 is much stronger, with growth of 4.5%. This is premised on a continued, gradually improving US economy,

3.10.3 Sources of inflation



Source: CEIC Data Company (accessed 23 March 2012).

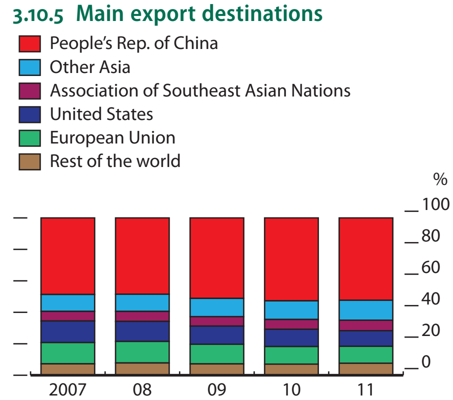
3.10.4 Property indicators



Note: Sales transaction refers to residential and nonresidential properties. Price and rental indexes refer to residential properties only.

Source: CEIC Data Company (accessed 14 March 2012).

3.10.5 Main export destinations



Source: CEIC Data Company (accessed 28 March 2012).

easing of the eurozone crisis, and slowing but still strong growth of the PRC economy.

Private consumption will remain the main source of stimulus, supported by full or near full employment and continued income growth. A decline in investor confidence is expected to cause investment to slow sharply in 2012 but then to strengthen in 2013 as the global outlook improves. Net exports are projected to be negative in the first half of 2012—a drag on economic growth—before becoming positive toward year-end.

Most of the four "pillar industries"—financial services, tourism, trade and logistics, and producer and professional services—are expected to continue expanding at a healthy rate, abetted by the PRC. Trade and logistics, however will slow in 2012 as a result of weak growth globally.

During the forecast period Hong Kong, China will continue to deepen its economic integration with the PRC through the Closer Economic Partnership Agreement and Pan-Pearl River Delta region platforms, and continue to expand its role as an international financial and trade center. It will also continue to expand its yuan business, supported by measures that encourage citizens of the PRC to invest in Hong Kong, China stocks, that allow repatriation of the yuan, and that increase yuan-denominated bond issuance in the territory (Figure 3.10.6).

Growth of tourism will provide an important injection to the economy, helping offset weakness in the trade and logistics sector. Visitor arrivals from the PRC surged by 24% to 28.1 million in 2011, accounting for 67% of the total (Figure 3.10.7).

External trade is expected to remain sluggish in 2012. In view of weak external demand, merchandise exports will show little growth and could even decline if the PRC, US, and European Union experience an unexpected setback. Since advanced economies account for close to 30% of East Asia's total export value, their import demand directly bears on demand for Hong Kong, China's exports. Service exports should remain buoyant, aided by tourism and the growth of professional services to the PRC. The current account surplus is forecast to narrow to the equivalent of 5.0% of GDP in 2012 and 2013.

Average annual inflation is expected to decline to 3.8% for the year as a whole, reflecting more stable food prices and lower commodity prices, except for oil. Also, the short-term price effects of government intervention in rental housing will have worked through, with a consequent drop in the housing component in the inflation index. Inflation is expected to drop further in 2013, to 3.3%, as food and housing prices continue to stabilize.

Fiscal policy is being realigned, from fighting inflation to ensuring stability of employment and income growth. For FY2012 (ending 31 March 2013), six priority areas have been identified for budget support and government action: supporting enterprises; preserving employment; caring for people; stabilizing the financial system; increasing land supply; and strengthening social capital.

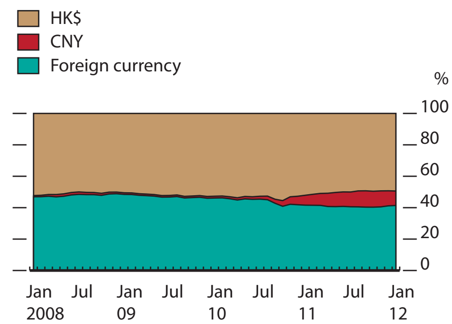
The 2012 budget indicates increased government expenditure of 7.5%, but a decrease in revenues in part because of one-time reductions in taxes on profits and salaries, waiving of business registration fees, and halving charges for import and export declarations. A budget deficit of

3.10.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.0	4.5
Inflation	3.8	3.3
Current account balance (share of GDP)	5.0	5.0

Source: ADB estimates.

3.10.6 Deposits

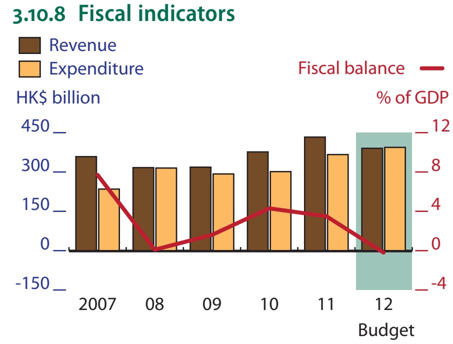


Source: CEIC Data Company (accessed 20 March 2012).

3.10.7 Tourist arrivals by area of origin

Source: CEIC Data Company (accessed 22 March 2012).

3.10.8 Fiscal indicators



Source: Hong Kong Monetary Authority.

about 0.2% of GDP is forecast (Figure 3.10.8). The government has a large accumulation of reserves in various funds established under the Public Finance Ordinance, projected to total HK$658.7 billion by the end of FY2012 (ending 31 March 2013), or the equivalent of 34% of GDP.

Monetary policy will continue to track closely that of the US Federal Reserve, so as to maintain the currency peg with the US dollar. Low interest rates will parallel those in the US, helping to stimulate growth during the weak global environment.

The main risk to the forecast for Hong Kong, China is the possibility of a marked slowdown of the PRC economy. A jump in oil prices could also be highly disruptive of global recovery.

Policy challenge—more equitable income distribution

Hong Kong, China has one of the highest degrees of income inequality among "very high human development countries," according to the *Human Development Report 2010*. Singapore ranks closely behind. Both economies compare more to developing than to developed countries.

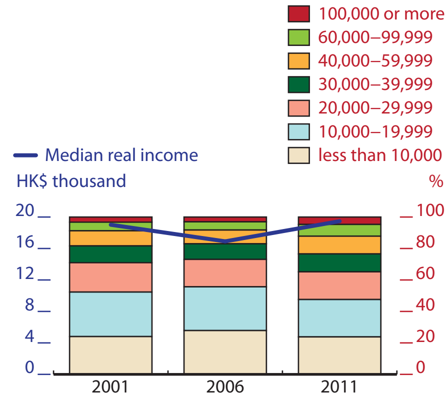
Initial results from the 2011 Population Census for Hong Kong, China provide more up-to-date information on income distribution. There was a decline in the absolute number of low-income households and a general increase in the number of households with high incomes (Figure 3.10.9). In real terms, the median income of households increased by an estimated HK$2,564 from 2006 to 2011. Even then, the median income of HK$19,472 in 2011 was just a few hundred Hong Kong dollars more than what it was a decade earlier. Further analysis of the census and other data is needed to better discern recent income distribution trends in Hong Kong, China.

Government expenditure for social services as a percentage of GDP has varied slightly over the past decade. Government expenditure for education was equivalent to 4.0% of GDP in 2000 but 3.6% in 2011. Expenditure on health declined from 2.5% of GDP to 2.4%. Social welfare expenditures, however, increased from 2.1% to 2.3%. The 2012 budget, which includes taxation and other forms of relief for low-income groups (e.g., public housing rental waivers), shows higher provision for social spending as a share of GDP except for housing and community amenities (Figure 3.10.10).

Strains on social services are illustrated by the long queue for public rental housing. Applicants for public rental apartments totaled 152,000 in FY2010, with an average waiting time of 2 years. According to a 2011 report by the Civic Exchange, the lowest income groups experienced deteriorating social services, housing, and employment conditions.

Conservative fiscal management and substantial accumulation of reserves allow for the provision of greater government expenditure for social services and housing—an effective means of reducing income inequality. The sound fiscal position provides scope for strategic government intervention in addressing the income distribution issue.

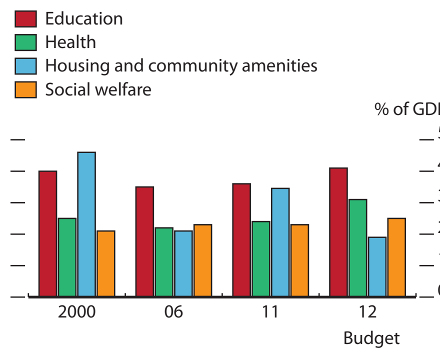
3.10.9 Household distribution by monthly income



Note: Income is in HK$.

Source: Census and Statistics Department. 2011 Population Census.http://www.census2011.gov.hk/en/main-table.html

3.10.10 Social spending



Note: Housing and community amenities refer to the policy area groups on housing, community and external affairs, and environment and food.

Sources: The Government of the Hong Kong Special Administrative Region. The 2012-2013 Budget. http://www.budget.gov.hk. Hong Kong Monetary Authority. Asian Development Bank. Statistical Database System. sdbs.adb.org (accessed 22 March 2012).

3.10.2 Gini coefficients, 2000–2010, selected economies

Japan	0.249
Korea, Rep. of	0.316
Canada	0.326
Australia	0.352
China, People's Rep. of	0.415
Singapore	0.425
Thailand	0.425
Hong Kong, China	0.434
Philippines	0.440

Source: Human Development Report 2010.

Republic of Korea

The export sector was surprisingly strong in 2011, but domestic demand wilted, resulting in economic growth below potential. Subpar growth is expected again this year, with the uncertain global outlook restraining trade and investment. Excessive household debt weighs heavily, prompting deleveraging but hampering efforts to lift the economy and reduce income disparities. Policy makers face the dual challenge of how best to shelter the economy from external risk and strengthen inclusive growth.

Economic performance

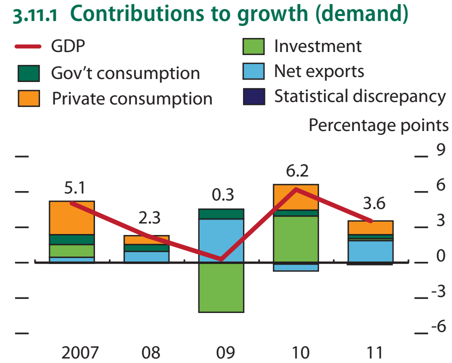
After surging by 6.2% in 2010, economic growth in the Republic of Korea slowed to 3.6% in 2011. As indicated by the economic performance prior to the 2008–2009 global financial crisis, a rate around 4% is closer to potential. A slowdown was expected—given the exceptionally high rate in 2010—but not to this degree. The underlying cause was sluggish domestic demand, particularly with respect to investment. Manufacturing output expanded by 7.1% and services by 2.6%, but construction contracted by 5.6%. The strength of manufacturing relates to exports as the mainstay of growth in 2011, a contrast with 2010, when high levels of consumption and investment spurred growth while the trade sector acted as a drag.

More precisely, net exports were strongly positive in 2011 (exports increased faster than imports) and accounted for over half GDP growth (Figure 3.11.1). Despite a much less rapid rise than in the previous year, private consumption added another third. Government consumption accounted for little, reflecting the completion of fiscal stimulus. Investment contributed even less as plant and equipment expenditures were relatively flat; facilities investment increased by less than 4%, down from 25% in 2010. Construction fell deeper into negative territory.

Growth momentum slowed during the year. Year on year, output was up 4.2% in the first quarter but then fell to the 3.5% range in the subsequent 3 quarters. Softening of growth was more evident quarter on quarter (Figure 3.11.2): reflecting the growing weakness of the economy, all the main components of GDP expenditure contracted in the fourth. This drop-off was especially pronounced for plant and equipment investment, but also extended to exports. The decelerating growth momentum closely paralleled the deteriorating global outlook.

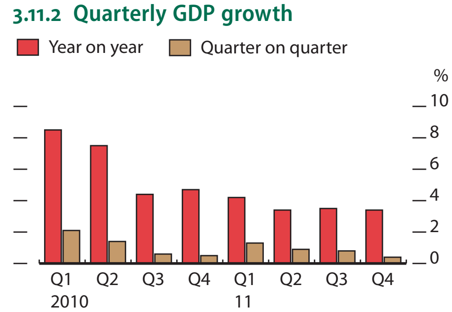
Merchandise exports increased in nominal terms by a subdued but still-healthy 20.0% in 2011 (versus 28.8% in 2010), underscoring exports' resilience. Export growth year on year, however, slowed steadily from 26.5% in the first quarter to 12.1% in the fourth (Figure 3.11.3). A flurry of ship orders and March's earthquake in Japan initially buttressed exports, but as the year progressed, softening demand—notably from the

3.11.1 Contributions to growth (demand)



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012).

3.11.2 Quarterly GDP growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012).

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

European Union—markedly dented the momentum of export-led growth. Robust exports to developing Asia only partly offset weakening demand from advanced economies. In turn, import growth fell steadily over the year, indicative of softening domestic demand. Merchandise imports rose by 23.8%, down from 31.5% in 2010. The pattern for services trade was broadly similar. The current account surplus is estimated to be the equivalent of 2.5% of GDP, slightly lower than in 2010. The won exchange rate against the dollar remained essentially unchanged at 1,100 (it was 1,150 in 2010).

Private consumption climbed by only 2.2% in 2011, half the year-earlier rate. As was the case with the export sector, it also weakened progressively during the year, starting with growth of almost 3% but falling to just over 1% by the fourth quarter (Figure 3.11.4). Consumer confidence fell in tandem, eroded by inflation and declining real household purchasing power. Further, gross domestic income increased by only 1%, as higher oil prices and a deterioration of the terms of trade cut into disposable income. The one positive note was a large pickup in employment of some 400,000, much higher than the usual 250,000.

The sharp investment slowdown is reflected in the industrial production index and the ratio of producer's shipments to inventory (Figure 3.11.5). Investment in export-oriented industries such as automobiles and semiconductors fell in parallel with the global outlook. The slowdown also partly reflects normalization from the exceptionally rapid investment growth of 2010. Construction investment contracted, reflecting the weak housing market and subdued public works activity.

Inflation, as measured by the consumer price index, rose to 4.0%, the upper limit of the Bank of Korea's inflation target band. Supply-side factors included domestic food prices as well as oil and other commodity prices. The spike in domestic food prices was caused by bad weather. While supply-side factors were the immediate catalyst of higher inflation in 2011, aggregate demand pressures also played a role. The central bank raised the policy interest rate during the first half of the year, then held monetary policy steady in light of the global outlook (Figure 3.11.6).

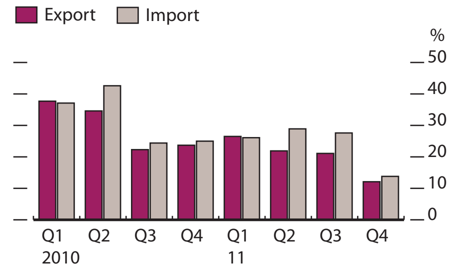
The government continued to consolidate its financial position, which had been sharply expansionary in response to the global financial crisis. The fiscal deficit narrowed progressively, to 0.7% of GDP from 4.8% in 2009 and 1.5% in 2010. Government expenditure rose to 21.2% of GDP and revenue even more significantly to 20.5%; the ratio of public debt to GDP fell marginally to 35%.

In summary, the country's overall economic performance in 2011 was worse than expected, largely due to the deteriorating global outlook as the year unfolded. Even though export growth slowed progressively during the year, it remained the main driver. Private consumption was supportive while investment lost steam.

Economic prospects

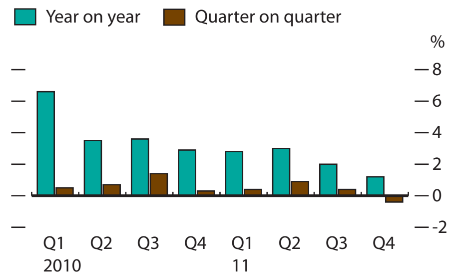
Growth for 2012 is forecast at 3.4% (below potential), rising moderately in 2013 to 4.0%. These rates are based on the expectation that the Republic of Korea's main export markets, including the European Union, the United States (US), and Japan, will experience slow growth at best. Thus the

3.11.3 Merchandise export and import growth



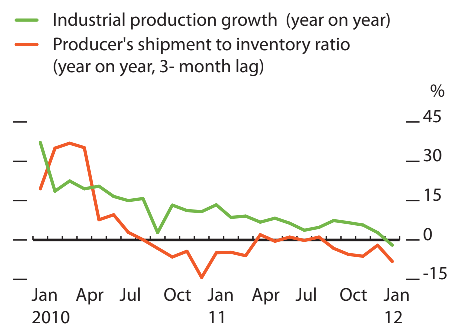
Source: CEIC Data Company (accessed 21 February 2012).

3.11.4 Private consumption growth



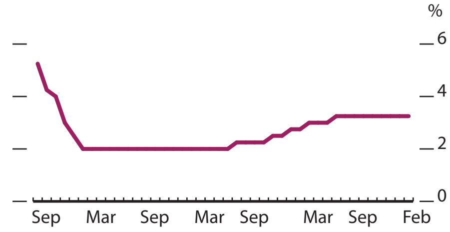
Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012).

3.11.5 Monthly industrial production and producer's shipment to inventory ratio



Source: CEIC Data Company (accessed 6 March 2012).

3.11.6 Month-end policy interest rate



Source: CEIC Data Company (accessed 8 March 2012).

pessimistic global outlook that so hampered the country's performance in the second half of 2011 will set the tone for the forecast period.

Exports in nominal terms are expected to increase by about 8% in 2012, or less than half last year's rate. Export unit prices are expected to remain flat, in contrast to significant gains in 2011. The fragile state of economic recovery in advanced countries is constraining demand for key exports from the Republic of Korea, such as automobiles, electronics, and other consumer durables. Demand for key ICT parts, such as memory chips used in personal computers, has also been affected.

More positively, exports of general machinery and other goods to the People's Republic of China and other emerging markets in Asia are expected to remain strong. Petrochemical exports will also be robust, including those to Japan. Overall export growth is projected to strengthen gradually during 2012 and into 2013, in line with a gradually improving global outlook. Imports will likely climb faster than exports, and the current account surplus to decline to around 2.0% of GDP. The US dollar exchange rate is unlikely to change much either way.

Investment is forecast to increase by little more than 2% in 2012. Subdued investment, especially in the export sector, has mirrored the worsening external environment. Corporate investment surveys indicate that major Korean firms plan to reduce investment relative to their levels in 2011 by 5–10%. Beyond weak business sentiment, an impediment to stronger investment is the decline in corporate profitability, notably among ICT firms. Another negative element for equipment investment is the recent fall in capacity utilization (Figure 3.11.7). Construction investment, including housing, which contracted in both 2010 and 2011, is expected to increase, but only moderately. Overall investment is expected to strengthen in the second half of 2012 as the global outlook picks up.

Private consumption is projected to increase by about 3% in 2012, or somewhat more strongly than in 2011. Various factors constrain its growth, though. Consumer confidence is weak (Figure 3.11.8) and is unlikely to strengthen until the global outlook improves convincingly. Purchases of consumer durables, especially automobiles, may be constrained by the prospective free trade agreement with the US, which is expected to lower prices. Further, sluggish exports will limit wage growth and ultimately private consumption. Real wage growth has lagged GDP growth since the mid-2000s and this trend is likely to continue. Excessive household debt also constrains increased private consumption, especially among low-income groups. On the positive side, inflation pressures are expected to ease and to help raise household purchasing power.

Inflation is forecast to decline to 3.0%, a full percentage lower than in 2011. It is anticipated that the ratcheting down of global growth predictions for 2012 and 2013 will be tracked by moderating commodity prices and help ease core inflation. However, international oil and food prices are volatile; they were high in the first part of 2011 then eased, but oil prices have again risen sharply. Supply shocks—such as a spike in oil prices—could prove highly disruptive. A firmer basis for optimism on inflation is the abatement of domestic demand pressures and the projected disappearance of the small inflationary gap that emerged in 2011 (Figure 3.11.9).

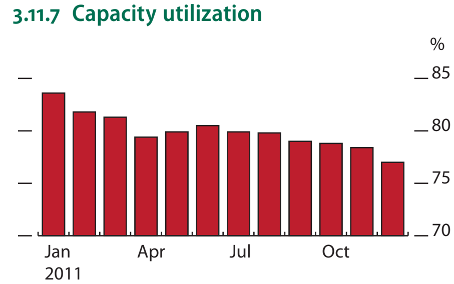
Employment is forecast to increase by 250,000—healthy but far short of the exceptional gain in 2011. The elasticity of employment growth

3.11.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.4	4.0
Inflation	3.0	3.0
Current account balance (share of GDP)	2.0	2.0

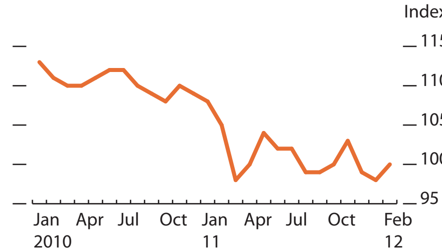
Source: ADB estimates.

3.11.7 Capacity utilization



Source: CEIC Data Company (accessed 6 March 2012).

3.11.8 Consumer confidence



Source: Bank of Korea. Economic Statistics System. http://ecos.bok.or.kr (accessed 6 March 2012).

relative to GDP growth in recent years reflects the large expansion of labor supply. This, in turn, stems from the reentry of retired 50-plus baby boomers into the workforce, usually self-employed, to cope with insufficient retirement income. "Silver workers"—those 60 and over—now constitute around 12% of the workforce. For those 65 and older, the employment rate is more than double the OECD average. Except for professionals, these workers are typically unskilled, on low wages and with little job security. Self-employment in small, scarcely profitable retail outlets is common. Strong employment growth therefore masks questions about the quality of employment.

The current basic monetary and fiscal policy framework is likely to continue—that is, to lower inflation while supporting growth. The policy interest rate is expected to remain largely unchanged. Although the adverse global environment may call for stimulus—including yet lower interest rates—the current policy rate of 3.25% is already accommodative. High and growing household debt further weakens the case for monetary loosening (Figure 3.11.10). The Bank of Korea will closely monitor developments, tightening monetary policy if inflationary pressures revive but loosening it if the economic outlook deteriorates further.

The fiscal position is fundamentally sound, as indicated by the public debt-to-GDP ratio of 35%, which is far lower than the OECD average. The relatively favorable fiscal conditions support continued consolidation within a medium-term fiscal framework. Public expenditure requirements associated with the country's aging population, among other pressures, call for a gradual buildup in the fiscal position. The government is targeting fiscal balance by 2014, if not sooner.

Summarizing the above considerations, GDP growth is likely to remain slightly below potential in the short term (Figure 3.11.11). Although domestic demand will help cushion some of the loss of momentum since the exceptional growth in 2010, the recovery will be gradual—tracking the global outlook.

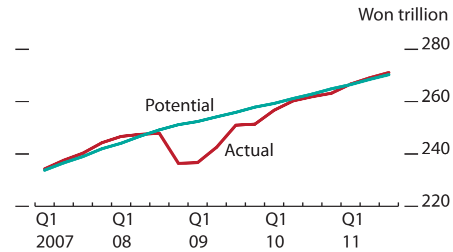
The main short-term downside risk for the economy stems from the eurozone's sovereign debt issue: the speed and effectiveness of its resolution bear heavily on the global outlook and hence prospects for Korean exporters. If the situation deteriorates into another global financial crisis, exports and GDP growth would be hard hit, as in 2008–2009. Alternatively, if the eurozone crisis is resolved faster and better than expected, growth could surprise on the upside.

Another source of external uncertainty is the potential impact on global oil prices of Middle Eastern geopolitical tensions. Concern over the change of political leadership in the Democratic People's Republic of Korea has abated. A domestic risk is the high and growing level of household debt.

Policy challenge—household debt

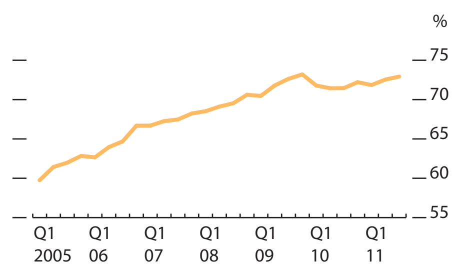
Household debt has continued to climb rapidly, despite regulatory efforts. However, the current surge in household debt appears to be driven by financing of consumption rather than purchases of homes, and the ratio of nonhousing to housing loans is rising (Figure 3.11.12). Further, household debt rose by 9% in 2011 whereas financial assets and real

3.11.9 Potential versus actual GDP, Q1 2007–Q3 2011



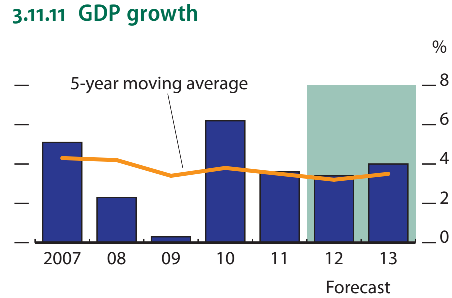
Source: LG Economic Research Institute.

3.11.10 Household debt-to-GDP ratio



Source: Bank of Korea. Economic Statistics System. http://ecos.bok.or.kr.

3.11.11 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 1 February 2012); ADB estimates.

estate owned by households went up by only 7.1%. This supports the view that households, in response to shrinking real disposable incomes, are borrowing more to finance consumption. It is expected that increases in household debt will slow in 2012, as the financial authorities are likely to clamp down on household borrowing to protect the soundness of the financial sector. The weak housing market will weigh on household loans and should act to help constrain the growth of household debt.

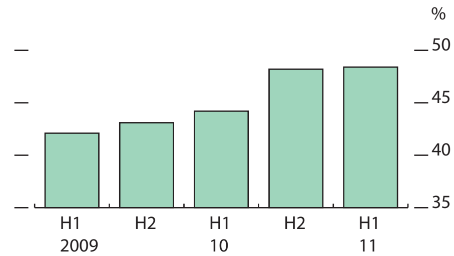
High and growing household debt may be a domestic risk for the economy, but the probability of it causing a macro financial crisis is quite small. The ratio of nonperforming household loans stood at 0.8% at end-2011. The banking sector's improved profitability and stronger capacity to absorb losses further reduces the likelihood of a financial crisis. Stringent loan-to-value regulations minimize the risk of a vicious cycle of falling housing prices and rising numbers of nonperforming loans. Household debt repayment pressures still affect macroeconomic performance though, because they crimp disposable income, private consumption, and aggregate demand.

Household debt also seriously affects certain groups of households and components of the financial sector. Low-income households may face financial difficulties for two reasons. First, slow economic and hence income growth limits their repayment capacity. Second, repayment pressures are likely to intensify owing to government efforts to rein in household debt. Financial institutions will become more cautious in rolling over loans and demand quicker repayment of the principal. For households in the bottom 20% by income, the ratio of debt to disposable income rose sharply in 2011 (Figure 3.11.13). Low-income households earning less than 20 million won annually accounted for about 40% of total loans, and these loans are more at risk of becoming nonperforming.

A related area of concern is the so-called secondary financial sector. This sector consists of financial institutions that deal extensively with borrowers with poor credit ratings and that have only limited capacity to absorb losses. The ratio of subprime loans and nonperforming loans has already risen sharply for these institutions. If the risk premium rises in response, borrowers' repayment ability will decline, setting in train a potentially intensifying cycle of nonrepayment by borrowers and worsening balance sheets in the secondary financial sector.

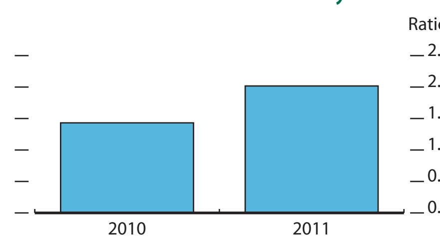
In 2011, authorities introduced several measures to address household debt. These included reinstatement of debt-to-income limits for mortgage loans and various measures to ensure low-income households' access to loans through the primary financial sector. While these measures are encouraging, authorities will need to closely monitor the growth of household debt, especially loans from the secondary financial sector to low-income households, and to take further cautionary measures.

3.11.12 Share of nonhousing loans



Source: LG Economic Research Institute.

3.11.13 Debt to disposable income, households in the bottom 20% by income



Source: LG Economic Research Institute.

Mongolia

Medium-term economic prospects are excellent, with a very large mining project expected to begin production early next year and another in the initial stage of development. Growth has been driven both by the booming mining sector and by too rapidly increasing government expenditure. There are signs of overheating, reflected in double-digit inflation. As already scheduled by the government, a substantial fiscal reserve needs to be built so as to protect against contingencies, including a drop in global commodity prices.

Economic performance

The economy grew by 17.3% in 2011, driven mainly by infrastructure spending related to mining activity (Figure 3.12.1). Gross capital formation increased by about 60%, including for equipment, buildings and intermediate goods, and public infrastructure. Investment in the world-scale Oyu Tolgoi copper and gold mine is projected to total $5 billion. The mine is nearing commercial production.

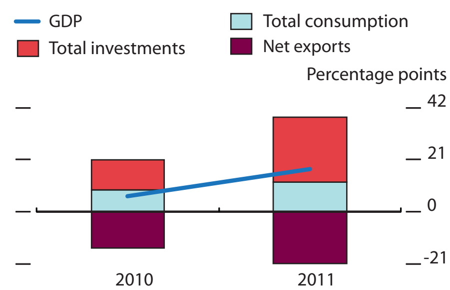
Domestic consumption was another important driver, rising by 14.5% in real terms. Private consumption was up strongly, supported by rising employment and incomes.

A surge in exports, almost entirely to the People's Republic of China (PRC), was driven by increases in the volume and value of coal output. Imports, however, surged even more, largely reflecting the equipment and machinery needs of mining. Net exports were negative and, therefore, heavily reduced the national accounts measure of overall growth.

Economic growth primarily originated in mining, but was quite broad-based (Figure 3.12.2). Domestic trade (wholesale and retail) rose by 42.5%, stimulated by large government cash payments to all citizens. Mining rose by 8.7%, manufacturing by 16.0%, and construction by 14.3%. Agriculture, which accounts for more than a third of total employment, increased by only 0.3%—disappointing progress in view of the sharp contraction in 2010. While official unemployment was less than 5%, labor force surveys indicate that the overall rate was about 9%, down from 13% at end-2010.

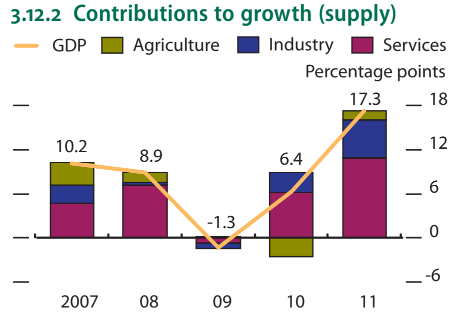
Macroeconomic management of the economy has been mixed. The government completed successfully a stand-by arrangement with the International Monetary Fund in October 2010 but since then fiscal policy has become more expansionary and pro-cyclical. Government expenditure in fiscal 2011 (1 January–31 December) surged by 55.6% to the equivalent of 44.2% of GDP as spending on social transfers, wages and cash transfers surged. Government revenue jumped by 40.9%, supported by sharply higher receipts from import duties on mining-related equipment and corporate and personal income taxes.

3.12.1 Contributions to growth (demand)



Source: National Statistics Office of Mongolia 2011. *Monthly Statistical Bulletin*. December. http://www.nso.mn

3.12.2 Contributions to growth (supply)



Source: National Statistics Office of Mongolia 2011. *Monthly Statistical Bulletin*. December. http://www.nso.mn

This chapter was written by Jan Hansen and Amar Lkhagvasuren of the Mongolia Resident Mission, ADB, Ulaanbaatar.

Late in the year, Parliament amended the budget to raise revenue and expenditure—by some 20% over the initial budget estimates for both revenue and expenditure. Compounding the inflationary effects of the spending increase, 20% of total budgetary expenditures were in December. The budget deficit was the equivalent of 3.6% of GDP, compared with a small surplus in 2010 (Figure 3.12.3). While excess mineral revenues were placed in a stabilization fund, as provided for by the Fiscal Stability Law (FSL) adopted in 2010, the overall budgetary framework was inappropriate for 2011 given the inflationary pressures.

The Bank of Mongolia (the central bank) tightened monetary policy throughout the year. It increased the reserve requirement for banks from 5% at the start of 2011 to 11% in August. It has raised the policy rate four times since early 2010 by a total of 1.75 percentage points to 12.75% by year-end. Adjusting for inflation, the slightly positive real interest rate indicates a modest contractionary monetary policy stance, although insufficient to offset excessive fiscal stimulus.

The official exchange rate of the local currency (the togrog) against the US dollar depreciated by about 11% during August–December 2011, reflecting global risk aversion and declining commodity prices, which similarly affected the currencies of other emerging, mineral-rich economies. The real effective exchange rate of the togrog was broadly stable over the year (Figure 3.12.4).

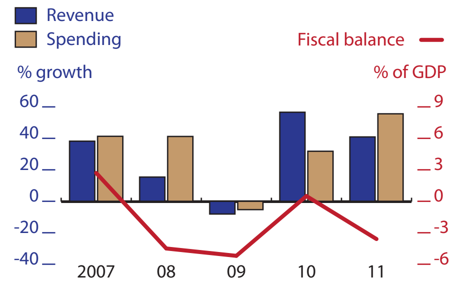
The institutional framework for monetary policy has been strengthened. The broadly flexible exchange rate system adopted since 2009 helps control inflation, provides an absorber against external shocks, and facilitates the real exchange rate changes that are likely to take place over the medium term in view of the rapid growth of the mineral sector. The new Central Bank Law, enacted in early 2010, mandates the Bank of Mongolia to concentrate solely on price stability. The real effective exchange rate does not seem to be out of line with medium-term fundamentals.

Broad money supply (M2) grew by nearly 40% through December 2011, too rapidly given the need to restrain inflationary pressures. The commercial banking system in Mongolia has structural weaknesses, with weak supervision and regulation. Several small to medium-sized banks are highly vulnerable. Year-on-year bank lending was up by more than 70% in December. The rapid acceleration in bank lending is fueling aggregate demand, heightening the vulnerability of banks and putting stress on the financial system.

For the year as whole, inflation was 9.2%, but varied widely with fluctuations in food prices and increased to 10.2% in December year on year (Figure 3.12.5). Inflation in Mongolia is volatile, making it hard to discern underlying inflationary pressures, which is crucial for guiding macroeconomic policy. The drop in inflation in early 2011 was largely due to a decline in meat prices through government-managed sales of meat reserves at below-market prices. (Meat constitutes about 40% of the food basket.) Core inflation (excluding food and energy) averaged 9.7%, indicating overheating of the economy.

External trade soared in 2011. The value of exports, largely minerals, rose by 64.4% to $4.8 billion, attributable to demand from the PRC (Figure 3.12.6). Imports more than doubled to $6.5 billion, driven by

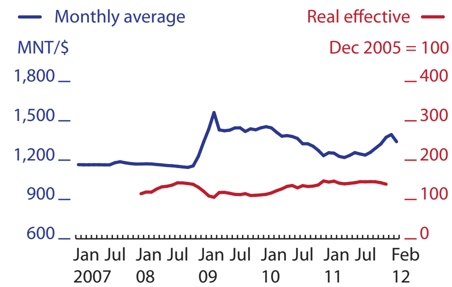
3.12.3 Fiscal indicators



Note: 2011 revenue includes infusion from the Stabilization Fund.

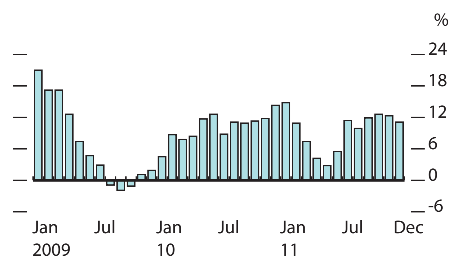
Source: National Statistical Office. 2012. *Monthly Bulletin*. January. http://www.nso.mn

3.12.4 Exchange rate



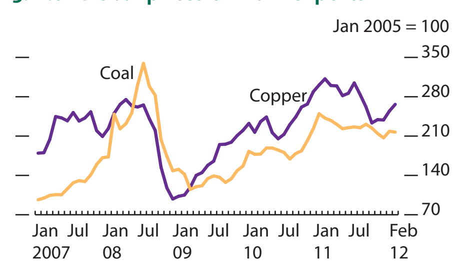
Source: CEIC Data Company (accessed 22 March 2012).

3.12.5 Monthly inflation



Source: Bank of Mongolia. 2012. *Statistical Bulletin*. January. http://www.mongolbank.mn

3.12.6 Global prices of main exports



Source: International Monetary Fund. Primary Commodity Prices. http://www.imf.org (accessed 22 March 2012).

purchases of equipment for mining as well as higher prices for oil and food. The current account deficit widened to $2.6 billion, which corresponded to about 30.0% of GDP in 2011 (as against 14% of GDP in 2010). The main source of financing of the current account deficit was foreign direct investment, which more than doubled to $3.7 billion. Gross international reserves by year-end totaled $2.5 billion, equivalent to 29% of GDP.

Economic prospects

The economy is forecast to continue growing at double digit rates: 15.0% in 2012 and 17.5% in 2013. The drivers of growth are expected to remain the same, notably mining-related investment and output. Commercial production from the Oyu Tolgoi mine is scheduled to begin in early 2013, accounting for the boost in growth that year. The time frame for developing the Tavan Tolgoi coal deposit, one of the world's largest untapped reserves, is less certain. Growth is likely to be further supported by strong growth in construction and services activity associated with mining, and by rising government spending.

With an estimated budget deficit of 1.0% in 2012, fiscal policy is expected to remain pro-cyclical. Government revenue is projected to rise by about 40% and expenditure by about 32%. Contingent liabilities may also increase significantly, reflecting the government's guarantee of bond issuances by the Development Bank of Mongolia and scheduled public–private projects. Under the amendments to the Social Welfare Law enacted in January 2012, a means-tested poverty benefit will be introduced at midyear, replacing the universal cash transfers from the Human Development Fund. This represents a major step toward setting up a fiscally sustainable social protection system while supporting the poor.

Inflation is expected to remain in double digits—15.0% in 2012 and 12.0% in 2013—owing to very high public spending and large pay rises for public-sector workers in 2012, as well as the emergence of supply bottlenecks in the mining industry and shortages in the labor market (Figure 3.12.7). Adherence to the FSL, in particular the phasing out of cash payments in mid-2012, will put the central bank in a better position to contain inflation in 2013. If, however, public spending growth does not moderate (as prescribed by the FSL), inflation may continue to accelerate beyond 2012. The recent exchange rate depreciation will further stoke inflationary pressure due to the high import content of consumer goods.

Monetary policy may need to play a more active role in countering inflationary pressures. The central bank's target for 2012 is an inflation rate below 10%, which will require further tightening of monetary policy. Containing credit growth, which is increasing systemic risks in the banking sector, will require strict enforcement of prudential regulation.

Export growth is projected to be robust in the forecast period, based on strong demand from the PRC and continued high commodity prices. Export earnings will also be boosted when the Oyu Tolgoi mine starts commercial production.

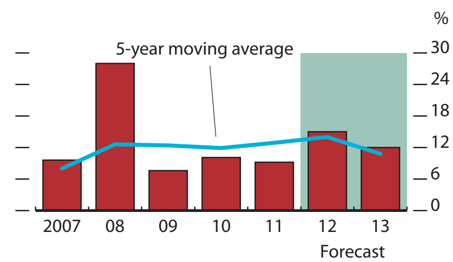
Imports will continue to be driven by investments linked to mining and strong growth in private consumption. As new mines come on stream and mineral exports surge, the current account deficit is expected to narrow to an estimated 25.0% and 15.0% of GDP in 2012 and 2013 (Figure 3.12.8).

3.12.1 Selected economic indicators (%)

	2012	2013
GDP growth	15.0	17.5
Inflation	15.0	12.0
Current account balance (share of GDP)	-25.0	-15.0

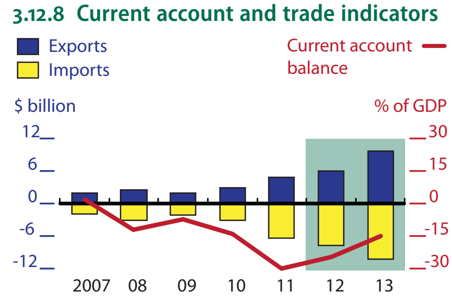
Source: ADB estimates.

3.12.7 Inflation



Source: Asian Development Outlook database.

3.12.8 Current account and trade indicators



Sources: Bank of Mongolia. 2012. *Balance of Payments Report*. January. http://www.mongolbank.mn; ADB estimates.

With committed investments for the Oyu Tolgoi mine and pre-operation activities related to the Tavan Tolgoi mine, foreign direct investment is set to remain high and to fully finance the current account deficit.

Downside risks to the forecast reflect Mongolia's small, open, mining-dependent economy. Because of the heavy dependence on mineral development and exports, and associated government revenue, the current account and state finances are highly vulnerable to commodity price fluctuations. Another risk is the possibility of a sharp slowdown in the PRC's growth, the destination for more than 90% of exports.

Domestically, weak corporate governance and regulation and supervision have resulted in the banking sector being vulnerable to external shocks; it could—as during the 2008–2009 crisis—generate severe financial stress.

Policy challenges—institutional strengthening and public finance management

Worldwide, countries have shown that, paradoxically, an abundance of natural resources can hinder their long-term development by increasing macroeconomic volatility, thus reducing incentives to invest in physical and human capital and undermining economic and political institutions. Resource dependence often leads to widening income disparities, as resource extraction creates relatively few jobs and a small proportion of the population may secure most of the income.

Mongolia, which historically had comparatively balanced income distribution, has in recent years seen a clear trend toward increasing inequality that could undermine its social cohesion and stability. An important medium-term challenge will be to improve its economic and political institutions so as to ensure transparent, accountable, and equitable management of natural resource revenue.

Macroeconomic management of an economy characterized by very rapid development of its natural resources often leads to what is called "Dutch Disease"—that is, high inflationary pressures, upward pressure on the exchange rate, crowding out of the private sector, and increasing vulnerability to external shocks. Recognizing the possible risks, the government strengthened the legal framework for fiscal policy and budget management through enactment of the FSL (in June 2010) and the Integrated Budget Law in early 2012.

The FSL aims to ensure that mining revenues are better managed by putting in place three complementary rules (Box 3.12.1). The FSL—if properly enforced—will make an important contribution to insulating fiscal policy from commodity price shocks and smoothing the economy's adjustment to higher mineral output. In turn, conservative management of fiscal resources will facilitate development of the nonmineral economy.

While the 2012 government budget appears to be overly expansionary, the authorities are expressing their commitment to the FSL. The Integrated Budget Law is a comprehensive law which aims to reform the entire budget process, from investment planning to budget execution and auditing, and puts in place a new framework for fiscal decentralization. It is vital that both these laws be implemented in spirit and practice.

3.12.1 Fiscal rules for budget discipline

Good fiscal policy is critical for helping to ensure that mineral wealth contributes to sustainable economic prosperity. The Fiscal Stability Law will promote needed budget discipline through three fiscal rules:

- *Ceiling on structural budget deficit of 2% of GDP*. The structural deficit adjusts the budget deficit to take account of trends in major mineral prices (currently copper and coal) and their impact on government revenues. The structural balance is calculated by using the moving average price of major minerals over 16 years (past 12 years, current year, and future 3 years). This provision takes effect in 2013.
- *Ceiling on expenditure growth*. Spending growth that is too fast leads to overheating and inflation and, from a budget perspective, is difficult to manage efficiently. The ceiling is the greater of the non-mineral GDP growth rate of the particular year or the average of the non-mineral GDP growth rate for the 12 consecutive preceding years. This provision takes effect in 2013.
- *Net present value of public debt must not exceed 40% of GDP*. This provision takes effect from 2014, with a transition period specified for the preceding years. It excludes any borrowing in which the government has agreed to contribute into the paid-in capital of a foreign mining entity and which is repayable from the future profits of the entity.

Taipei,China

Forward-looking business indicators are now more positive than in late 2011 but weak global conditions will limit export growth in this trade-heavy economy. Domestic demand should continue to provide a relatively strong base, supported by rising incomes reaching around US$21,000 per capita this year. A gradually improving global outlook will boost growth in 2013, but longer term, increased R&D and investment is needed to secure broad-based, stable growth through diversification and restructuring of the economy.

Economic performance

Following the post-recession rebound, economic growth slowed to 4.0% in 2011 (Figure 3.13.1). Growth decelerated to 1.9% in the fourth quarter, reflecting the slump in gross capital formation and investor concerns about the global outlook.

Positive net exports accounted for most of the increase in output, despite weak external demand, as the slowdown in exports was less marked than that for imports.

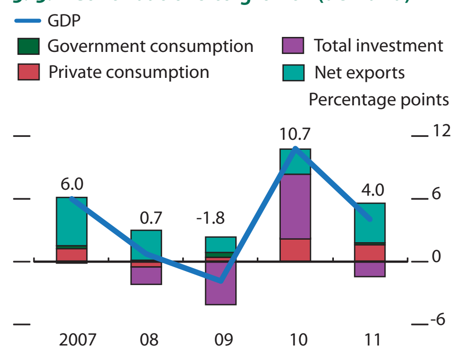
Domestic demand was mixed, as domestic consumption was relatively strong but investment declined. Private consumption rose by 3.0% in 2011, supported by robust job growth, low unemployment (4.4%), and rising earnings. Government consumption picked up by about 2%. Private investment, however, fell by 2.3%, more sharply so in the second half of the year as business enterprises, especially in electronics, put their investment plans on hold. Public investment declined even faster, by 8.4%, as stimulus-related infrastructure outlays were gradually completed (Figure 3.13.2).

Growth was almost evenly distributed between industry and services. The former grew by 4.4% for the year—in contrast to 2010 when it jumped by 23%—slowing sharply in the fourth quarter. Manufacturing rose by 4.9% but construction activity was flat, in line with a slowing property market. Services saw modest gains in wholesale and retail trade, finance and insurance, information and communications, and strong gains in hotel and restaurant services. Agriculture grew by 1.9%, but accounts for less than 2% of GDP.

Inflation of 1.4% was well within the central bank's target. Measures to curb mortgage lending, as in the previous year, continued to slow residential property price increases. The appreciating local currency against the United States (US) dollar—up 7.4% through end-December 2011, taking it to near the rate before the global financial crisis—also helped curb inflation.

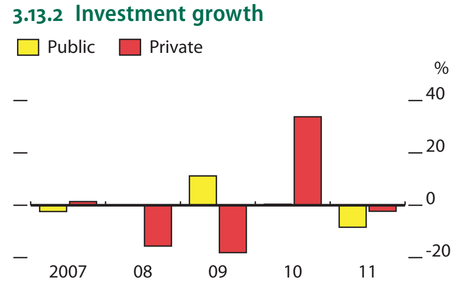
Monetary policy continued tightening in 2011 (Figure 3.13.3). However, from September 2011 the central bank kept the discount rate

3.13.1 Contributions to growth (demand)



Source: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw (accessed 15 March 2012).

3.13.2 Investment growth



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw; CEIC Data Company (both accessed 15 March 2012).

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

unchanged at 1.875%, as concerns mounted about the risk of another global economic slowdown. Money supply and bank credit expansion climbed only slowly, although loans to the private sector increased faster than in 2010, at 8.1%.

Fiscal policy remained accommodative, with a deficit of 2.5%. Overall government expenditure increased by 4.4%, reflecting rising social welfare payments and development-related initiatives. Revenue rose by 10%, supported by a healthy rate of expansion in nominal GDP. Public debt is projected to rise to the equivalent of 37% of GDP, still below the limit of 40% set by law.

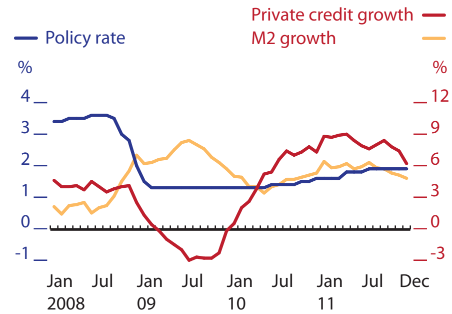
Trade decelerated (Figure 3.13.4). Growth of goods exports slowed to 12.1%, on a combination of weakening external demand and adjustment from the unsustainable 34.6% postcrisis rebound of 2010. Exports to advanced countries slumped while developing Asian markets remained relatively strong. In particular, the Economic Cooperation Framework Agreement with the People's Republic of China (PRC) resulted in rapid growth in exports of products included under the Early Harvest Program.

Merchandise import growth contracted to 13.0% from 43.1% in 2010, as imports of capital goods fell sharply. The trade surplus increased by 4.5% to US$27.6 billion.

The services account was in surplus, boosted by strong growth in tourist arrivals from the PRC. The income account remained positive as repatriated profits and dividends from Taipei,China's investments abroad exceeded its payments to nonresidents. A current account surplus of US$41.3 billion was recorded, equivalent to 8.8% of GDP.

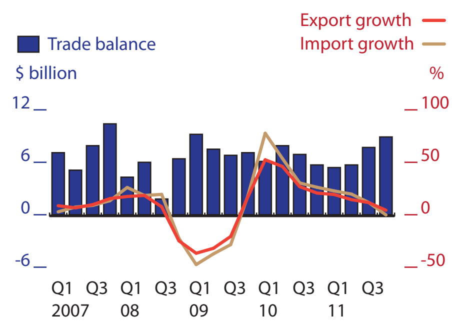
Direct investment recorded a net outflow of US$14.8 billion (Figure 3.13.5), due mainly to firm expansions abroad and relocation of less advanced parts of the manufacturing base to the PRC. Portfolio investment registered a net outflow of US$35.7 billion, much higher than the previous year, reflecting both concern about the global outlook and safe-haven capital flight. The decline in the capital account more than offset the rise in the current account, bringing foreign reserves down to 82.6% of GDP, from 89% in 2010.

3.13.3 Credit indicators



Source: CEIC Data Company (accessed 16 March 2012).

3.13.4 Trade indicators



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw; CEIC Data Company (both accessed 15 March 2012).

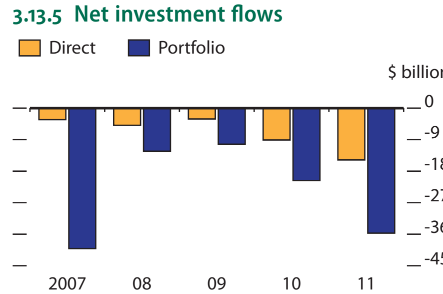
Economic prospects

Growth is forecast to slow further in 2012 to an annual 3.4%, on the uncertain world outlook and moderating rate of expansion of the PRC, the island's largest trading partner. Improvement to 4.6% is forecast for 2013, as both domestic and external demand strengthen.

Growth of exports of goods is forecast to weaken to about 4% in 2012, or a third of the year-earlier rate. Exports of services will be more robust, growing by more than 7%, supported by greater tourist arrivals from the PRC as visa restrictions are relaxed further. Continued growth of exports to developing Asian markets in 2012 and 2013 will compensate in part for the slow growth of exports to developed countries.

Imports of goods and services will also slow sharply, but less so than exports, in part because of the rising cost of oil imports. Net exports will remain positive. Both exports and imports will strengthen as the economy strengthens in the latter half of 2012 and into 2013. The current

3.13.5 Net investment flows



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw; CEIC Data Company (both accessed 15 March 2012).

account surplus is expected to decline to about 8.0% of GDP for this year and next.

Private consumption is forecast to increase by 2.5% this year, supported by relatively low unemployment, low interest rates, and recovering consumer confidence (Figure 3.13.6), which had fallen at end-2011 following cutbacks in overtime work and encouragement for employees to take leave.

Investment is expected to register little growth in 2012, reflecting the high degree of uncertainty about global demand for information-technology products. Opening the semiconductor and flat-panel subsectors to foreign investment (announced in March 2011) has so far not met expectations. However, another round of liberalization, which began in March 2012, together with the expected gradual resurgence of growth in the US and other major markets, should lead to a pickup in investment later this year and during 2013.

The National Development Plan for 2012, announced in December 2011, is also expected to lift investment in the second half of 2012 and in 2013.

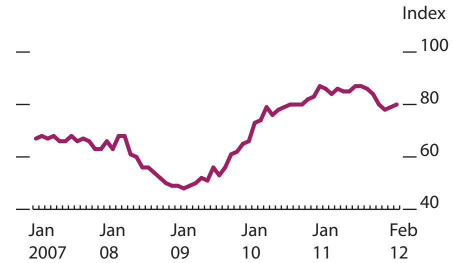
Fiscal policy, however, will be less stimulative than last year. Overall expenditure is budgeted to drop marginally, as spending under the Special Budget will fall to almost zero—with the winding up of crisis measures in response to the 2009 typhoon and the stimulus measures related to the 2008–2009 recession. Revenue is expected to increase by 5%, resulting in a narrowing of the deficit to about 1–2% of GDP, consistent with the government's policy of gradual fiscal consolidation.

Inflation is expected to remain little changed in 2012 and 2013, at 1.5% and 1.6%. Oil prices are forecast to be marginally higher than last year but slow growth, both domestically and internationally, will in general ease commodity and other prices, including those for food. Property prices have started to decelerate, a result of the monetary authority's policies on curbing speculative activities. The upsurge in consumer prices in December–January is considered a short-term aberration, attributable to bad weather and increased demand during the Chinese New Year.

In January, authorities announced that investors from the PRC would be allowed to acquire stakes in local banks and financial holding companies, helping the local stock market rise (by 14%) and the national currency to appreciate against the US dollar (by 2.5%) from end-2011 to mid-March 2012. Uncertainties about the global economy will, however, encourage the central bank to closely monitor exchange rate movements and to keep interest rates at their current levels, while ensuring that inflation stays in check. Monetary policy is expected to tighten in 2013.

Risks to the economic forecast stem primarily from the eurozone sovereign debt crisis and the consequences for the global economy if it were to deepen. Another risk is instability in the Middle East, with the possibility of an oil spike and derailment of economic recovery in the US and elsewhere.

3.13.6 Consumer confidence



Source: CEIC Data Company (accessed 15 March 2012).

3.13.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.4	4.6
Inflation	1.5	1.6
Current account balance (share of GDP)	8.1	7.9

Source: ADB estimates.

Policy challenge—industrial diversification and competitiveness

A major policy challenge for Taipei,China is diversifying the economy and achieving a more broad-based, resilient growth model. It is highly dependent on exports, which equal about 70% of total output. Further, more than 40% of its exports are based on electronics products (Figure 3.13.7). As an export-led-economy, it is highly susceptible to conditions in its main markets, notably the PRC; Hong Kong, China; the US; European Union; and Japan (Figure 3.13.8).

The competitiveness of the electronics sector is a further concern. Although the sector has evolved over several decades from pure assembly to a high-tech, well-integrated industry, international competition has increased relentlessly, notably from the Republic of Korea. The growing scarcity of low-cost labor in Taipei,China over the past decade or more has prompted some companies to relocate manufacturing plants to the PRC and elsewhere. In turn, this has raised concern that the migration of industry will "hollow out" the economy. Financial difficulties of Taipei,China's leading memory-chip makers since the global financial crisis, as indicated in their declining share prices (Figure 3.13.9), have underscored the need for restructuring and innovation.

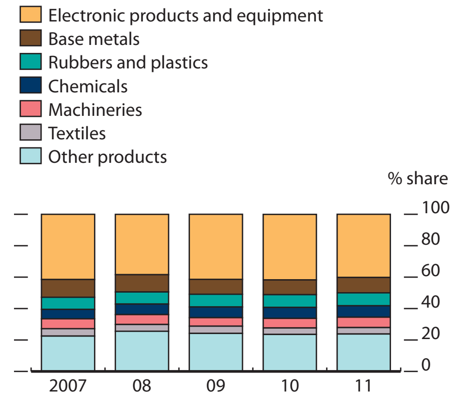
Taipei,China's competitive position has been further challenged by bilateral trade agreements. Of particular significance, the Republic of Korea–US Free Trade Agreement signed in March 2012 poses stepped-up competition in a wide range of industries, including electronics. Beyond that, the Republic of Korea is scheduled to start negotiations on free trade with the PRC and Japan in May this year.

Recognizing the need for industrial restructuring and strengthened competitiveness, in 2011 the government stepped up efforts to enhance technological innovation, cultural and creative industries, R&D activities, and traditional industries. It also includes investment incentives for innovative foreign and domestic investors. Diversification into rising industries, such as biotechnology, renewable energy, ecological agriculture, and medical care, will require stronger R&D support: according to IMD's *World Competitiveness Yearbook,* total R&D spending in 2009 was equal to 2.9% of GDP, less than the 3.4% for the Republic of Korea and 3.5% for Japan.

The response of the private sector to diversifying and making itself more competitive will be critical. Innovation in products and processes will be essential, as well as deciding on what products to get out of or to avoid. From a public policy perspective, perhaps the most important focus should be on improving the investment regime and on opening more sectors to investment, thereby creating more opportunities for domestic and foreign investors.

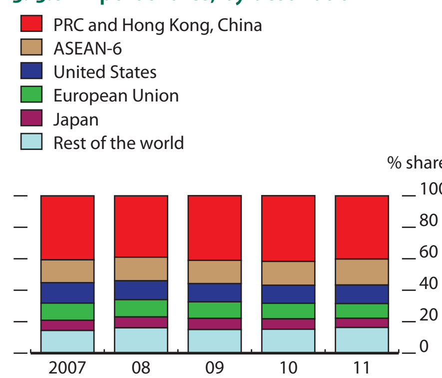
One spur may be that Taipei,China's rank in *Doing Business 2012* was 25—far behind both Singapore and Hong Kong, China (first and second), and the Republic of Korea (eighth, up from 15 in 2010). The government, in partnership with the private sector, needs to improve in those areas where the economy ranks poorly and to ease regulatory impediments in key sectors.

3.13.7 Export shares, by product



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw; CEIC Data Company (both accessed 15 March 2012).

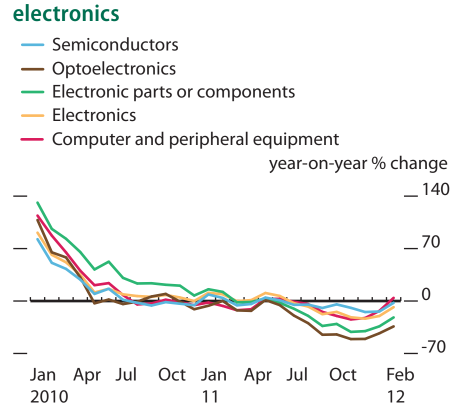
3.13.8 Export shares, by destination



Note: ASEAN-6 = Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam; PRC = People's Republic of China.

Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.stat.gov.tw; CEIC Data Company (both accessed 15 March 2012).

3.13.9 Selected share price movements, electronics



Note: The data refer to subindexes in TWSE.

Sources: CEIC Data Company; TWSE. http://www.twse.com.tw (both accessed 15 March 2012).

South Asia

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Afghanistan

Full responsibility for security is to be handed over to the government by end-2014 as international troops are withdrawn. Since economic development (as well as security) has depended heavily on aid and international military spending, the transition will require the country to find new sources of growth and ways to achieve fiscal sustainability, in an uncertain security environment. These challenges will require major domestic efforts and reforms alongside substantial external support by donors if development momentum is to be sustained.

Economic performance

GDP growth is estimated to have slowed to 5.7% in FY2011 (ending 20 March 2012)—following an 8.4% expansion the previous year—mainly because of a large fall in agricultural foodgrain production owing to unfavorable weather conditions for a second year (Figure 3.14.1).

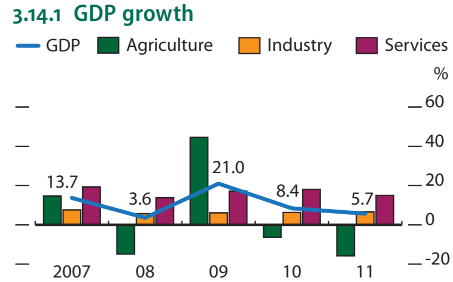
Private consumption remained the main source of economic growth, fueled by the large aid inflows that underpin most of the demand for goods and services. Growth in services activity, which accounted for 53% of GDP, moderated during the year, reflecting lower foreign inflows. Domestic investment is estimated at 22.6% of GDP, including private investment of just over a third of that.

Opium production increased by 61% in 2011, rebounding from a disease the year earlier that wiped out much of the crop, and farmers responded to high prices offered by traffickers. Farm income for opium in 2011 is estimated to exceed $1.4 billion, equivalent to nearly 8% of GDP; export value may be as much as $2.4 billion. Opium is not counted as part of GDP, but earnings generated by it and then retained and spent in the country boost domestic demand.

Consumer prices are highly volatile because of heavy import dependence, including food and fuel (Figure 3.14.2). Overall (year-on -year) inflation, which peaked at 18.2% in January 2011, receded to 9.2% in February 2012, mainly due to a fall in food inflation, which dropped from 21.0% to 7.1% mainly because of declining global food prices. Nonfood inflation was fairly stable in this period—varying around 14%—kept high by price adjustments for electricity and fuel, construction materials, transport, and housing rents. Average inflation in FY2011 is estimated at 10.5%.

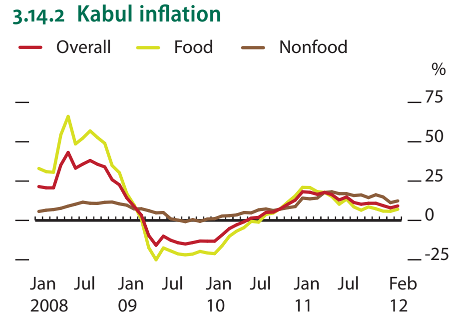
Revenue collection is estimated to have met the FY2011 budget target of AF98.8 billion (11.5% of GDP), reflecting tax administration reforms, improved tax compliance, and new tax measures such as a business receipts tax (Figure 3.14.3). Operating expenditure is estimated to have increased by 37.0% in FY2011, mainly because of growing security expenditure taken on to the budget and rapid implementation of pay and grading reforms for civil servants. Domestic revenue coverage of

3.14.1 GDP growth



Source: Ministry of Finance.

3.14.2 Kabul inflation



Sources: Central Statistical Office of Afghanistan; Da Afghanistan Bank.

This chapter was written by Rehman Rahmani of the Afghanistan Resident Mission, ADB, Kabul.

operating expenditure therefore fell, to about 65% from 73% a year earlier; the balance of operating expenditure was financed through donor grants.

The government tightened its policy on new project additions to the development budget in view of the low execution rate, which has been a major concern for the government and donors in recent years. The government has been struggling to meet its budgetary targets to achieve the Millennium Development Goals, for example.

The central bank adopted a relatively tight monetary policy during FY2011 to contain inflation pressures, although they largely stemmed from global price increases. Growth in currency in circulation was cut by nearly half to 17.8% from 34.2% in FY2010. The afghani remained broadly stable in real effective terms; it depreciated by about 8% against the dollar during FY2011 (Figure 3.14.4).

The current account deficit (excluding grants) is estimated to have narrowed by about 5.5% of GDP to a deficit of 34.3% of GDP in FY2011 (Figure 3.14.5). The narrowing trend reflects the fact that grant financing has remained broadly stable in dollar terms at about $6.3 billion in recent years but is falling in relation to a growing nominal GDP. Including grants, the current account is expected to run a surplus of 0.1% of GDP in FY2011, down from the 1.7% surplus in FY2010 due to a much smaller expansion in exports. The financial account improved slightly on increased foreign direct investment as a result of initial investment in mining industry. Gross international reserves are estimated to have increased to $6.1 billion, equivalent to cover 8.4 months of imports.

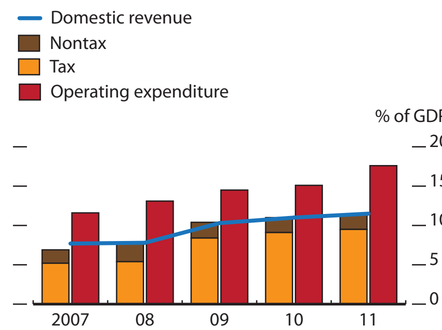
Economic prospects

Economic activity will continue to be driven mainly by consumption expenditure and is expected to pick up to 7.1% in FY2012 (assuming more favorable weather for agriculture). A slowdown to 5.8% is expected in FY2013, though, because of declining local spending from foreign security forces as they gradually withdraw and waning grant-financed development spending that is not channeled through the government budget. An economic program with the IMF under its Extended Credit Facility was agreed in November 2011 and it provides an overall macroeconomic adjustment framework for the next 3 years, as well as guidance to reform banking regulations after the failure of Kabul Bank (Box 3.14.1).

The government's operating budget deficit will come under pressure in the next 2 years because of increases in security spending, continuing pay and grading reforms in the civil service, absorption of the public servants paid by donors, and operation and maintenance cost of projects handed over by donors. Projections indicate that recurrent spending will rise to 18.6% of GDP, while domestic revenues will stay at about 11.5% of GDP over the next 2 years, thus domestic revenue will fall by another 3 percentage points to finance about 62% of recurrent expenditures. Increases in operating and development grants, however, are expected to keep total budget expenditure higher at over 25% of GDP in FY2012 and FY2013, or about 1.5–2 percentage points above that in FY2011.

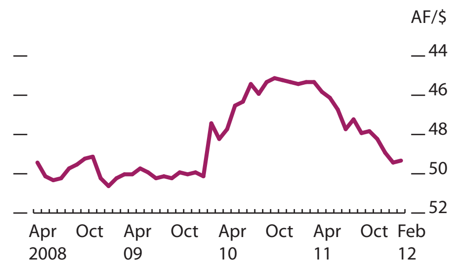
Monetary policy aims to bring down inflation to about 5% in the next 2 years. While the main drivers of prices are external and out of direct control, the *Asian Development Outlook 2012* baseline assumes broadly

3.14.3 Fiscal indicators



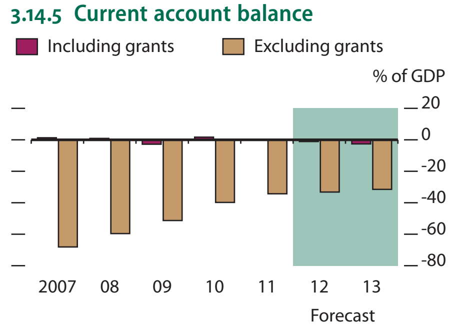
Source: International Monetary Fund. 2011. *Country Report* No. 11/330. November. http://www.imf.org

3.14.4 Nominal exchange rate



Source: Da Afghanistan Bank. http://www.centralbank.gov.af

3.14.5 Current account balance



Source: International Monetary Fund. 2011. *Country Report* No. 11/330. November. http://www.imf.org

3.14.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.1	5.8
Inflation	4.6	5.0
Current account balance (share of GDP)	-1.1	-2.5

Source: ADB estimates.

stable global commodity prices, indicating that this objective is attainable. The monetary authorities also intend, as in the past, to operate to smooth out volatility in the exchange rate and strengthen international reserves. Donors' projected substantial, though declining, aid inflows will facilitate meeting these objectives.

Foreign aid will continue to finance most of the balance-of-payments deficit, though pressures here will begin to emerge in the next 2 years. The current account deficit (excluding grants) as a share of GDP is projected to fall to 33.2% in FY2012 to 31.5% in FY2013 as responsibility for security is handed over to the government. Mainly because of reduced (export) sales to nonresidents and also some fall off in public grants, the current account balance (including grants) will turn to a deficit estimated at 1.1% of GDP in FY2012 and 2.5% of GDP in FY2013. Because domestic exports are so small, the country has very limited debt-carrying capacity and will be forced to rely on foreign direct investment and highly concessional loan assistance to cover these deficits.

Policy challenge—coping with the transition

The planned foreign troop pullout by end-2014 is seen lowering annual growth by at least 2–3 percentage points after that date, due to reduced local spending by these forces and by foreign civilian organizations with international and national staff. Unemployment will go up when local staff hired by foreign security and civilian organizations are laid off.

The fiscal impact of the transition will come mainly from increasing pressure on the government to take over externally financed operating expenditures (security and nonsecurity); declining grants to the government's development budget; and donors' continuously declining externally financed development budgets (some of their projects will be brought on budget). Over the next 10 years, fiscal policy will have to balance the takeover of externally financed security spending and other expenditures, while increasing propoor and development outlays within a very tight budget constraint. The transition will lead to limited fiscal space, thereby pushing back fiscal sustainability (defined as domestic revenue funding the government's recurrent expenditure). Without sustained, high grant assistance, the concept of fiscal sustainability is reduced to fiscal survival.

Afghanistan's debt burden could rise substantially in the near future. Current public sector debt is around 12.1% of GDP, but with a heavy reliance on external grants to finance its budget, a rapid reduction in grants could require the government to assume new loans to meet its financing needs. A worsening security environment could exacerbate these financing requirements and reduce the government's ability even to collect domestic revenue.

The external sector will be affected through pressures on the current account balance and the exchange rate due to declining aid inflows. But a weak policy, regulatory, and institutional framework seems to be more challenging for Afghanistan's competitiveness than the exchange rate, as shown by the World Bank's *Doing Business Report 2012*. Afghanistan stands at 160 out of 183 countries, showing further degradation from 154 the previous year.

3.14.1 Kabul Bank crisis update

Fraudulent loans came to light at Kabul Bank, the largest bank in the country, in September 2010, triggering a run on deposits. The central bank initially placed the bank under conservatorship, appointed new management and guaranteed all deposits. Subsequently, Kabul Bank was placed under receivership and its assets have been split into "good" and "bad" banks.

The bank's deposits and good assets are with a bridge bank called New Kabul Bank, which will likely be privatized in FY2012. The bad assets have been retained by the receiver, appointed and overseen by a newly created independent Financial Dispute Resolution Committee. Based on the latest estimates, around $935 million (principal and interest) are receivable, although this amount is likely to increase when an audit is completed. Formal charges have been brought against two shareholders who represent over 50% of the assets sought for recovery and seven bank officers, but the legal process is moving slowly.

This crisis exemplifies the risks of rapid banking sector growth with weak governance and rule of law, and a lack of capacity and experience in supervision at the central bank. In November 2011, the government and IMF agreed to a new 3-year Extended Credit Facility that includes measures to address corruption and strengthen regulation and supervision over the banking system.

Bangladesh

Economic growth in FY2011 continued strong. Macroeconomic imbalances, however, have emerged: the balance of payments is under strain from high commodity prices, increased oil imports for power generation, and weakened exports; rising subsidy costs, mainly for fuel, are intensifying fiscal pressures and domestic borrowing, and inflation is at a multiyear high. Growth is expected to slow as the country grapples with these imbalances. Lifting growth in the medium term entails removing infrastructure bottlenecks, mobilizing additional budget resources, attracting greater investment, and upgrading labor skills.

Economic performance

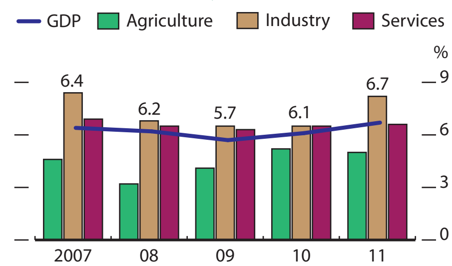
Growth picked up slightly to 6.7% in FY2011 (ended June 2011) from 6.1% (Figure 3.15.1). The upturn reflected a robust industrial expansion at 8.2% because of a strong rebound in export-oriented manufacturing and better performance by domestic market-based industries. More reliable power supply to industry helped performance, as contracted, private small plants began supplying power to the national grid. Agriculture maintained strong growth of 5.0%, aided by favorable weather and better access to credit and extension services. An expansion in trade activities helped maintain services growth of 6.6%.

On the demand side, private consumption, supported by a surge in credit, was the key growth driver in FY2011. Total fixed investment rose only slightly to 24.7% of GDP, from 24.4% in the previous year. Foreign direct investment (FDI) remained very low, at less than $1 billion.

Average annual inflation rose to 8.8% from 7.3% in FY2010 owing to the marked rise in global food and commodity prices, a strong expansion in domestic credit, and depreciation of the taka in the latter half of the fiscal year. Price pressures have intensified in FY2012 and year-on-year inflation climbed slightly from 10.2% in June 2011 to 10.4% in February 2012; nonfood inflation more than doubled to 13.6% but food inflation edged down to 8.9% (Figure 3.15.2). In addition to the rapid expansion in credit, stronger price pressures came from upward adjustments in domestic administered fuel and electricity prices, and from sharper taka depreciation because of continued high import demand, especially fuel imports.

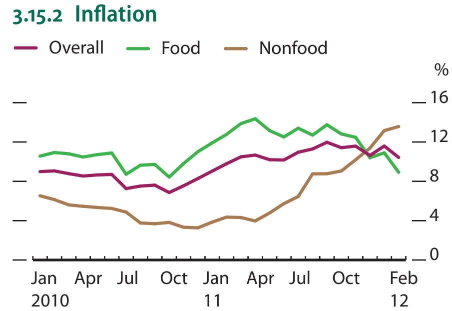
Net credit to government, which grew rapidly by 35.0% in FY2011, shot up to 62.4% in the 12 months to January 2012 (Figure 3.15.3), coinciding with a rapid rise in the cost of subsidies financed by the budget. Credit to the private sector, which climbed by 25.8% in FY2011, slowed to 18.9% by January 2012, although it remained higher than the annual monetary program target of 18.0%. The central bank raised policy rates to rein in the credit expansion and attendant domestic demand pressures, but it

3.15.1 GDP growth by sector



Source: Bangladesh Bureau of Statistics. 2011. *National Accounts Statistics*. May.

3.15.2 Inflation



Source: Bangladesh Bank. 2012. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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

also provided occasional liquidity support to the commercial banks, partly countering these measures' impact.

Revenue collection was buoyant in FY2011, with the revenue-to-GDP ratio rising to 11.6% from 10.9% in FY2010, owing to the pickup in economic activity and improvement in tax administration. Total government spending increased by nearly 25% to 15.9% of GDP from 14.6% in the previous year, as current spending mounted because of a rise in subsidies for food, fuel, fertilizer, and electricity. The budget deficit (4.3% of GDP) nonetheless, remained below target (5.0%), largely because implementation of the annual development program was weak, reflecting continued capacity constraints in key line agencies. The bulk of the budget financing came from domestic sources (3.4% of GDP), mostly from the banking system (Figure 3.15.4), as sales of national saving certificates fell off from the high level a year earlier and foreign financing was lower than expected (0.9%).

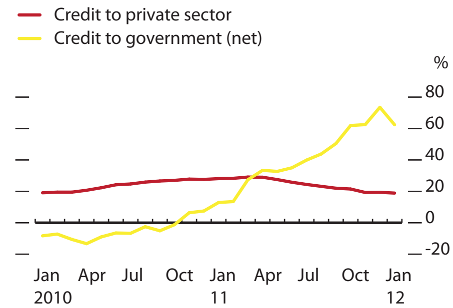
Export growth jumped to 41.7% in FY2011, reflecting a sharp recovery in garment demand in the main markets in the European Union (EU) and the United States (US) and a pickup in garment exports to new markets though these remain a small part of total sales. Garment export earnings grew by 43.4%, buoyed in part by higher export prices following the rise in prices of cotton, yarn, and accessories. Exports of other products also grew rapidly with a rise in demand and also reflecting the low base in the previous year.

Imports grew in step by 41.8% owing to larger import costs of raw materials for the garment industry, higher global commodity prices—especially for foodgrains, fertilizer, and fuel—and the generally strong domestic demand conditions. Foodgrain imports rose very steeply, buoyed by larger volumes as well as price, as the government sought to build large stocks to bolster food security. Because the base for imports is much larger than that for exports, even with similar growth rates, the trade deficit widened by 2.0% of GDP. Worker remittances, the main offset to the trade deficit, expanded by only 6.0% however, down from 13.4% the previous year.

The larger trade deficit and slower growth in remittances took the current account surplus down sharply to only $995.0 million (0.9% of GDP) in FY2011 from $3.7 billion (3.7%) the previous year (Figure 3.15.5). The combined capital and financial accounts recorded a deficit of $984.0 million in FY2011, versus the deficit of $139.0 million in FY2010, because of the larger outflows on account of trade credit and lower net inflows of foreign assistance. The overall deficit was $925.0 million in FY2011, a sharp turnaround from the surplus of $2.9 billion in FY2010.

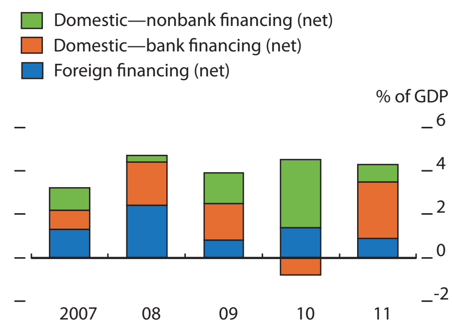
Because of rapidly growing import demand, the exchange rate came under pressure, especially in the second half of FY2011, and the taka depreciated by 6.3% against the dollar during the year. Balance-of-payments pressures continued in the first 7 months of FY2012 and the taka depreciated further by 12.2% (Figure 3.15.6). The real effective exchange rate depreciated by 9.0% in the year to January 2012, implying some gain in export competitiveness, as nominal depreciation of the currency offset higher inflation than in major trading partners.

3.15.3 Credit growth



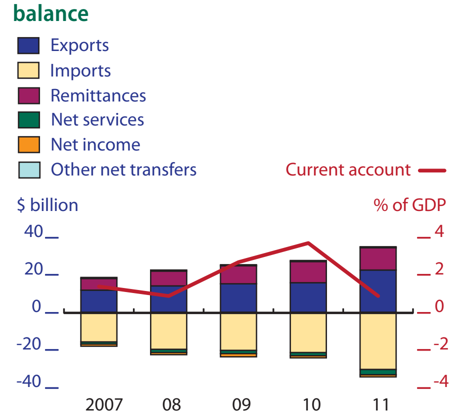
Source: Bangladesh Bank. 2012. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

3.15.4 Budget deficit financing



Source: Asian Development Outlook database.

3.15.5 Components of the current account balance



Source: Bangladesh Bank. *Annual Report 2010–2011*. http://www.bangladesh-bank.org

Economic prospects

The forecasts for FY2012 and FY2013 assume that it will be hard to contain inflation in FY2012, despite policy tightening. It is expected that credit tightening measures announced in the central bank's January 2012 Monetary Policy Statement would more effectively damp inflation in FY2013. It is also assumed that the government will further raise fuel and electricity prices, and mobilize more foreign financing of the budget, as part of its efforts to eliminate external and domestic imbalances and put the economy on a sustainable higher growth path. Finally, political stability and normal weather are expected to prevail.

GDP growth in FY2012 is projected to slow to 6.2%. The performance of exports, a key growth driver, is weakening as the year progresses, largely because of weaknesses in its key market, the eurozone, which is in a prolonged period of adjustment to its debt crisis. Export growth slowed sharply to 13.0% in the first 8 months of FY2012, from 40.3% in the year-earlier period, which will also affect production in export-linked domestic industries. The rise in interest rates is expected to moderate domestic demand. GDP growth in FY2013 is expected to slip to 6.0% as interest rates are raised to bring down inflation, and as export growth slows further.

Agricultural growth in FY2012 will moderate to 4.4%, crimped by rising irrigation costs (reflecting higher fuel and electricity prices) and because of the high base in the previous year. In FY2013, sector growth is projected to rise slightly to 4.5% in response to better procurement prices, as the government steps up food procurement programs and strengthens policy support.

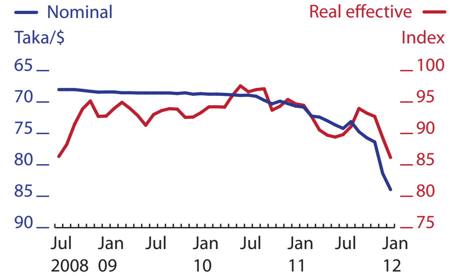
Industrial growth is expected to slow to 7.8% in FY2012, mainly reflecting falling export demand. Higher interest rates and labor costs as well as the expected increases in fuel and electricity prices will further raise the cost of production and squeeze profit margins. Higher interest rates will also weaken the construction industry and investment activity. Industrial growth is projected to ease to 7.5% in FY2013 reflecting policies to eliminate imbalances in the economy taking greater hold, and weakening domestic and external demand conditions.

In FY2012, services growth will slip to 6.2%, as growth in agriculture and industry slows. With industry activity slowing further in FY2013, expansion in services will ease to 6.0%.

Annual average inflation will edge up to 11.0% in FY2012. While food inflation has traditionally driven up the headline rate, the sharp rise in nonfood prices from July 2011 has emerged as a major policy concern. To rein in inflation, the central bank continued the previous year's credit-tightening measures and raised its policy rates in September 2011 and January 2012 by 100 basis points each, to 7.75% and 5.75%, respectively. They are expected to be raised more. In January 2012, the central bank abolished the cap on commercial bank lending rates to more effectively transmit its policy to the private sector. Inflation is projected to slow to 8.5% in FY2013 as monetary tightening takes greater hold.

Overseas workers remitted $8.4 billion in the first 8 months of FY2012, 12.2% more than in the equivalent period a year earlier, reflecting a steep rise in the number of workers leaving for overseas jobs since June 2011 (Figure 3.15.7). The upturn in worker placements and remittances is a welcome financial development that will both help sustain family incomes

3.15.6 Exchange rates



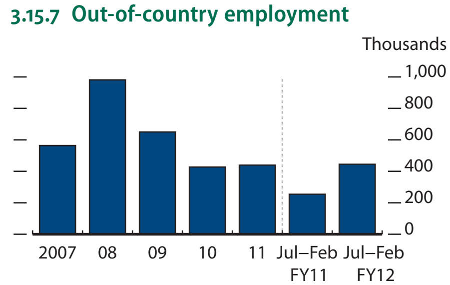
Source: Bangladesh Bank. 2012. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

3.15.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.2	6.0
Inflation	11.0	8.5
Current account balance (share of GDP)	-0.5	-1.0

Source: ADB estimates.

3.15.7 Out-of-country employment



Source: Bangladesh Bank. 2012. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org and domestic consumption, and contain the current account deficit. Most Bangladeshi overseas workers go to Gulf countries and are largely recruited to fill low-skill jobs. Remittances are expected to grow by 10.0% in FY2012, from 6.0% a year earlier, and rise further by 12.0% in FY2013.

Export growth is projected to slow to 12.0% in FY2012 and further to 10.0% in FY2013, mainly reflecting weak demand for garments (over three-fourths of exports) from the eurozone and from the US, which is experiencing a slow recovery from its financial crisis. In the first 8 months of FY2012, growth in knitwear exports declined sharply to 8.7%, from 43.9% in the year-earlier period, although growth in woven fabric exports held up well at 22.2% (Figure 3.15.8), benefiting from the EU's relaxed rules of origin (from January 2011). Growth in other export items also slowed markedly. While taka depreciation should favor exporters, the benefits are being largely negated by the lower prices negotiated by garment buyers. Although garment exports to new (mainly developing country) markets are becoming more important, they are yet to become major markets to offset declining exports to the EU and US, the two dominant traditional markets.

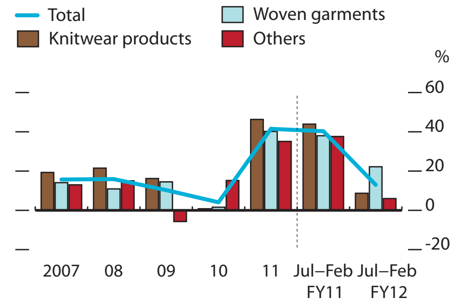
Imports grew by 15.6% in the first 7 months of FY2012. Growth in imports of foodgrains, consumer goods, capital machinery and industrial raw materials moderated from a year ago, although some intermediate goods, especially fuel and fertilizer, grew very strongly. Imports are forecast to grow by 17.0% in FY2012 and stay robust at 15.0% in FY2013 to cover fuel requirements for what is becoming a more reliable power generation, even as economic growth moderates.

The current account is projected to move to a deficit of 0.5% of GDP in FY2012 and to 1.0% in FY2013 as the trade deficit widens further (Figure 3.15.9). Foreign exchange reserves declined further in the first 8 months of FY2012 (Figure 3.15.10) as the current account surplus nearly halved and a large deficit was still recorded in the capital and financial accounts. Net inflows of foreign assistance declined, although FDI inflows rose marginally. Pressure on the balance of payments is expected to intensify in the forecast period, with larger import payments relative to export and remittance receipts. The government is seeking to adopt policies to address the growing imbalances, including discussing a 3-year program with the International Monetary Fund under its Extended Credit Facility.

The FY2012 budget aimed at revenue growth of 24.4%, although revenue collection in the first 7 months of the fiscal year indicates that this target is unlikely to be met. The budget set growth in public spending at 25.8%. While current spending is likely to greatly exceed the budgeted amount because of the rapid rise in subsidies, utilization of the annual development program will again fall short of allocation, which is expected to keep the fiscal deficit within the budgeted 5.0% of GDP (Figure 3.15.11). Domestic financing, mainly from banks, was set to cover 3.7% of GDP, while the remaining 1.3% was planned to come from foreign financing.

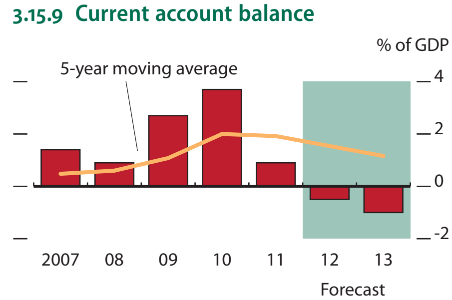
Subsidies are putting increasing pressure on the budget. The government has raised fuel and electricity prices in phases to cut them, but these adjustments are too small to cover rising costs. Indeed, spending on subsidies is expected to increase from the previous year's 2.2% of GDP to 3.4% in FY2012, or more than a quarter of projected revenue collection for the year.

3.15.8 Growth in exports and components



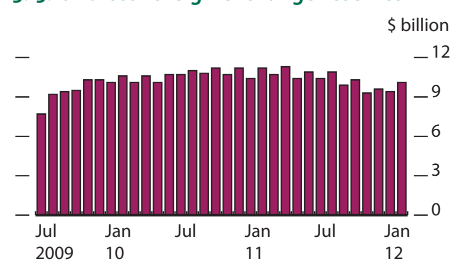
Sources: Bangladesh Bank. 2012. *Major Economic Indicators: Monthly Update*. February; *Annual Report 2010–2011*. http://www.bangladesh-bank.org

3.15.9 Current account balance



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

3.15.10 Gross foreign exchange reserves

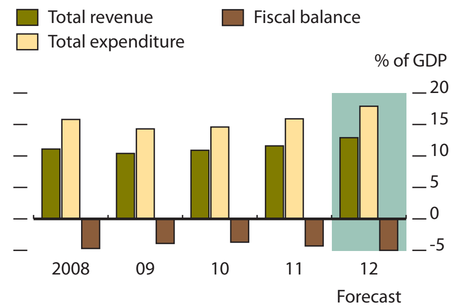


Source: Bangladesh Bank. 2012. Monthly Economic Trends. February. http://www.bangladesh-bank.org

The state-owned Bangladesh Petroleum Corporation is facing challenges in mobilizing foreign exchange to pay for its fuel import bill, which is projected to rise by more than half in FY2013. It has obtained a $2.5 billion loan from the Islamic Development Bank, but unless further timely adjustments in fuel prices are made, this loan will ultimately have to be repaid from budgetary resources.

The projections are subject to various downside risks. The global economic slowdown may be more severe than expected, while policy tightening could be compromised by political considerations: the government may find it politically costly to further raise fuel and electricity prices.

3.15.11 Government budget trends



Source: Asian Development Outlook database.

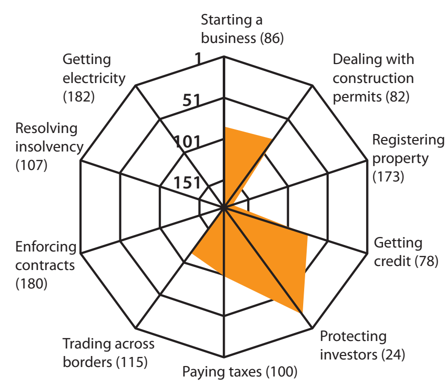
Policy challenge—strengthening growth policies

In the short term, Bangladesh needs to reduce its growing fiscal and external imbalances. It needs to cut subsidies by adjusting fuel and electricity prices, creating space for more—acutely needed—outlays on infrastructure and human development, and reducing the budget's excessive domestic borrowing. The effort to expand the economy's productive capacity will also require higher domestic revenue, which could be raised by strengthening tax reforms and attracting more concessional financing. Monetary policy tightening would need to continue to reduce inflation and eliminate pressure on reserves through reducing import demand. Exports need to be raised through broadening the export base and deepening access to new markets.

Over the long term, the government needs to substantially improve the business climate (Figure 3.15.12) in order to scale up private investment, including FDI, as highlighted in the World Bank's *Doing Business 2012*. As shown in the World Economic Forum's *Global Competitiveness Report 2011–12*, Bangladesh lags far behind other countries in South Asia in infrastructure (Table 3.15.2). To mobilize resources needed for closing these wide infrastructure gaps, greater private participation in infrastructure development, including public–private partnerships, is essential to supplement finite public resources. The capital market also needs to be developed as a source of long-term infrastructure financing.

Bangladesh has a raft of strategic advantages, including cheap labor and a location in a fast-growing region, which can help attract large FDI inflows into light industry. In several countries in Asia, labor costs are rising fast, opening up prospects for foreign investors to relocate investment to Bangladesh. To attract greater FDI, however, it is essential to remove infrastructure bottlenecks, make land readily available, upgrade skills of the labor force, and remove administrative delays and impediments.

3.15.12 How Bangladesh ranks on *Doing Business* indicators



Note: Numbers in parentheses show ranking out of 183 countries worldwide, 1 = best.

Source: The World Bank. Doing Business database. http://www.doingbusiness.org/data (accesssed 14 March 2012).

3.15.2 Comparison of infrastructure quality, 2011

	Country ranking[a]	Overall infrastructure	Electricity	Roads	Railroads	Ports	Air transport
		1 = extremely underdeveloped, 7 = extensive and efficient (by international standards)					
Bangladesh	129	2.8	1.6	2.9	2.5	3.4	3.5
China, People's Rep. of	69	4.2	5.5	4.4	4.6	4.5	4.6
India	86	3.8	3.1	3.4	4.4	3.9	4.7
Pakistan	109	3.5	2.2	3.7	2.8	4.1	4.3
Sri Lanka	48	4.7	5.0	4.5	3.8	4.9	4.9

[a] Ranking out of 142 countries, 1 = best.

Source: 2011 World Economic Forum, *The Global Competitiveness Report 2011–2012*.

Bhutan

After a solid year, the outlook remains favorable with growth staying robust, in part driven by the construction of large hydropower projects. Current account deficits will remain high, though, reflecting the projects' import requirements—but associated capital inflows are expected to keep the overall balance of payments in surplus. A main challenge for government is to implement policies that would rapidly expand private sector activity to boost job opportunities and broaden the country's economic base.

Economic performance

Growth is estimated to have moderated slightly to 8.3% in FY2011 (ended 30 June 2011) from 9.3% a year earlier (Figure 3.16.1). Reflecting the country's hydropower project cycle, the construction phase is under way on four large projects that would more than double power capacity, thus construction and manufacturing (cement mainly) are the main drivers of expansion. Electricity generation capacity has not risen since 2007, so power production provided little impetus to growth—sales to India rose by only about 4% during the year. Expansion in services eased solely on community services while the rest of the components remained robust.

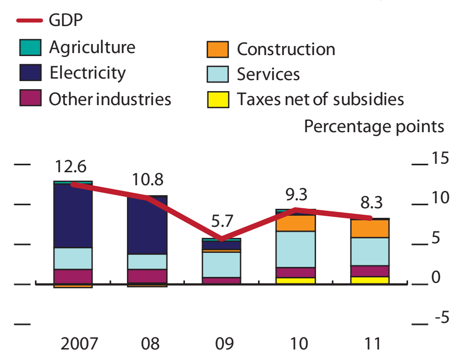
Agriculture has been unable to record significant growth in the past 7 fiscal years, and is gradually losing its overall share of output, because it is hard to provide development services to raise productivity to the many small villages in the remote mountainous parts of the country.

Broad money (M2) growth moderated—along with the economy—to 21.2% in FY2011, mainly due to small expansion in net foreign assets. Private sector credit grew 31.9% in FY2011, broadly in line with its long-term average of 32%, concentrated in housing and construction and in personal loans. The ratio of nonperforming loans declined to 8.5% at end-FY2011 from 10.2% a year earlier.

Local price movements continue to follow India's because Bhutan's currency is pegged to India's and because the country keeps strong trading ties with its giant neighbor (taking about 90% of exports and providing 75% of imports). Bhutan's average inflation, therefore, rose to 8.6% in FY2011, almost twice the FY2010 rate. (Food prices rose by 9.3% and nonfood prices by 8.0%—Figure 3.16.2.)

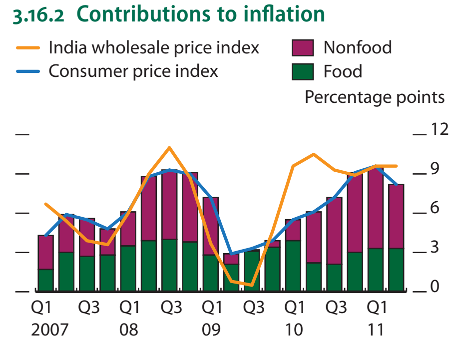
The government revenue-to-GDP ratio fell to 39.1% in FY2011 from 46.4% a year earlier as nontax revenue growth slowed (Figure 3.16.3). Expenditures (43.8% of GDP) rose by 14.4% in FY2011 on the back of rising capital expenditures reflecting hydropower construction and a pay hike for public servants from January 2011. The fiscal deficit was 4.7% of GDP in FY2011 (from a surplus equivalent to 1.6% of GDP in FY2010) and was financed mostly from domestic borrowing.

3.16.1 Contributions to growth (supply)



Source: National Statistics Bureau. 2011. *National Accounts Statistics 2010*. http://www.nsb.gov.bt

3.16.2 Contributions to inflation



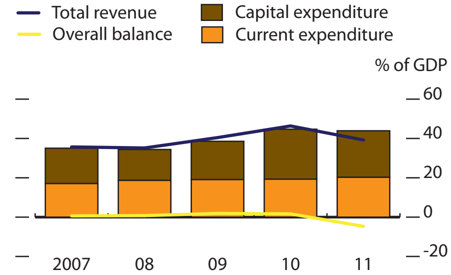
Source: Royal Monetary Authority of Bhutan. 2011. *Selected Economic Indicators*. June. http://www.rma.org.bt

This chapter was written by Jeffry Kongoasa and Ruzette Mariano of the South Asia Department, ADB, Manila.

According to the Royal Monetary Authority (RMA), public external debt amounted to 76.2% of GDP at end-FY2011. By currency, nearly three-fifths was in Indian rupees; by use, just over two-fifths of the total had been allotted for hydropower loans and the balance for development projects.

Even though the current account deficit widened from 9.9% of GDP in FY2010 to about 20.6% in FY2011 as trade deficit widened from 20.9% of GDP to 30.2%, the overall balance of payments recorded a sizable surplus equivalent to 5.7% of GDP as loans and capital grants more than compensated for the current account deficit (Figure 3.16.4). However, Bhutan's external position with India has weakened greatly because export growth to it has slowed, given that power sales have reached generation capacity and that import demand has accelerated because of the power construction program and strong economic growth. At end-FY2011 Bhutan's rupee reserves amounted to about one week of imports, although convertible currency reserves were high at nearly $890 million, equivalent to about 9 months of total (essential and inessential) imports (Figure 3.16.5).

3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. http://www.rma.org.bt

Economic prospects

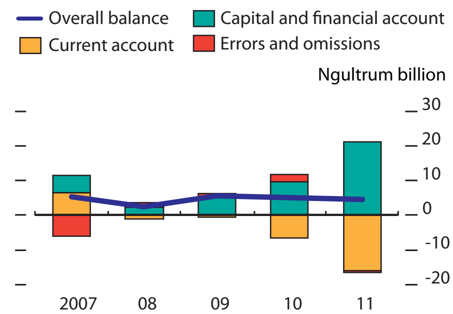
Growth is forecast at 8.0% for FY2012 and 8.5% for FY2013 largely on the account of continued hydropower construction. The FY2012 budget will continue to support high growth with total planned expenditure to increase by about 11%. More than half the budget is allocated to capital expenditure, which rises by about 13%, with about two-thirds of it financed by grants. Current expenditure is slated to grow by 9%, mainly on account of public servants' salary revisions and higher operations and maintenance expenses. The overall deficit is projected to rise to 6% of GDP.

Inflation is expected to moderate to 7.3% in FY2012 and 6.5% in FY2013, broadly in line with assumed price developments in India. The *Asian Development Outlook* baseline forecast of relative stable global oil and food prices underpins a favorable outlook.

The current account deficit is projected to stay high at 20.0% and 22.2% of GDP in FY2012 and FY2013, mainly owing to continued high imports for power plant construction. The overall balance of payments is expected to remain in surplus reflecting continued substantial project loans and capital grants. The tight overall balance with India is not expected to improve and pressures on rupee liquidity will persist.

In recent years the RMA has borrowed through an overdraft facility (at relatively steep rates) with the State Bank of India and through a credit line with the government of India to keep an adequate working balance. Its borrowing from the overdraft exceeded Rs8 billion as well as reaching the Rs3 billion credit line limit with the government before end-2011. The RMA sold $200 million of its convertible currency reserves in November 2011 to eliminate this expensive overdraft and to partly pay other rupee debt. However, liquidity pressures caused the RMA in March 2012 to clamp down on import spending and to restrict the use of reserves to importing priority items, including fuel. Because Bhutan's constitution requires foreign reserves to provide 12 months of cover for essential imports and they are about at this level, there is limited scope to sell additional reserves. To avoid disrupting the economy, the RMA is, therefore, expected by

3.16.4 Balance-of-payments indicators



Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. http://www.rma.org.bt

3.16.5 Gross international reserves

Source: Royal Monetary Authority. 2012. *Annual Report FY2011*. http://www.rma.org.bt

April 2012 to negotiate a higher ceiling on the credit line with the Indian government and, possibly, carry out a currency swap arrangement through the facilitation of the SAARCFINANCE. Power exports from the plants under construction will, of course, provide an enduring solution.

The RMA and the Reserve Bank of India are working to establish guidelines to create a base-rate system for Bhutanese financial institutions, expected to come in this fiscal year, which would make loan pricing more transparent and foster competition in the sector. This is a precursor to the RMA's carrying out monetary policy by setting policy rates, a change that would be a more effective mechanism for monetary policy.

3.16.1 Selected economic indicators (%)

	2012	2013
GDP growth	8.0	8.5
Inflation	7.3	6.5
Current account balance (share of GDP)	-20.0	-22.2

Source: ADB estimates.

Policy challenge—broadening the economic base

The private sector needs to expand to tackle rising unemployment. The unemployment rate has averaged 3.5% in the last 3 years, well above the government target of 2.5% set for 2013. Unemployment is an especially serious problem among those aged 15 to 24 years—over 45% of the unemployed, this group has a 9.4% jobless rate (Figure 3.16.6). This stems from limited job openings and deficiencies in labor skills necessary for employability in various sectors. The government is the employer of choice especially among the young but the absorptive capacity of the public sector to hire more staff is nearing saturation. Hydropower—the industrial mainstay—offers very few jobs.

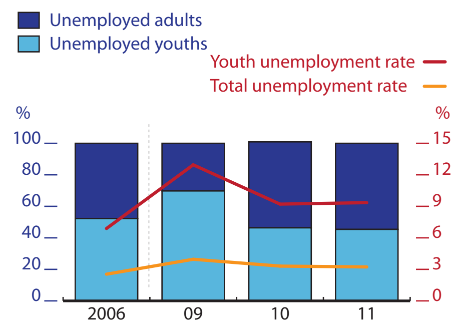
The government recognizes the problem. Its Economic Development Policy, issued in 2010, specified fiscal incentives to attract foreign direct investment (FDI). It has, therefore, drafted new FDI regulations that include clearer provisions for owning land as well as liberalizing other features of current regulations. The policy also identified niche business opportunities for cottage and small industries and tourism, where the government believes it can promote local entrepreneurship.

The government has identified the information and communication technology industry as a promising niche sector. The country's first park for this, the Thimpu Techpark, was inaugurated in 2011 and is expected to attract FDI and provide some high-skilled jobs. The industry is, however, still at a very early stage.

According to the World Bank's 2010 *Bhutan Investment Climate Assessment Report*, the top constraint for small firms is access to finance. In an effort to ease it, the government has recently adopted expanded microfinance policies, including subsidized interest rates, new credit products suitable for small firms, and incentives for socially and environmentally friendly lending.

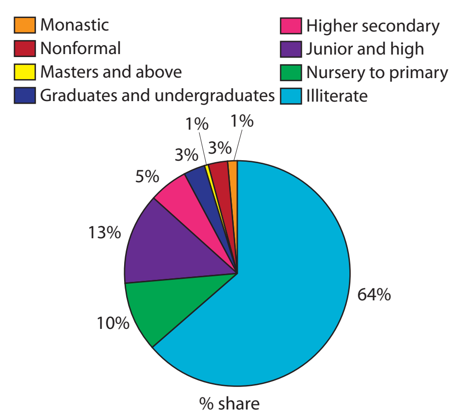
The same report notes that the major constraint for large firms is inadequate education. The 2011 Labor Force Survey Report noted that only 6% of the work force has received higher secondary education (and 3% has tertiary education) (Figure 3.16.7). The government has introduced competency-based training programs for five trades, namely, auto-mechanics, construction carpentry, plumbing, masonry, and industrial electrical. It has also launched a grant program to train tertiary graduates working in the private sector. Other constraints faced by large firms include the difficulty in hiring foreign workers, transport difficulties, high tax rates, and restrictive labor regulations.

3.16.6 Unemployment



Source: Ministry of Labour and Human Resources. 2011. *Labour Force Survey Report*. http://www.molhr.gov.bt

3.16.7 Education level of employed persons, 2011



Source: Ministry of Labour and Human Resources. 2011. *Labour Force Survey Report*. http://www.molhr.gov.bt

India

GDP growth slowed markedly in FY2011 as industrial and investment activity slumped and the current account deficit widened. A combination of tight monetary policy to counter persistently high inflation, strained global economic conditions, larger subsidies that pushed up the budget deficit, and lack of political consensus on resolving the policy impediments to growth were factors in the downdraft. Boosting investment and growth to match the strong performance of recent years will hinge on reaching agreement on measures to deal with long-standing and challenging policy issues. The outlook is for a moderate pickup.

Economic performance

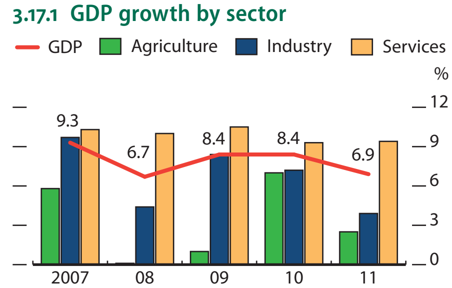
Economic growth fell to 6.9% in FY2011 (ended 31 March 2012) from 8.4% in FY2010 according to the government's advance estimates. The pace slowed as the year progressed (Figure 3.17.1). The slowdown was concentrated in industry and driven by slumping investment activity, falling exports in the latter months, and attendant weakening in consumer spending.

Investment growth recovered quickly from its low point in the depths of the global financial crisis, although the trend reversed once more to a marked decline over the past 2 fiscal years (Figure 3.17.2). Notably, in the first 3 quarters of FY2011, fixed investment is estimated to have fallen by 0.25% from the corresponding period a year earlier, although the government's advance estimates of GDP for the full fiscal year show an increase of 5.6%.

However the final data for the year turn out, the downward trend is evident—as is the need to reverse it to get the country back on its recent-year high growth path. The causes of investment's sharp deceleration are multiple, including the slump in the global economy and trade, tighter monetary policy and higher nominal interest rates (to combat persistent high inflation), a larger than expected budget deficit in FY2011 (adding to uncertainty over the direction of the economy), and a growing sense of a national policy paralysis (due to political parties' inability to agree on certain issues, including structural measures).

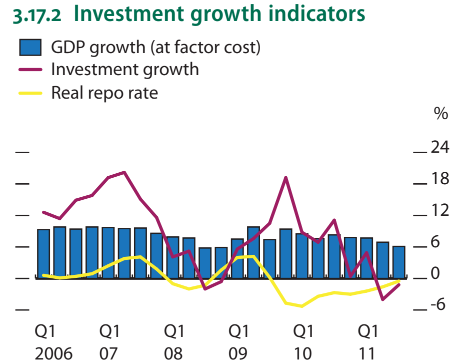
Industrial growth dropped to a decade-low 3.9%. Slumping investment took its toll: manufacturing growth fell by half to 3.9%, largely reflecting weak capital goods output, and construction growth fell to 4.8% from 8.0% a year earlier. In industry, mining contracted by 2.2%, partly due to uncertainty over land and environmental clearances. Coal production continued its slowing-growth trend of recent years, shrinking by 1.5%. The controlling state monopoly is unable to ramp up production to meet rapidly growing demand from new power plants, thereby increasing reliance on more costly imports. Natural gas production fell by 8.8%, owing to technical problems at a large new field and pricing issues.

3.17.1 GDP growth by sector



Source: Ministry of Statistics and Programme Implementation.

3.17.2 Investment growth indicators



Source: CEIC Data Company (accessed 24 March 2012).

This chapter was written by Abhijit Sen Gupta of the India Resident Mission, ADB, New Delhi.

On a brighter note, services continued to grow rapidly, at 9.4%, accounting for nearly 80% of overall GDP growth and reflecting continued strong performance in trade, hotels, transport, communications, and financial services. With good monsoons, rice and wheat production is estimated to have hit records. Agriculture's 2.5% expansion was low compared with the previous year's weather-related 7.0% recovery, but still came in close to trend (3%).

Inflation, which persisted at 9.5–10% through most of FY2011 despite earlier rounds of monetary tightening, eased to 7.0% by February 2012 (Figure 3.17.3). This moderation largely reflected a drop in food prices. A proxy for the core rate, nonfood manufactured goods inflation remained at around 8% then fell to 5.5% in February 2012. Since monetary tightening aimed to stabilize this measure, the central bank has seen progress in bringing it down to its historical average of 4%, consistent with maintaining stable inflationary expectations.

After 13 consecutive policy rate hikes since March 2010, the Reserve Bank of India (RBI) left rates on hold at its December 2011 and February 2012 policy review meetings (Figure 3.17.4). With progress on slowing nonfood inflation, as of late-March 2012 it was expected to relax monetary policy for the new fiscal year when the deficit-reduction measures announced in the FY2012 budget in mid-March are passed by Parliament.

Credit growth moderated in FY2011 across a broad spectrum of activities, reflecting slowing economic activity, monetary tightening, and banks' risk aversion. Asset quality of banks deteriorated moderately due to weaker business conditions.

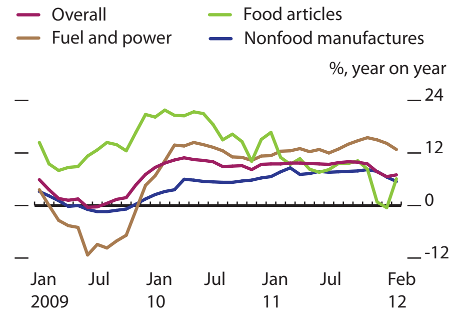
The RBI deregulated the savings deposit rate—allowing banks to set differential interest rates on savings deposits over a minimum amount—and, to a large degree, interest rates on the various nonresident Indian deposit facilities.

A revenue shortfall and expenditure overshoot, relative to target, pushed the central government budget deficit to an estimated 5.9% of GDP in FY2011, as against the 4.6% budget target. Revenue was down by 3.3% from the previous year when it was bolstered by large receipts from auctions of third-generation telecommunications spectrum. It was also 5.7% short of target, about equally due to a shortfall in the planned sale of government-held stock in public sector corporations because of weak stock market conditions and to the economic slowdown denting tax collections.

Expenditure grew by 10.1% in FY2011 and was nearly 5% above the budget target, mainly owing to greater subsidies. Higher global prices and a weaker currency led to an increase in fuel (190%) and fertilizer (34%) subsidies, while higher minimum agricultural support prices helped raise the cost of food subsidies (20%) over the budget targets. All these subsidies amounted to 2.3% of GDP in FY2011.

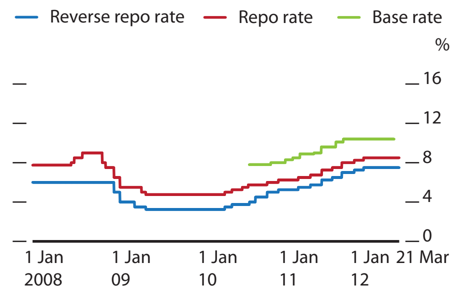
The current account deficit widened to an estimated 3.6% of GDP (Figure 3.17.5). The very rapid growth in exports in the first half of FY2011 was not sustained in the second owing to slowing demand from advanced economies, restricting growth to 21.0% at $303 billion. Higher commodity prices and an increase in import volume, including large imports of gold, generated a 24.0% rise in imports to $473 billion, expanding the trade deficit to 9.1% of GDP (from 7.6% in FY2010), partly offset by a strong services trade surplus and larger remittances.

3.17.3 Wholesale price index



Source: Ministry of Industry and Commerce.

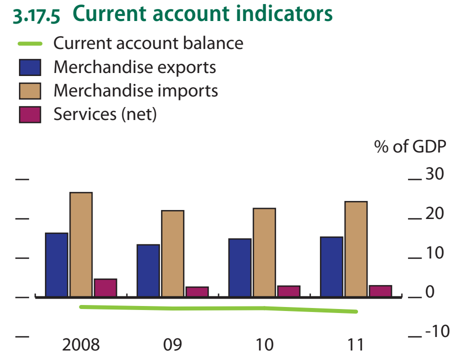
3.17.4 Policy interest rates



Note: The base rate was adopted to provide an accurate indicator of the minimum rates charged to prime borrowers.

Sources: CEIC Data Company (accessed 27 March 2012); ADB estimates.

3.17.5 Current account indicators

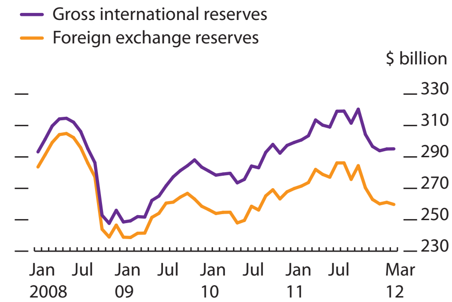


Source: Reserve Bank of India.

The heavy current account deficit was mostly financed by financial inflows. With concerns over sovereign debt and fiscal prospects in the United States and eurozone, net portfolio inflows were slight for much of the year but picked up after November to reach an estimated $15 billion in FY2011, about half that of a year earlier. Improved foreign direct investment (FDI) and larger commercial borrowing and bank loans by the private sector rounded out the financing.

Official gross international reserves fell by about $10 billion (to about $295 billion), mainly in the latter months of the year (Figure 3.17.6) on intervention by the RBI to prevent excessive downward drift (and volatility) in the exchange rate. Over FY2011, the rupee depreciated by about 12% against the US dollar; the real effective exchange rate weakened by about 4% (Figure 3.17.7). Stock market prices drifted lower for most of FY2011 and then strengthened in early 2012, helped by a marked increase in portfolio investment. Nevertheless, the BSE Sensex was down about 10% in FY2011.

3.17.6 International reserves



Note: Gross international reserves include gold and special drawing rights.

Source: Reserve Bank of India. http://www.rbi.org.in (accessed 27 March 2012).

Economic prospects

Investment is likely to remain lackluster for some time because new project announcements continued to decline during the third quarter of FY2011 (Figure 3.17.8). Data on planned capital spending from the Centre for Monitoring Indian Economy also point toward a sharp increase in the number of stalled projects, reflecting a host of structural bottlenecks related to fuel and power shortages, delays in environmental clearance, and other policy hurdles.

Business sentiment has deteriorated on various indicators in the RBI's Business Expectation Index (Figure 3.17.9), and in similar surveys conducted by chambers of commerce. On balance, these business indicators suggest that investment will remain subdued in FY2012.

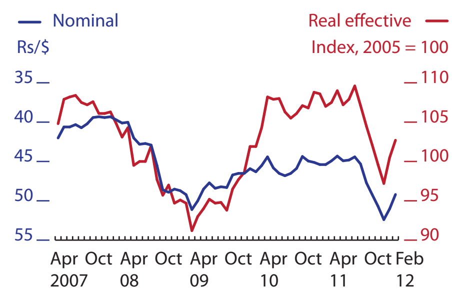
The impact of monetary easing and lower interest rates, improving external conditions, and some progress on stalled reforms and removal of the bottlenecks should lead to a revival of industrial activity starting in the second half of FY2012 and into FY2013. But their effect is likely to be limited until the government eliminates the policy issues. Recent steps, such as increasing the pace of road building as well as fast-track clearances for coal and power projects, are encouraging, though many other issues remain in the wings.

A normal monsoon would help agriculture expand at its trend rate (around 3%), in turn bolstering rural incomes and private consumption. The services sector, which has so far been resilient to the domestic slowdown, is expected to maintain its solid growth, supported by robust trends in private consumption spending and in urbanization. The global slowdown is, however, likely to trim growth in software and business services.

Based on assumptions for growth in industrial countries and oil prices, as well as expected moves toward monetary easing coupled with budget deficit reduction, GDP growth in FY2012 is forecast to nudge up to 7.0%. Recovery in the global economy and resolution of some of the structural bottlenecks are expected to increase GDP growth to 7.5% in FY2013.

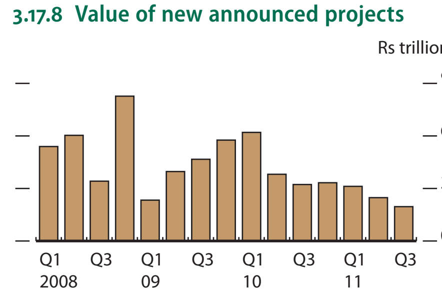
Sustaining the progress against inflation in FY2012 depends on macroeconomic policies and structural reforms. Much of the past

3.17.7 Exchange rates



Source: CEIC Data Company (accessed 27 March 2012).

3.17.8 Value of new announced projects



Source: Centre for Monitoring Indian Economy. 2011. *Monthly Review of the Indian Economy*. March.

2 years' inflation stemmed from increases in the prices of high-protein foods, fruits, and vegetables rather than foodgrains. With rising incomes, demand has increased faster than supply for these, thus agricultural policies will need to be directed to improving the efficiency of the regulatory, production, and distribution systems. There is also considerable suppressed inflation, as the administered prices of diesel, kerosene, and liquefied petroleum gas—significantly below global oil prices—require heavy budget subsidies. Adjusting domestic prices will push up inflation but is necessary to align fiscal policy with the needs of expanding infrastructure investment.

Inflation is expected to continue to decline in FY2012 due to the strong base effect, normal monsoons in FY2011, weakening global commodity prices, and lagged impact of monetary policy on expectations suppressing demand-side inflation. Consequently, inflation is expected to ease to 7.0% in FY2012. The rate in FY2013 will depend on tackling structural food price pressures and the extent of fiscal consolidation, as FY2013 is a pre-election year. An easing of crude oil prices and supply-side bottlenecks is likely to contribute to inflation falling further to 6.5% in FY2013.

Increasing tax rates, widening the tax net, and capping the subsidy bill are expected to reduce the fiscal deficit to 5.1% of GDP in FY2012, signaling a return to fiscal consolidation (Figure 3.17.10). The increase in excise duty and service tax from 10% to 12% as well as the introduction of a negative list for the service tax is expected to take revenue growth to 23%. However, the actual realization of revenue from asset sales, such as disinvestment of publicly owned companies and auction of telecom spectrum, which are expected to generate 0.7% of GDP, will crucially depend on market conditions.

The budget has expenditure rising moderately by 13.1% and subsidies falling by 12.2%—fuel's by 36.3% (Figure 3.17.11). These targets seem optimistic, given elevated oil prices and the limited pass-through to domestic retail prices.

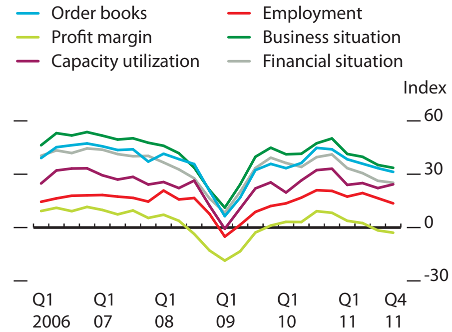
Still-high global oil prices and softening external demand will continue to exert pressure on the current account deficit in FY2012. However, sluggish investment and industrial activity will help damp non-oil import growth. Moreover, gold imports, which boosted imports in FY2011, are expected to be trimmed by a higher tax this year. Overall, imports are expected to grow by 15% in FY2012.

Moderation of growth in the advanced economies will adversely impact exports as well as receipts on account of software and business services. Export growth is forecast to slip to 14.0% in FY2012. Remittances are expected to show strong growth as banks are now free to set rates in response to market forces. The current account deficit is forecast to improve marginally to 3.3% of GDP in FY2012.

Improved economic prospects in the advanced economies are expected to boost export growth to 19.0% in FY2013. At the same time, an uptick in domestic growth will increase import demand, leading to imports growing by 18.0%. Strengthening economic activity in the advanced countries is seen encouraging services exports, leading to the current account deficit moderating to 3.0% of GDP in FY2013.

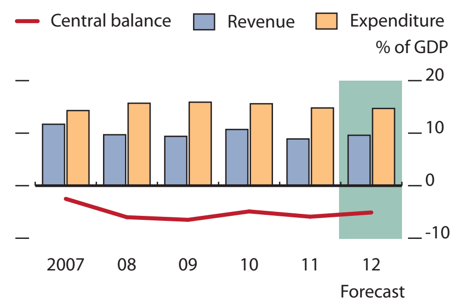
Portfolio investment is expected to be relatively volatile, and be influenced by the extent of investor risk aversion, global liquidity, and

3.17.9 Industrial outlook survey



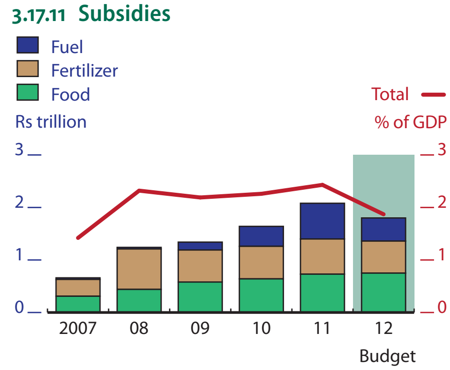
Source: Reserve Bank of India. http://www.rbi.org.in (accessed 20 March 2012).

3.17.10 Central government budget indicators



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 18 March 2012).

3.17.11 Subsidies



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 18 March 2012).

improvement in domestic fundamentals. FDI is likely to increase only modestly; however, external borrowings are set to remain healthy given the interest rate differential with advanced economies. The current account deficit is expected to be financed by capital flows.

The above forecasts are subject to a number of risks. The global environment remains fragile and a worsening of the situation in the eurozone would have a significant adverse impact. A poor monsoon, fiscal slippage, or a continued policy logjam to resolve some of the long-standing issues would also prove detrimental to growth.

3.17.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.0	7.5
Inflation	7.0	6.5
Current account balance (share of GDP)	-3.3	-3.0

Source: ADB estimates.

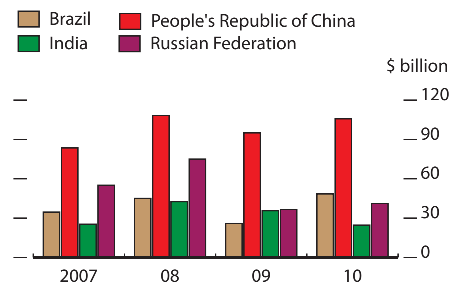
Policy challenge—attracting FDI

In view of the large investment needs of the economy, especially infrastructure, a reasonable current account deficit is appropriate, notwithstanding India's high savings rate. The government's clear preference is for the deficit to be financed by equity flows rather than debt flows and for FDI over volatile portfolio flows.

FDI has increased in recent years from the 1990s' negligible levels, but remains small relative to comparable destinations: according to UNCTAD's *World Investment Report 2011*, in 2010 it came to only $24.6 billion, compared with $105.7 billion for the People's Republic of China, $48.4 billion for Brazil, and $41.2 billion for the Russian Federation (Figure 3.17.12).

A key issue confronting FDI is acquisition of land for economic activity as it involves a number of complex issues. These include use of agricultural land for nonagricultural purposes, adequate compensation, displacement of people—including indigenous tribal populations—and the dichotomy between state and center laws, which in many cases has impeded investment. The Land Acquisition, Rehabilitation and Resettlement Bill, introduced in Parliament in 2011, addresses some of these issues, although reaching a consensus among the various stakeholders is likely to be arduous.

3.17.12 FDI inflows



Source: United Nations Conference on Trade and Development. *World Investment Report 2011*.

Environmental issues such as high ecological costs and concerns about tribal rights have held up some foreign projects. In mining, for example, securing licenses and clearances has become contentious, given that most mineral deposits are in forested areas, home to the country's indigenous tribes. The draft Mining and Minerals Development and Regulation Bill is deemed by the industry as taxing it too heavily. Similarly, government initiatives, like guidelines for the Comprehensive Environmental Pollution Index and demarcation of stretches of ecologically sensitive coastline, need to ensure that they do not deter investment in critical sectors.

Certain elements of labor laws deter investment, and need to be revisited if India is to attract FDI into labor-intensive manufacturing. The need for labor market reforms has been long recognized by policy makers but the issue is highly fraught, lacking the necessary political support for change. Weak infrastructure, especially in the areas of transport, power, and education and training, has also reduced India's attractiveness to FDI.

Finally, inconsistent policy making can also damp investor confidence by raising transaction costs and uncertainty about the business environment. Reducing the number of clearances and introducing single-window nodal agencies can help to remove regulatory hurdles and fast-track projects.

Maldives

The economy grew fast in 2011 owing to continued strong growth in mainly Asia-sourced tourism, but still has to grapple with hefty fiscal and external imbalances. A devaluation of the local currency in April 2011 should help, over the longer term, counter dollar shortages, though it has pushed inflation higher. The resignation of the president in February 2012—succeeded by the vice president, from the opposition—was met with unrest and has raised uncertainty for the outlook. The impact on tourism, however, is expected to be limited.

Economic performance

The economy grew by 7.5% in 2011, supported by continued buoyant growth in tourism and related sectors such as construction, transport, and communications (Figure 3.18.1). Tourism, accounting for about 30% of GDP, saw a second year of strong recovery with arrivals up by 17.6% (Figure 3.18.2). An influx of visitors from the Peoples' Republic of China (up by 67%) and elsewhere in Asia (up 13%) again drove the expansion, while growth of European tourists slowed to 6%. Asian visitors now make up a third of the market.

Fisheries, the main source of employment in the outer atolls, has steadily declined from its peak in 2006. The total catch declined by about 5% in 2011, although the value of fish exports posted a strong gain on increases in price and volume of sales. The volume of the fish catch is not expected to improve, given the continued decline of fish resources in the Indian Ocean.

Inflation in 2011 moved to double digits, reflecting a steep rise in prices of fish, a staple, and increases in global food and oil prices, exacerbated by a 16% devaluation of the local currency against the US dollar (Figure 3.18.3).

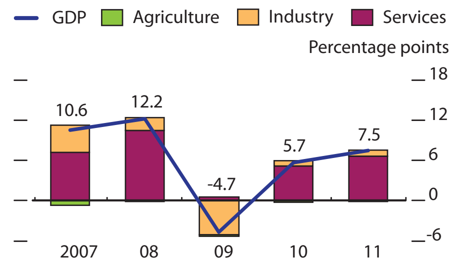
The budget deficit improved substantially to 10.2% of GDP (16.1% in 2010). Although further tax reform was delayed, the Tourist General Service Tax (T-GST) that came into effect during the year helped lift revenue by 38.9%. Growth in expenditure was kept to 12.4% in line with the expansion in nominal GDP, holding expenditure to just over 40% of GDP.

Broad money supply (M2) increased by about 20%, driven by the rise of government claims and expansion of private sector credits. Credit to the private sector grew by 6%, largely owing to an increase in wholesale and retail trade and investment in resort development.

The current account deficit is estimated to have widened to $647 million (31.9% of GDP) from $463 million the previous year, reflecting the economic recovery, much higher commodity prices, and

This chapter was written by Huiping Huang of the South Asia Department, ADB, Manila.

3.18.1 Contributions to growth (supply)



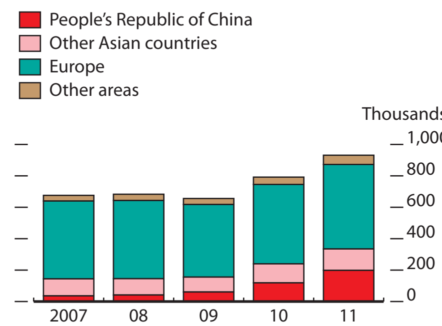
Source: Maldives Monetary Authority. 2012. *Monthly Statistics*. February. http://www.mma.gov.mv

3.18.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.5	4.5
Inflation	4.5	7.5
Current account balance (share of GDP)	-38.0	-38.0

Source: ADB estimates.

3.18.2 Tourist arrivals



Source: Maldives Monetary Authority. 2012. *Monthly Statistics*. February. http://www.mma.gov.mv improved tourism receipts. Preliminary estimates indicate that financing fell short of the deficit and gross international reserves went down by about $15 million to $335 million.

Economic prospects

The economic outlook is of course tightly interwoven with developments in tourism. The political instability and unrest in the capital Malé and other atolls in early 2012, which were widely reported in the foreign media, caused some cancellations and will likely hold back the growth in bookings in 2012. Still, the Maldives has an established reputation as a high-quality destination and has traditionally strong marketing links with Europe and demand is fast growing among Asia's increasingly affluent middle class.

Assuming no major incidents of unrest in the lead-up to the presidential election (the date has yet to be set) tourism should stay robust. With the outlook underpinned by a sizable expansion in government expenditure, economic growth is expected to moderate to 3.5% in 2012 and then pick up to 4.5% in 2013.

The budget deficit for 2012 is set to ease slightly, but remains heavy at 9.7% of GDP. Total budget revenue in 2012 is expected to rise substantially despite reduced import tariff rates provided in the 2012 budget. Large deficits have been financed both domestically, mainly by issuance of Treasury bills and privatization of state-owned assets over the past several years, and externally by borrowings. But the privatizing approach is reaching a limit, and Treasury-bill financing cannot be sustained in the long term.

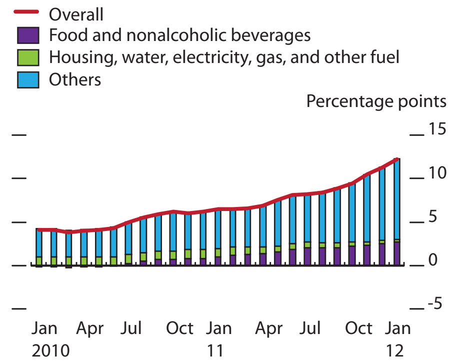
A more immediate complication for the budget is that already-programmed multilateral financing could be postponed due to the delays in completing the program because of unmet performance criteria. The GST Act that was approved by Parliament had a lower T-GST rate for 2013 and beyond.

On the expenditure side, the second phase of the redundancy plan of further downsizing the civil service will be difficult to implement in 2012 due to political conditions.

Inflation is expected to moderate in 2012 and then move higher in 2013 on domestic demand pressures, pacing global commodity prices. Pressure from the persistently large fiscal deficit remains, though tightening of monetary policy will be partly offsetting.

With likely slower growth in tourist arrivals, earnings are expected to moderate. Slower growth and an expected modest fall in global oil prices will ease the import bill a little, although the current account deficit will widen and as a share of GDP climb to about 38.0% in 2012 and 2013.

3.18.3 Contributions to inflation in Malé



Source: Maldives Monetary Authority. 2012. *Monthly Statistics*. February. http://www.mma.gov.mv

3.18.1 Policy challenge—reducing the budget deficit

Since 2009, the government has sought to implement an economic program aimed at reducing the large fiscal deficit, but with Parliament and presidency in the hands of different political parties, progress has been slow.

It looks set to remain that way in the medium term, too, because, although an initial voluntary redundancy plan for government staff and the first phase of a detailed plan for staff reduction has been carried out, the second phase (or raising taxes) faces strong political resistance.

Expanding the tax base could be one outcome of creating regional economic and commercial centers in larger islands outside Malé, with the right policy incentives for population consolidation.

Such moves would also help diversify the economy from tourism—four-fifths of the economy is directly or indirectly related to the industry—and create a more inclusive growth model other than expanding resorts.

The new centers could help bring forward myriad opportunities for trade, construction, and transport, and creating jobs for locals (tourism relies heavily on expatriate workers).

Nepal

Growth slowed in FY2011 on weaker remittance inflows, a downdraft in real estate, fuel and power shortages, and continued political uncertainty. Inflation stayed hovering around the double-digit threshold, and the banking system came under stress. The outlook is for a modest pickup in growth but with some progress in bringing down inflation. Timely completion of the peace process, including an agreement on a federal structure and on a new constitution, would allow political leaders to focus on spurring growth and development.

Economic performance

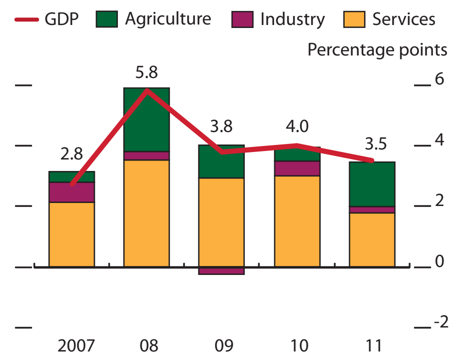
Economic growth dipped to 3.5% in FY2011 (ended 15 July 2011), restrained by slower growth in the worker remittances that underpin consumer spending, a deep correction in the real estate market, and continued political uncertainties (Figure 3.19.1). Expansion in services slowed sharply on hesitant consumer spending and a marked decline in tourism receipts. Industrial growth fell by half, reflecting severe fuel and electricity shortages, weak construction, and the closure of several manufacturing plants owing to labor–management disputes. Favorable weather allowed agricultural output to rebound, but the gain was too little to prevent overall GDP growth from slowing.

Inflation was high in FY2009–2011, broadly mirroring price developments in India, with which Nepal has a pegged exchange rate arrangement and tight trade links (Figure 3.19.2). Escalating food prices were the main driver in the first half of the year and, as these moderated in the second half, nonfood prices picked up, partly because of increases in fuel prices by the Nepal Oil Corporation, the state-owned monopoly supplier. Prices were adjusted several times (political pressure reversed two of the increases), but were inadequate to prevent either a buildup of arrears with the India Oil Corporation or supply disruptions, which led to frequent fuel shortages and transport strikes.

The budget deficit widened from 1.9% to 2.4% of GDP in FY2011: capital spending picked up, marking the government's moves to improve project implementation, and revenue fell short of target. Revenue collection as a share of GDP fell for a second year, mainly because of sharply weaker growth of customs receipts and value-added tax (VAT) (Figure 3.19.3), damped by stagnant non-oil imports and slow growth in private consumption (a key source of VAT). The deficit was financed mainly by borrowing from banks.

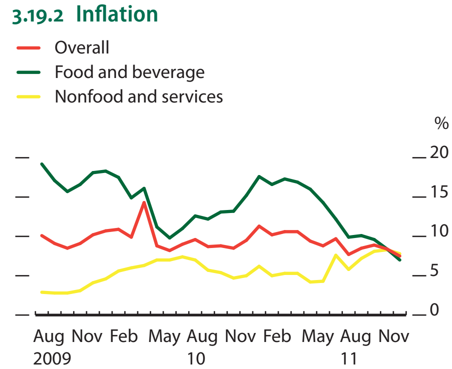
Nepal Rastra Bank, the central bank, focused much of its effort in FY2011 on managing vulnerabilities in the financial sector. In recent years a growing number of small financial institutions have aggressively

3.19.1 Contributions to growth (supply)



Source: Ministry of Finance. 2012. *Mid-term Review of the FY2011-12 Budget*.

3.19.2 Inflation



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

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

attracted deposits from commercial banks to expand their lending, especially for real estate. As market prices of property have fallen heavily, the share of nonperforming loans has increased throughout the financial system, and several small institutions required emergency assistance. Balance-sheet problems at banks coupled with too few attractive lending opportunities ensured slow growth in credit to the private sector, despite abundant bank liquidity that pushed the interbank rate down (Figure 3.19.4).

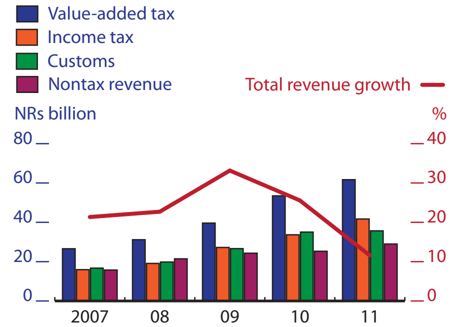
With about half the banking system's credit collateralized by property, the central bank is encouraging bank consolidation through incentives (it has approved six merger deals and is reviewing another six) and intends to use other measures to assist banks through a troublesome period.

The current account deficit slimmed to 0.9% of GDP in FY2011 after widening to 2.7% of GDP a year earlier. Exports, having declined in FY2010, grew by 11.7%, thanks to a rebound in the growth of traditional exports such as carpets and pashmina (Figure 3.19.5), items that mainly go to countries other than India.

Apart from the slower worker remittances—possibly affected by the unsettled times in the main employment destination of the Middle East—a key hindrance to greater improvement in the current account was the higher oil import bill, as non-oil imports were essentially unchanged from a year earlier. The Nepal Tourism Year 2011 campaign did attract tourists over and above the usual numbers, but as most were budget tourists from neighboring countries earnings fell by nearly 10% from a year earlier.

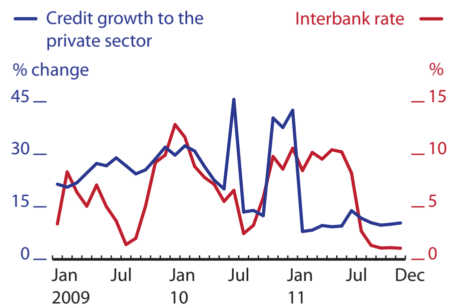
Net capital inflows more than covered the current deficit and gross international reserves increased to $3.5 billion in December 2011 (Figure 3.19.6).

3.19.3 Revenue indicators



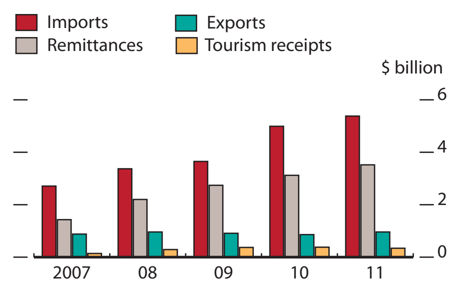
Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.4 Credit to private sector and interbank rate



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

Economic prospects

Economic performance in the forecast period depends primarily on how the political situation evolves. Timely completion of the peace process, including a draft of the constitution ready by the 31 May deadline, will help spur growth, but will require an agreement on federal restructuring—one of the main contentious issues in the peace process. Such closure could allow political leaders to refocus on the economic agenda, paving the way for measures ushering in much-needed private participation in development, boosting business confidence, and improving labor relations. It would also allow them to pursue policies in the Immediate Action Plan for Economic Development and Prosperity, announced in January 2012.

Assuming that the peace process shows success—and that the weather is normal—GDP is projected to grow by 4.5% in FY2012. The improvement from a year earlier will come from faster growth in agriculture and services. Strengthening remittances and rebounding tourism earnings (foreshadowed in the early months of the fiscal year) will buttress services. Industry is notable by its absence as a growth driver: with no improvement expected in power supply, its performance will remain sluggish.

GDP growth will slow to 4.0% in FY2013, around the speed limit for an economy inhibited by long-standing structural bottlenecks and policy distortions that can be addressed only gradually. Agriculture's expansion in FY2011 and FY2012 reflects a recovery (from earlier poor weather) that provided a fillip to growth in the sector and to GDP, but that upturn masks deep-seated problems in raising low productivity and growth to the sector's higher potential.

Inflation gently declined in the first half of FY2012, pointing to an annual average of 8.0%. Food inflation is benefiting from better harvests as well as mitigated global price pressures. The high base effect of the previous year and supportive monetary policies will also keep price rises down. Despite pressures from needed upward revisions in fuel prices, inflation is expected to ease to 7.0% in FY2013, broadly in line with India's.

On the monetary side, the central bank will maintain its focus on encouraging financial sector consolidation, reforming poorly performing banks, enhancing financial inclusion, and strengthening its own supervisory capacity. Managing commercial banks' liquidity will remain tricky, given the need to strike a balance between containing inflation and supporting growth (for the latter, the central bank has directed commercial banks to increase lending to agriculture and energy).

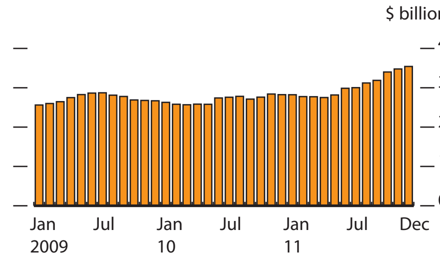
The trade deficit will widen over the next 2 years, with faster growth in imports than exports spurred by sustained high oil prices, and by a rise in non-oil imports. Yet the current account is projected to move to a surplus of 0.5% of GDP in FY2012 and to 1.0% of GDP in FY2013 owing to stronger remittances and tourism receipts. Remittances will accelerate because of the high number of out-migrants in FY2011 and wage increments in destination countries; tourism receipts are on the rise, apparently reflecting the delayed impact of the Visit Nepal Year 2011 campaign.

The FY2012 budget, which was announced on time for the first time since the Constituent Assembly elections in 2008, targeted growth in revenue and expenditure of 19% and 25%, respectively, compared with the estimated amounts in FY2011 (Figure 3.19.7). Though ambitious, if these targets are met, they would create a domestic borrowing need of about 2% of GDP—reflecting the government's continued commitment to fiscal prudence.

Yet the government still faces an uphill task in fiscal management. Recent years have seen the budget increasingly stretched by subsidies, in particular to public enterprises. Such payments in FY2012 are put at about one-fifth of budget expenditure, and rolling them back in a politically charged environment will be hard. Building the physical infrastructure and human resources for the envisaged federal structure will also require heavy spending.

The government needs to end such subsidies, and create a fiscal cushion, including bringing the informal sector into the formal tax base. In addition, expanding the tax base is necessary to reduce dependence on foreign aid, which finances about three-fifths of government capital spending. Public external debt as a share of GDP has stabilized in recent years primarily because the World Bank and ADB (the two largest donors) have been providing a significant share of their contribution in the form of grants, but at more than one-third of GDP, it warrants prudent debt management.

3.19.6 Gross international reserves



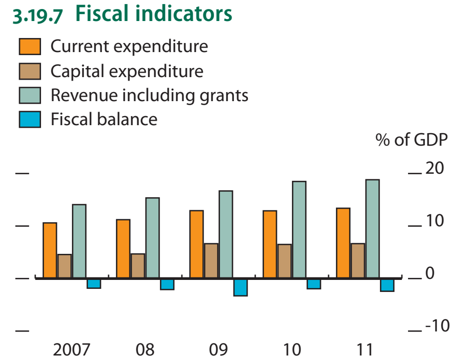
Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.1 Selected economic indicators (%)

	2012	2013
GDP growth	4.5	4.0
Inflation	8.0	7.0
Current account balance (share of GDP)	0.5	1.0

Source: ADB estimates.

3.19.7 Fiscal indicators



Source: Asian Development Outlook database.

Policy challenge—politically induced market distortions

In recent years, the economy has suffered from several market distortions, originating mainly in the fragile political environment and compounded by poor law enforcement (Table 3.19.2). These distortions—seen most clearly in electricity theft and technical leakages (estimated at 29% of total output), business cartels, fuel hoarding and frequent shortages, and transport syndicates—are responsible for keeping prices high and for exacerbating the already-poor investment climate.

Fuel shortages are a direct result of the slow reform of Nepal Oil Corporation. It subsidizes petrol, diesel fuel, and liquefied petroleum gas. The subsidies are partly financed by profits on sales of kerosene and aviation turbine fuel, which are sold above the international price. The prices of subsidized items are being adjusted upward, but there is strong political pressure to maintain high subsidies. The corporation's losses came to NRs11 billion (0.8% of GDP) in FY2011.

The government's decision to recruit a professional managing director for the corporation is a step in the right direction, but wholesale reform, accompanied by complete deregulation of oil prices and legal provisions to allow private service providers in the market, is needed. (Well-directed social protection measures would, of course, be required.) Ultimately, the corporation should cover its own operating costs and make a reasonable return on the government's invested capital.

The country reels under severe power shortages, lasting up to 16 hours a day during the winter months of low hydropower generation, because potential demand is twice current supply. Fixing this situation to provide a foundation for exploiting the country's vast water resources for power generation will be difficult as it requires huge public expenditure as well as public–private partnerships for financing. The first step is to reform Nepal Electricity Authority, allowing it to set tariffs that would induce investment and to tackle its arrears and power theft, without undue political friction.

The current reform of Agriculture Development Bank, which was originally fully owned by the government, lends credence to the view that well-sequenced reforms of human resources, information technology, and commercialization can turn a poorly performing institution into a financially viable entity without impairing its development mission. Nepal has 36 public enterprises, and 11 of them incurred heavy losses in FY2011. Many—particularly the ones with many employees, such as the Nepal Water Supply Corporation—have losses greater than their assets, reflecting the urgent need for public enterprise reform.

3.19.2 The most problematic factors for doing business (% of responses)

Government instability/coups	21.8
Inefficient government bureaucracy	11.8
Policy instability	10.4
Corruption	10.0
Inadequate supply of infrastructure	8.6
Restrictive labor regulations	8.1
Access to financing	7.7
Poor work ethic in national labor force	7.2
Inadequately educated workforce	3.4
Inflation	3.4
Tax regulations	2.5
Crime and theft	2.3
Foreign currency regulations	1.1
Tax rates	1.1
Poor public health	0.6

Note: From a list of 15 factors, respondents were asked to select the five most problematic factors for doing business in their country and to rank them between 1 (most problematic) and 5.

Source: World Economic Forum. 2011. The *Global Competitiveness Report 2011–2012*. http://www.weforum.org/issues/global-competitiveness

Pakistan

The economy continues to be affected by structural problems, including a domestic energy crisis, a precipitous decline in investment, persistently high inflation, and security issues. Budget deficits remain high, driven by substantial subsidies and losses at state-owned enterprises, and tax revenue below target. The slow growth in recent years was exacerbated by widespread floods in FY2011. Unless progress can be made in resolving these fundamental problems, the growth outlook will stay modest.

Economic assessment

Severe floods at the start of FY2011 (ended 30 June 2011) disrupted economic activity in most sectors in the first half of the year. A slight recovery during the second half—supported by higher prices for key exports and expanded services activity in part related to flood relief—kept growth positive at 2.4% for the year (Figure 3.20.1). Solid growth in livestock, minor crops, and wheat and sugarcane outweighed a marked fall in cotton and rice harvests to allow a 1.2% expansion in agriculture.

Industry, however, stagnated under the weight of energy shortages and low investment. Thus for the fourth year the economy was characterized by low growth (a period average of 3%), well below the estimated 7% needed to provide a firm basis to provide jobs to new labor-force entrants, increase per capita income, and reduce poverty.

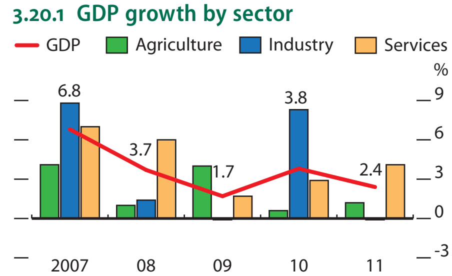
A surge in workers' remittances, higher civil service salaries, greater farm income from increases in commodity prices, and higher outlays in the wake of the floods lifted total consumption expenditure by 7%, which accounted for more than 90% of GDP growth in FY2011.

Investment continued to shrink, reflecting structural and security issues: gross fixed investment has declined for 4 years, from about 21% of GDP in FY2007 to 11.8% in FY2011 (Figure 3.20.2), the lowest rate since FY1974. This trend raises concerns that production capacity is being eroded, undermining growth prospects for the near and medium term.

Inflation, already under pressure from increasing global commodity prices, remained high, reflecting flood-related shortages, especially for food, and higher costs due to damaged transport networks. Peaking at more than 15% in December 2010, inflation eased modestly in the second half, and declined to 13.3% for the year to June 2011.

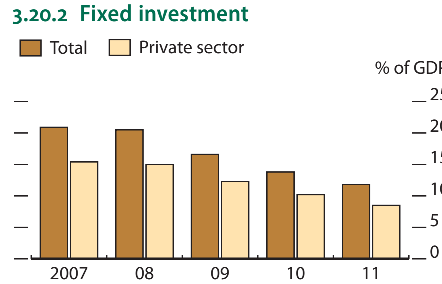
Responding to price pressures, the central bank tightened monetary policy in FY2011, raising the discount rate by 50 basis points in each of July, September, and November 2010, bringing it to 14%. As inflation stabilized and the balance of payments strengthened in the second half, the central bank made no further increases in the rate for the rest of FY2011.

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2010–11*. http://www.finance.gov.pk

3.20.2 Fixed investment



Source: CEIC Data Company (accessed 23 March 2012).

This chapter was written by Dawn Elizabeth Rehm and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

Higher-than-planned budget expenditure and declining foreign investment inflows caused the government to rely heavily on the banking system to finance the budget deficit in FY2011, continuing its pattern of taking the bulk of new bank lending (Figure 3.20.3). Credit to the government increased by 23.7% and was the main factor in pushing growth in money supply up to about 16% in FY2011, from 12.5% a year earlier, underpinning persistent inflationary pressures.

Credit to the private sector continued to expand slowly (4%), and was largely directed to higher working-capital requirements in the face of much higher prices for cotton and textiles, sugar, and edible oils. The vast majority of credit to corporate entities and to small and medium-sized enterprises apparently went to day-to-day operations rather than investment.

Fiscal imbalances grew in FY2011, as revenue shortfalls and current expenditure overruns led to a budget deficit of 6.6% of GDP (Figure 3.20.4), higher than the 4% target announced in the FY2011 budget. While the FY2011 deficit was boosted by outlays of PRs120 billion (0.6% of GDP) to partly clear accumulated debt in the energy sector, the bulk of the overrun from the targeted deficit reflected unrealistic revenue targets and underbudgeting for current outlays, particularly for subsidies.

Revenue rose by 15.9%, well below the 26.2% pace envisaged in the budget, as enactment of planned revenue measures encountered political resistance. While flood-related tax surcharges (in force March–June 2011) helped lift receipts that quarter, general government tax revenue for FY2011 declined to 9.8% of GDP from 10.1% a year earlier.

Current expenditure was reduced from 16.7% of GDP to 16.1%, but still outstripped budgeted levels by 15.2%. Development spending—including flood relief—was held to 30% below target in an effort to narrow the expenditure–revenue gap. Within current expenditure, subsidies surged by 70% from a year earlier, to three times their budgeted allocation.

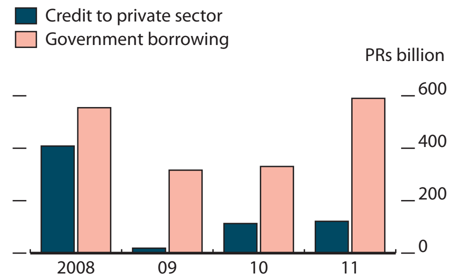
The balance of payments benefited from a doubling of cotton prices and higher food sales (mainly surplus wheat) that underlay a 28.9% expansion in exports. Imports grew by 14.9%, largely reflecting price rather than volume increases. Weak investment activity was mirrored in a decline in imports of much needed power generation and electrical equipment.

Buoyed by a strong expansion of remittances (up 25.8% to $11.2 billion), by flood-related grants, and by inflows from the United States (US) Coalition Support Fund, the current account posted a marginal surplus of 0.1% of GDP. The financial account recorded a surplus of $2.1 billion.

Foreign exchange assets of the banking system strengthened to $18.2 billion, with reserves of the State Bank of Pakistan (SBP) peaking at $14.8 billion at end-June 2011. Positive developments in the balance of payments helped stabilize the exchange rate against the US dollar: the Pakistan rupee depreciated by 2.0% in FY2011, following a 6.3% depreciation the year before.

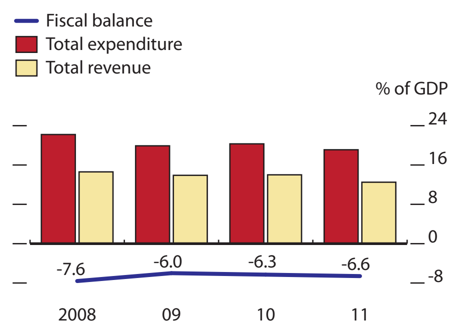
Public debt continued to climb in FY2011 (Figure 3.20.5). Domestic debt jumped by 29.2% to PRs6.0 trillion (33.3% of GDP). External debt increased to $57.9 billion but declined as a share of GDP (to 27.5%). Treasury debt sales were concentrated in short maturities for most of the year, bringing the average maturity of domestic debt to only 18 months.

3.20.3 Banking sector credit (yearly flows)



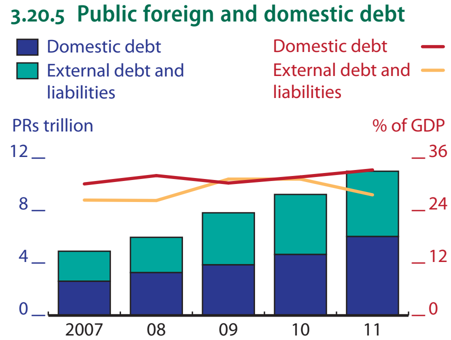
Source: State Bank of Pakistan. 2012. *Statistical Bulletin*. February. Table 2.5. http://www.sbp.org.pk

3.20.4 Fiscal indicators



Source: Ministry of Finance. *Pakistan Economic Survey 2010–11*; Pakistan Fiscal Operations July-June 2011. http://www.finance.gov.pk

3.20.5 Public foreign and domestic debt



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 3 March 2011).

Economic prospects

The economy is expected to grow modestly without a more predictable energy supply and improved investment flows. Evidence from the FY2011 Household Integrated Economic Survey indicates a widening income gap between rich and poor, with income for the two lowest quintiles (40% of the population) growing more slowly than the average. In addition, food inflation has averaged 18% a year for the past 3 years (much higher than overall inflation), ensuring that a larger share of income, particularly for the lower quintiles, is required to meet this essential need. With low investment and economic growth below the pace needed to accommodate the predominately young population, the rich–poor income gap is set to widen further.

Energy outages and damage to the cotton crop from floods (for the second consecutive year) in early FY2012 are expected to hold fiscal year growth to 3.6%. The impact of substantial gas and power load-shedding from December 2011 and continuing into FY2012 is holding down both manufacturing output and export performance.

Moreover, textile manufacturers report substantial reductions in orders this year, as unpredictable energy outages prevented many of them from meeting their production commitments last year. Manufacturers' associations have expressed concerns that energy outages will nullify any potential gains from European Union tariff waiver concessions (on 75 items, including textiles, approved in February 2012).

With little relief expected for power shortages and assuming no major floods similar to those experienced in the past 2 years, economic growth in FY2013 is forecast to strengthen marginally to 4.0%. Private and government consumption expenditure should continue to drive growth, as investment remains depressed.

After slowing to 9.7% in December 2011, inflation (year on year) picked up to 11% in February 2012 (Figure 3.20.6). Core inflation remains near double digits, pointing to continued persistence of inflationary pressures. Increases in energy prices in March 2012 and further expected adjustments will keep upward pressure on prices. For FY2012 as a whole, average inflation is projected at 12.0%. On assumptions of a strengthened budget performance and broad stability in oil and other global commodity prices, inflation could ease to 10.0% in FY2013.

Slower inflation and measures by the government to contain borrowing from the SBP supported an easing of monetary policy. In two separate steps (July and October 2011), the central bank reduced the policy rate by 200 basis points to 12%. With a weakening overall balance of payments, however, and a decline in reserves, the SBP has kept the rate at 12%.

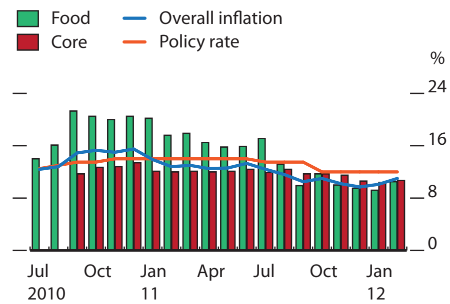
Fiscal developments for FY2012 present a mixed picture. Federal Board of Revenue collections are much improved, running a full 33% ahead of last year's performance for the first 6 months (Figure 3.20.7). This reflects improved economic activity in the first half of the year, as well as extension of the flood-related tax surcharges and improvements to tax administration. Yet it is unclear that the overall revenue target for FY2012 will be achieved, as this in part depends on the sale of third-generation telecoms licenses in the latter part of FY2012—a sale already rescheduled over the past 2 years.

3.20.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.6	4.0
Inflation	12.0	10.0
Current account balance (share of GDP)	-1.8	-1.9

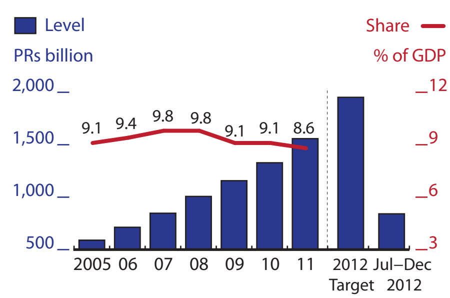
Source: ADB estimates.

3.20.6 Inflation and policy rate



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 3 March 2011).

3.20.7 Federal Board of Revenue tax collections



Sources: Ministry of Finance. *Pakistan Economic Survey 2010–11*; Federal Board of Revenue. http://www.fbr.gov.pk (accessed 26 Jan 2012).

Despite the implementation of an automated pass-through of input price increases to electricity tariffs, the overrun on energy subsidies is expected to be more than triple the amount budgeted, at slightly above 2% of GDP, as key energy-efficiency measures have been delayed and state-owned enterprises continue to absorb the losses. Taken together, uncertainties over nontax revenue and higher than targeted current expenditure point to a budget deficit in excess of the 4.7% of GDP target.

The external accounts are increasingly fragile, as the current account returns to deficit (Figure 3.20.8), with scant cushion from the financial and capital accounts. Lower prices for key export commodities, particularly cotton, combined with higher import prices, pushed the current account from near balance for the first 7 months of FY2011 to a deficit of $2.6 billion (1.8% of GDP) by end-January 2012. The deficit is expected to remain unchanged as a share of GDP over the rest of FY2012—as strong growth in remittances continues to offset a widening trade balance—increasing slightly to 1.9% in FY2013.

Growth in export receipts slowed to 7.2% for the first 7 months of FY2012 from 20.1% for the same period the previous year, as cotton prices declined and export industries were hit by increased load-shedding. Imports were 17.7% higher, largely reflecting substantial payments for oil. The services account showed similar signs of deterioration, with services exports contracting by 22.0% as inflows from the US Coalition Support Fund declined.

Workers' remittances expanded by 23.4% during July 2011–February 2012, slightly slower than the pace for the same period a year earlier.

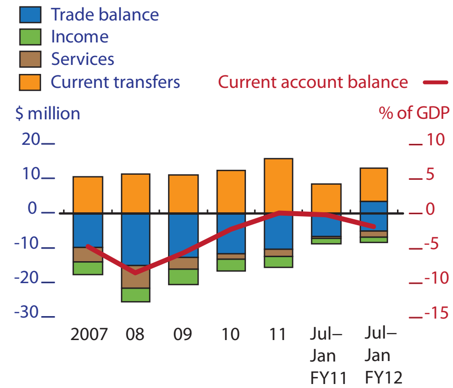
Official foreign exchange reserves declined by $2.4 billion in the first 7 months of FY2012 (Figure 3.20.9), reflecting the current account deficit and a sharp narrowing of the capital and financial account surplus as inflows continued to fall and debt service payments mount. Reacting to pressure on reserves, the Pakistan rupee depreciated by 5.7% against the US dollar in the first 8 months (Figure 3.20.10).

Policy challenge—efficiency constraints

Power is the main constraint for economic growth, as load-shedding intensifies and becomes less predictable (Box 3.20.1). Estimates from the Planning Commission suggest that losses arising from power and gas shortages held down GDP growth by 3–4 percentage points in FY2011 and FY2012. Improved management of power resources could ameliorate predictability of load-shedding to allow the private sector to better schedule work and minimize costs.

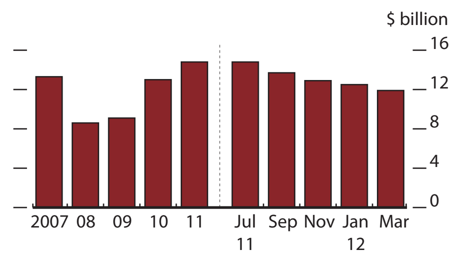
The current system, with tariff and collections below cost recovery, is a major deterrent to investment for capacity expansion in the sector. Cost recovery has not yet been achieved despite substantial increases in tariffs over the past 2 years, and measures to bring down costs have not been effective. For every unit of power sold, there is a loss to the sector reflected in the form of subsidies or accumulation of losses in the state-owned power companies. An outstanding accumulation of PRs220 billion was carried into FY2012, and an additional financing of 1–1.5% of GDP is likely to be required in FY2012. Implementation of many of the actions taken by the government has been complicated by legal challenges.

3.20.8 Current account components



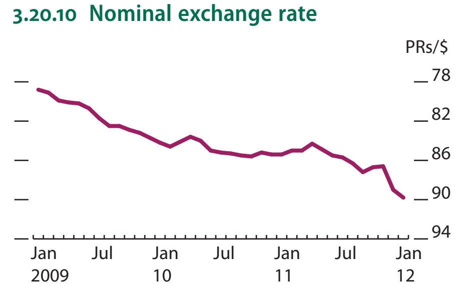
Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 26 January 2012).

3.20.9 Foreign exchange reserves



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 1 February 2012).

3.20.10 Nominal exchange rate



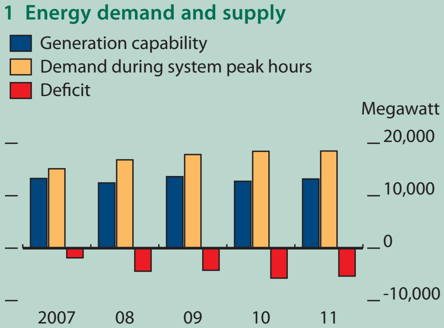
Source: State Bank of Pakistan. 2012. *Statistical Bulletin*. February. http://www.sbp.org.pk

State-owned enterprises represent a heavy drain on fiscal resources. Pakistan Railways, Pakistan International Airlines, and Pakistan Steel Mills have incurred steep losses for the past several years. The challenge of improving efficiency and putting these enterprises on a viable commercial footing is formidable. Reforms are needed, including a separation of these enterprises from operational interference by government ministries.

3.20.1 Energy challenges

The power shortage is the main factor constraining economic growth. The supply-demand gap at peak hours reached over 5,000 megawatts (MW) in FY2011 (Box figure 1). This reduced economic output, hitting manufacturing the hardest.

1 Energy demand and supply



Sources: Government of Pakistan. National Electric Power Regulatory Authority (NEPRA). *State of Industry Report 2011.*

The cause of the power sector crisis can be divided into three pillars: cost-efficient generation capacity not keeping up with demand, financial issues, and management issues.

The supply–demand gap has widened because of a lack of investment in energy. The government has in fact added 1,604 MW to the system by commissioning six new independent power producers (1,264 MW) and a nuclear power plant (340 MW). A 49.5 MW wind power plant has recently obtained financing.

However, other domestic resources (hydro, gas, and coal) have not grown enough to cover demand, thereby increasing reliance on imported fuel oil. The energy mix has changed from predominantly hydro to thermal, which consists of domestic gas and imported fuel oil.

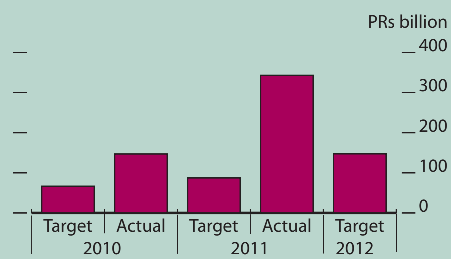
Industrial, retail, and fertilizer users are competing for the depleting gas supply, the preferred fuel for existing thermal plants. Plans to increase domestic gas production, import liquefied natural gas, pipe gas from neighboring countries, or bring in electricity from Central Asia have yet to materialize.

Financial issues are rooted in the fact that the cost-recovery tariff determined by the National Electric Power Regulatory Authority is not applied to customers. Thus the government bears the differential as a subsidy. Losses and costs excluded from the tariff formula also accumulate at the public sector company level. The lack of financing leads to arrears for the power generation and fuel companies.

Timely payment to these companies, essential for the sector's reliability, has become increasingly difficult, partly because of increased dependence on imported fuel, which is subject to wide price fluctuations. The cost of (oil-based) power generation in the country escalated by almost 40% in the 2 fiscal years ending FY2011. Despite steep increases in tariff and fuel price adjustments, customer tariffs remain below cost recovery, requiring large government subsidies to keep the system operating (Box figure 2).

The focus on massively increasing spending on power subsidies, reforms, and efficiency measures has been unable to remedy the accumulation of arrears in the system.

2 Power subsidies



Sources: Ministry of Finance. *Pakistan Economic Surrvey 2010–11*; Federal Budget 2011–12. http://www.finance.gov.pk

To improve management, the government has appointed independent boards for the public power companies to select chief executive officers for these companies. Efforts are also ongoing to decrease commercial and technical losses (around 20%). However, these efforts have been overshadowed by the increase in costs and unwillingness of some customers to pay the higher tariffs.

For a sustainable and reliable power sector, a multiyear plan with solid support from customers and other stakeholders needs to be implemented.

Sri Lanka

Growth stayed high in 2011 despite bad weather, which affected agriculture. A policy to keep the exchange rate stable in the face of credit-fueled strong domestic demand led to a growing trade deficit and loss of official reserves, while nonfood prices trended sharply higher. The authorities in response adopted in February 2012 more flexible exchange rate and monetary-tightening policies, and made steep power and fuel price adjustments. The outlook is for moderate but still strong growth.

Economic performance

The economy grew at 8.3% in 2011 as the country continued to absorb the benefits of the end of its long-running civil conflict in May 2009 (Figure 3.21.1). Industrial output (accounting for a little less than one-third of GDP) expanded by 9.6%. Within that, manufacturing grew by 8.1%, led by the export-oriented readymade garment industry. Construction and mining came in at double-digit growth, reflecting projects started since the conflict ended.

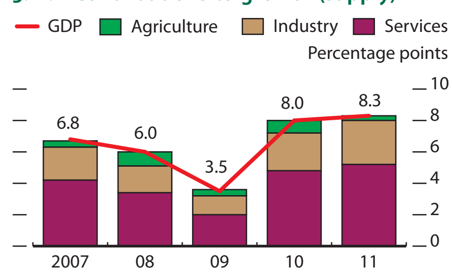
Services, the largest component of GDP (three-fifths), climbed by 8.8%. Hotel and restaurant activity was up by one-third, reflecting a 30.8% increase in tourist arrivals. Both transport and communications grew with the further integration of the northern and eastern provinces (former conflict areas) with the rest of the economy.

Agricultural output, however, was hit by adverse weather and heavy flooding in early 2011 and was down in the first half, but it picked up in the second to show annual growth of 2.5%.

Private consumption remained the main driver of economic expansion, fueled by remittances, greater demand from the northern and eastern provinces, and salary increases for civil servants and the defense forces. Investment activity also strengthened owing to implementation of major infrastructure development initiatives (especially in transport, energy, water, sanitation, and irrigation) and rising business investment, including international companies seeking a foothold in a fast-expanding economy. Private investment focused on tourism, telecommunications, manufacturing, and housing.

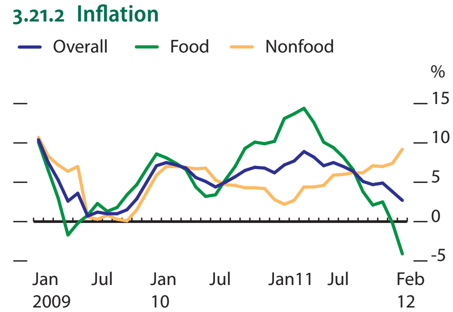
Overall inflation remained in single digits in 2011, averaging 6.7% and little changed from a year earlier (Figure 3.21.2). Food inflation, though, was volatile, reflecting flood damage, crop failures, and price pressure early in the year and, later, declining prices as production recovered. Nonfood inflation trended upward, due to strong demand and price increases for diesel, petrol, kerosene, liquefied petroleum gas, and bus fares late in 2011 and in February 2012, when it reached 9.2%. Fuel prices were suppressed during 2011 as international oil prices shot up by 41%

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2011 and Prospects for 2012.* http://www.cbsl.gov.lk; ADB estimates.

3.21.2 Inflation



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 12 March 2012).

This chapter was written by Tadateru Hayashi, Nimali Hasitha Wickremasinghe, and Savindi Jayakody of the Sri Lanka Resident Mission, ADB, Colombo.

during 2010 and 2011. The government kept rises in petrol and diesel prices to 19% and 15%, respectively. Ceylon Petroleum Corporation lost a reported SLRs90 billion in 2011 (1.4% of GDP), mainly by selling oil to Ceylon Electricity Board below cost.

The central bank kept monetary policy rates low in 2011 to boost economic growth through rapidly expanding credit. Growth in credit to the private sector has accelerated rapidly since early 2010, fueling the pace of economic activity: year-on-year growth reached 34% in midyear and then plateaued (Figure 3.21.3). Construction, agriculture, and wholesale and retail trade have been prominent recipients. The central bank aimed at maintaining inflation at mid-single-digit level and signaled a tightening of policy by raising its repurchase and reverse repurchase rate by 50 basis points to 7.5% and 9.0%, respectively, in February 2012.

The budget deficit was narrowed in 2011 through a reduction of expenditure as a share of GDP, even as the proportion of government revenue in GDP fell. The deficit is estimated at 7.0% of GDP, improving from 2010's 8.0% (Figure 3.21.4). Total revenue increased by 12.3% in 2011 from a year earlier (tax receipts rose by 14.2%). Revenue as a share of GDP, however, fell by 0.5 percentage points to 14.3% in 2011, despite a 16.6% rise in nominal GDP and strong imports. The weaker performance seems largely due to tax holidays and incentives eroding the tax base. Total expenditure, which rose by 9.1%, moderated to 21.4% of GDP from 22.9% in 2010, reflecting government efforts to rationalize recurrent spending. Capital expenditure was maintained at 6.0% of GDP.

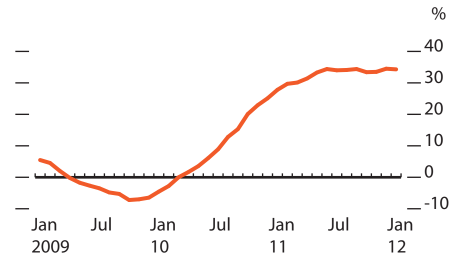
While exports expanded strongly, imports jumped because of higher oil prices and strong domestic demand, more than doubling the current account deficit to 7.3% of GDP in 2011 (Figure 3.21.5). Export earnings rose by about 22.4% to $10.5 billion, mainly owing to a 24.6% expansion in garment sales, a near 60% surge in rubber and rubber products, and strong prices for other agricultural products. Imports jumped by 50.4% to $20.2 billion, driven mainly by increases in imports of oil, intermediate goods for the garment industry and other raw materials, and capital goods. Export growth was weaker in the second half of 2011 than the first, while that of imports stayed high.

Improved workers' remittances and an increased surplus in the services account helped contain the current account deficit. Earnings from tourism shot up by 44% to $830 million, even though tourist arrivals, especially from Europe, slowed during the second half. Workers' remittances, up by 25.0%, remained the single largest foreign exchange earner, at $5.1 billion or 8.7% of GDP.

Foreign direct investment inflows exceeded the government target of $1 billion in 2011 as there was an influx of investments into the tourism, apparel, and information technology industries. Net inflows to the capital and financial accounts largely offset the current account deficit.

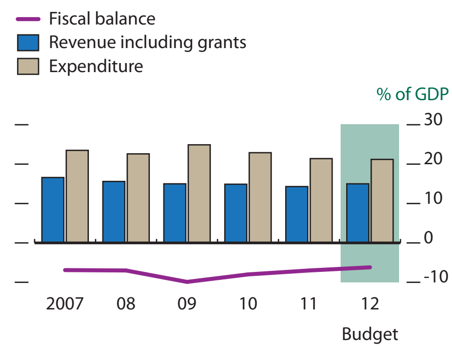
The central bank defended the foreign exchange rate (in a band around SLRs110/$1) against downward pressure from the current account deficit for most of 2011, although the government announced a 3% devaluation when presenting the 2012 budget in November 2011 (Figure 3.21.6). With strong demand pressures, gross official reserves fell continuously during the latter part of the year to $5.96 billion by end-December 2011, covering 3.5 months of imports (Figure 3.21.7).

3.21.3 Growth of private sector credit



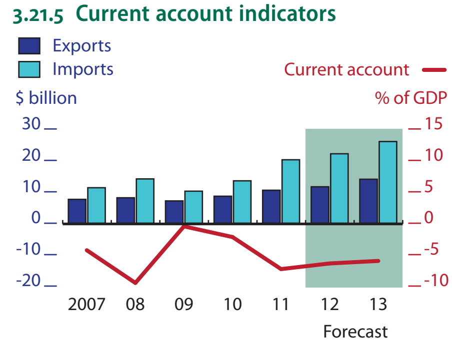
Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 12 March 2012).

3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2010*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2012*. http://www.treasury.gov.lk

3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2011 and Prospects for 2012*. http://www.cbsl.gov.lk; ADB estimates.

In February 2012, the central bank announced that it would limit its intervention in the foreign exchange market, moving toward greater market determination of the exchange rate. By end-March the rate reached SLRs129.6/$1, a 14% depreciation year on year.

Economic prospects

Although the economy is projected to maintain its strong performance of the last 2 years, growth prospects for 2012 are less favorable than in the past, and the pace of expansion will moderate. This easing is partly due to slower growth in industrial countries and attendant weaker growth in global demand and trade, and partly due to domestic factors: the rebound has largely run its course and with little slack in production capacity signs of overheating have emerged that will require tighter demand-management policies to forestall the buildup of serious economic imbalances.

Growth is expected to edge down to a still high 7.0% in 2012 as trends in investment, exports, tourism, remittances, and consumption remain broadly favorable; agriculture growth should be high, assuming normal weather. With the expected stronger performance of the global economy in 2013, growth is expected to recover to 8.0%, driven mainly by domestic and foreign investment.

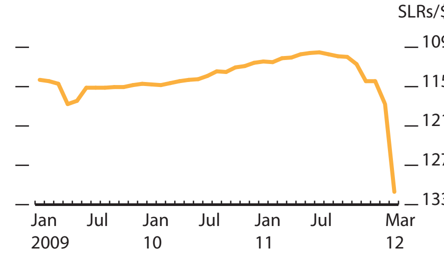
Fiscal policy will focus on further narrowing the budget deficit in 2012 to 6.2% of GDP. The budget plans most of this improvement to come from an 19.8% increase in revenue and grants, based on assumptions of rapid growth (8.5–9%) and inflation in mid-single digits. But with growth likely to be slower than this rate, it will be hard to reach the revenue target. Expenditure is slated to rise more slowly than revenue: planned economies in current spending should allow capital outlays to rise to 6.6% of GDP, in line with the target in the government's Development Policy Framework. The government plans to bring the deficit down to 5.8% in 2013, by improving income tax and value-added tax collection and further streamlining current expenditure.

The public debt ratio has been reduced over the last few years, although it was still very high at an estimated 78.9% of GDP at end-November 2011 (Figure 3.21.8). The impact of currency depreciation on external debt, additional budget borrowing, and slower growth is on course to worsen the debt-to-GDP ratio in 2012.

Monetary policy will focus on stabilizing inflation in mid-single digits and eliminating balance-of-payments pressures and loss of reserves. In moving toward this objective the central bank raised policy rates in early February 2012 and directed commercial banks to limit credit expansion to 18% during the year, alongside the moves to liberalize the exchange rate.

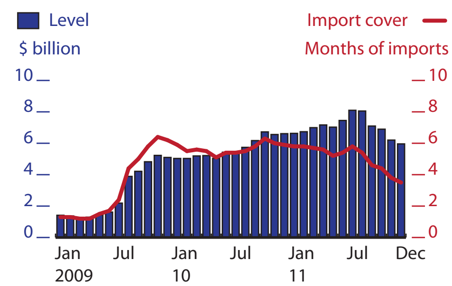
While the expected global slowdown and stable commodity prices in 2012 should curb external inflationary pressure, diesel and petrol prices were raised by 37% and 9%, respectively, and a surcharge (25–40%) was imposed on household electricity bills, all in February 2012. However, currency depreciation will also raise inflation through higher import prices. Inflation is forecast to be 8.0% in 2012 and fall marginally to 7.0% in 2013 owing to easing pressures from exchange rate depreciation and energy price adjustments a year earlier.

3.21.6 Exchange rate



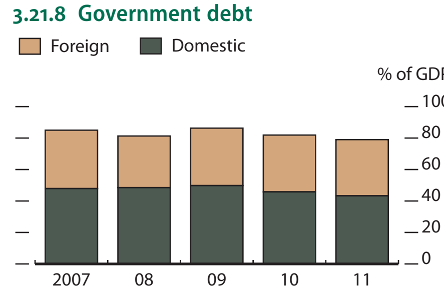
Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 26 March 2012).

3.21.7 Gross official reserves



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various years. http://www.cbsl.gov.lk

3.21.8 Government debt



Note: 2011 data are up to end-November.

Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 12 March 2012).

Export growth is expected to fall to 11.0% in 2012, mainly owing to weaker demand, especially from Europe. Still, the trade gap is projected to stabilize, as import growth will also be much slower as higher interest rates, tighter credit, and a marked depreciation in the exchange rate are felt, especially for consumer goods. The current account deficit is projected to edge down to 6.4% of GDP in 2012, reflecting the more stable trade gap and continued large gains in remittance receipts. Growth in tourism-related inflows will take a hit but the sector will stay a major earner.

With stronger industrial-country growth and a pickup in trade in 2013, stronger export growth is projected to help narrow the current account deficit to 6.0% of GDP.

3.21.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.0	8.0
Inflation	8.0	7.0
Current account balance (share of GDP)	-6.4	-6.0

Source: ADB estimates.

Policy challenge—boosting private investment

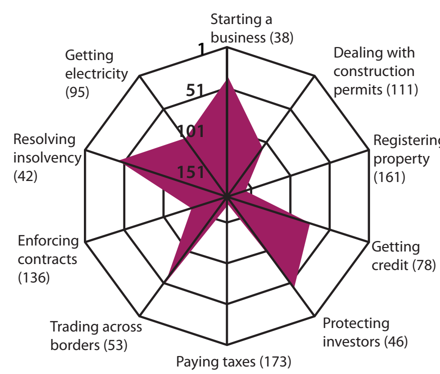
The government's Development Policy Framework for 2010–2016 aims to raise GDP growth to above 8% in the medium term and to nearly double per capita income from $2,400 to $4,200 at the end of the period. The government has therefore embarked on an ambitious plan to remove infrastructure bottlenecks. It has already undertaken significant investments in some sectors, especially among the major infrastructure development initiatives.

The government, as seen in the framework, would like to see a greater role for the private sector through increased investment by both domestic and foreign investors, as investment is key for increasing supply capacity and bolstering growth. The framework also seeks private investor participation (beyond the traditional areas of industry and commerce) in infrastructure. The framework projects private investment to rise from around 21% of GDP in 2011 to about 26–28% in the next few years.

Yet despite the improved political and economic environment, growth in private investment—domestic and foreign—is falling below planned levels. One reason is that the government has taken only a few steps to reduce red tape and improve the business climate, needed to create the conditions for ramping up private investment. Although Sri Lanka's position in the World Bank's *Doing Business* survey has improved in 2012 to 89 (out of 183 countries) from 98 in 2011, some challenges still deter private investment (Figure 3.21.9), especially paying taxes.

Investor confidence is a key factor in attracting investment and this requires a predictable policy environment as articulated and reinforced through the legal, regulatory, and institutional framework. Thus the lack of such an environment for the private sector is a major obstacle to private sector development. Developing that framework will reduce uncertainties in the business environment and avoid unplanned actions that may send mixed signals to potential investors.

3.21.9 How Sri Lanka ranks on *Doing Business* indicators



Note: Numbers in parentheses show ranking out of 183 countries worldwide, 1 = best.

Source: The World Bank. Doing Business database. http://www.doingbusiness.org/data (accessed 20 March 2012).

Southeast Asia

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

Brunei Darussalam

This hydrocarbon-based economy grew slightly faster in 2011 and is expected to maintain modest growth during the forecast period. The pace of inflation lifted last year, but will likely ease in 2012. Substantial fiscal and current account surpluses provide a cushion against shocks. Diversifying sources of growth is the main challenge.

Economic performance

The economy grew by an estimated 2.9% in 2011, quickening from a revised 2.6% in 2010 (Figure 3.22.1). Growth stemmed from production and exports of natural gas and crude oil, which account for two-thirds of GDP, and a better performance by the nonenergy sector.

The oil and gas sector expanded by 2.2% in the first 3 quarters of the year, mainly owing to a 5.1% increase in production of liquefied natural gas (LNG). A large methanol plant, opened in May 2010, made its first full-year contribution to growth in 2011.

The nonenergy sector grew by 2.8% in the 3 quarters. It comprises—mainly government—services, and small agriculture and manufacturing output. Government services (about one quarter of the economy) grew by 3.3% in the 3 quarters. Strong growth of about 20% was recorded in air transport and hotels and restaurants services. Manufacture of garments declined for a fourth consecutive year.

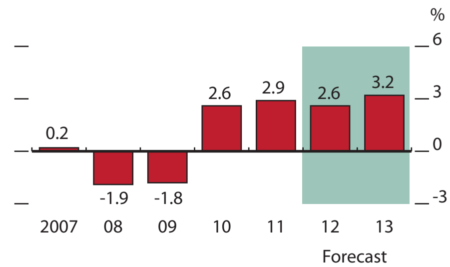
Government price controls and subsidies keep inflation to the 1–2% range most years—a bracket again achieved for the full year (2.0% on average). Higher global prices for food and other consumer goods nudged up inflation to 2.8% year on year in October 2011, before it receded (Figure 3.22.2). Tobacco prices jumped after the government raised excise duties on tobacco in November 2010.

Helping to contain inflation, the Brunei dollar appreciated against the US dollar by 8.4% on average last year, a result of its peg to the Singapore dollar through a currency board arrangement.

Merchandise exports, mostly LNG and oil, rose by an estimated 32.5% to US$12.4 billion in 2011, propelled by higher global prices for hydrocarbons. According to import data from Japan and the Republic of Korea, the biggest LNG customers, in 2011 these countries together lifted their purchases from Brunei Darussalam of LNG by 39% (to US$5.6 billion) and of oil by 33% (to US$1.9 billion).

Merchandise imports are much lower than exports, reflecting the small economy (GDP of about US$17 billion in 2011) and population (423,000). Imports rose by an estimated 19.3% to US$2.8 billion. The trade

3.22.1 GDP growth

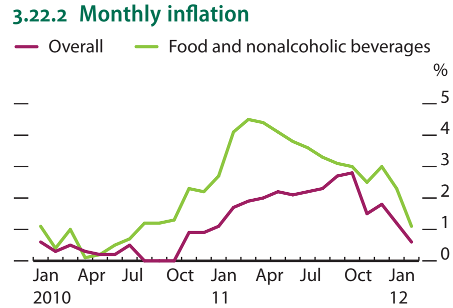


Sources: Asian Development Outlook database; ADB estimates.

3.22.1 Selected economic indicators (%)	2012	2013
GDP growth	2.6	3.2
Inflation	1.8	2.0
Current account balance (share of GDP)	50.0	50.0

Source: ADB estimates.

3.22.2 Monthly inflation



Source: CEIC Data Company (accessed 28 March 2012).

This chapter was written by Mohammed Parvez Imdad of the Southeast Asia Department, ADB, Manila.

surplus soared and the current account surplus increased to an estimated 50% of GDP.

Taxes, dividends, and royalties from hydrocarbons provide the government with about 90% of its revenue to fund wages for the large public sector and finance public services and subsidies. Rising oil prices boosted revenue by 43% in FY2010 (ended 31 March 2011). Government spending fell slightly owing to a decline in capital outlays, leaving a fiscal surplus equivalent to about 16% of GDP.

The government established the Autoriti Monetari Brunei Darussalam in January 2011 to supervise the financial sector and manage monetary affairs. It also set up a Deposit Protection Corporation to insure deposits up to B$50,000 for individual depositors. A centralized credit bureau is being formed to help banks assess the creditworthiness of borrowers.

Concerned about rising household debt and banks' high exposure to consumer loans, the authorities required banks to curb consumer lending and they tightened limits on credit card debt. The ratio of consumer loans to total credit fell sharply to 39% as at September 2011. Lending to the private sector fell by 5.3% during the first 7 months of 2011.

Economic prospects

The economy is expected to maintain modest growth during the forecast period (Figure 3.22.1 above), based on solid demand and prices of oil, investment in oil exploration, high levels of government spending, and gradual development of the nonenergy sector.

Two large export-oriented projects linked to hydrocarbons received government approval in 2011—a US$2.8 billion natural gas–based petrochemical complex and a US$2.5 billion oil refinery and aromatics cracker. (The country has only one small oil refinery.)

The complex, to be built at the Sungai Liang industrial park by Japanese companies, could eventually involve six downstream plants to produce chemicals for fertilizers, textiles, and plastics. The refinery and cracker project is planned by a firm from the People's Republic of China for the Pulau Muara Besar industrial zone. If it proceeds as proposed, it will have capacity of 135,000 barrels of oil a day and produce petroleum products and chemicals for textiles.

Current infrastructure activity includes completing the Pulau Muara Besar port and updating the Brunei international air terminal to double its capacity to 3 million passengers a year.

Inflation is projected to ease slightly to average 1.8% in 2012 as prices of imported food soften. It will edge up in 2013. Large current account surpluses are likely to be sustained, mainly on exports of oil and gas, and on income flows from the country's overseas investments.

3.22.1 Policy challenge—diversifying growth

Heavy reliance on oil and gas leaves the economy vulnerable to swings in global hydrocarbon prices. It also exposes it to dwindling production, unless exploration companies find new oil and gas fields. Oil output declined from a peak of 219,000 barrels a day in 2006 to 170,000 barrels in 2010.

Moreover, the oil and gas sector employs only about 3% of the work force. The government provides jobs to the majority of those in work, but says it can no longer absorb the growing number seeking employment.

A government drive to attract petrochemicals and other energy-related industries is having some success. Port facilities and an export processing zone are being built to attract manufacturers. The authorities have identified Islamic businesses including halal products, financial, logistics, and telecommunications services, and tourism for development, and have allocated funding for public–private partnerships.

To redress weaknesses in the business environment, the government plans to further cut the corporate income tax rate to 20% (it was 30% in 2006), to tax income from exports of domestically produced goods at just 1%, to lower excise duties for some machinery used in industry, and to set up a Business Facilitation Center.

It might also want to consider opening more areas for private participation and better align public–private remuneration packages so that private business can attract skilled workers.

Cambodia

Despite the worst floods in over a decade, economic growth remained robust in 2011, underpinned by exports of garments and footwear and by tourism. This year growth is forecast to soften, before picking up in 2013. Average inflation, lifted by higher prices for food and fuel in 2011, is projected to moderate this year. Better public debt strategies led to an upgrade in the debt sustainability rating.

Economic performance

Growth picked up to an estimated 6.8% in 2011, largely on increased exports of garments, footwear, and milled rice, as well as rising numbers of inbound tourists.

Industry remained the primary source of growth, expanding by an estimated 13.9% (Figure 3.23.1) and driven mainly by robust export growth of garments and footwear to the United States (US) and the European Union (EU). US garment and footwear imports from Cambodia in 2011 climbed by 17.8% to $2.7 billion (Figure 3.23.2). Exports of garments and footwear to the EU surged by 51.1% to $1.62 billion, largely due to relaxed rules of origin for imports into the EU that gave Cambodia (and some other developing countries) duty-free access to that market from January 2011.

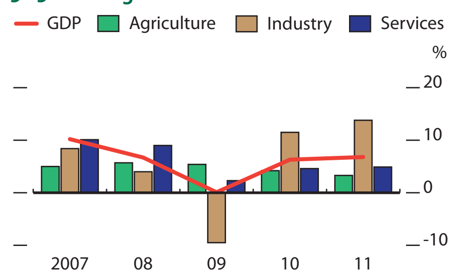
The number of jobs in the garment industry gradually recovered from a little over 319,000 at end-2010 to an estimated 330,000 by end-2011. Although this was still below the 353,000 jobs at end-2007—before the global recession—industry sources estimate that there were also more than 50,000 vacancies.

The strong growth of the industry sector was also supported by a steady increase in milled rice exports. A doubling in the value of approved construction projects in 2011 suggests a welcome recovery in this subsector.

Agriculture, representing about a third of GDP, was disrupted in September and October by the most severe flooding in more than a decade. Damage and economic losses, mainly to infrastructure and agriculture, were estimated at $624 million, some 5% of GDP. The floods lowered wet-season rice production, though output in the dry season increased, and fisheries production rose by 4.5%. Agricultural growth overall expanded by an estimated 3.3%.

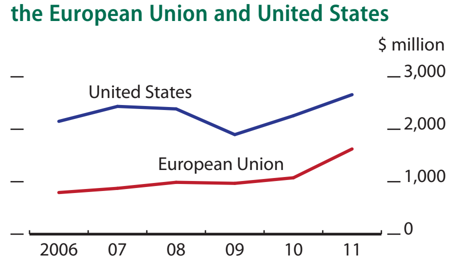
A buoyant tourism industry supported growth of 5.0% in services. Tourist arrivals picked up by 14.8% to 2.9 million in 2011 (Figure 3.23.3), with arrivals from Asia particularly strong. Growth in tourism benefited the hotels and restaurants, retailing, and transport and communications subsectors. Greater public confidence in the financial sector underpinned continued expansion there.

3.23.1 GDP growth



Sources: National Institute of Statistics; ADB estimates.

3.23.2 Exports of garments and footwear to the European Union and United States



Notes: Using import data from US OTEXA and Eurostat. Data from Eurostat were converted to US dollars using €/$ average exchange rate for the year. Footwear exports are for January–November 2011 for the US.

Sources: Office of Textiles and Apparel. http://otexa.ita.doc.gov (accessed 20 March 2012); Eurostat. http://epp.eurostat.ec.europa.eu (accessed 21 March 2012).

This chapter was written by Peter Brimble and Poullang Doung of the Cambodia Resident Mission, ADB, Phnom Penh.

The surge in global prices for food and fuel pushed inflation from 3.3% year on year in January 2011 to 7.1% in June and July. Inflation then began to ease (Figure 3.23.4), although the floods put some upward pressure on rice prices. For the year, inflation averaged 5.5%, up from 4.0% in 2010.

Reflecting the economic pickup, credit to the private sector accelerated from 27% at end-2010 to 31.7% a year later. More than 95% was denominated in foreign currency, mostly US dollars. Broad money (M2, excluding foreign currency outside banks) increased by 21.5% year on year at end-2011, driven by growing foreign currency deposits as a result of increased export earnings. The riel appreciated by 2.9% against the US dollar during 2011.

An expansionary fiscal stance since 2009 has considerably reduced the government's deposits in the banking system from about 8% of GDP in 2008 to around 4% in 2011 (Figure 3.23.5). The overall fiscal deficit (excluding grants and other expenditure adjustments), though staying high, narrowed to an estimated 7.6% of GDP in 2011 from 8.1% in 2010. Most of the gap (6.5 percentage points of GDP) was financed by external grants and concessional loans, the rest by drawdowns of government deposits.

Domestic revenue, estimated at 12.7% of GDP, fell short of target. Property tax, introduced in July 2010, started to generate income in 2011, making a small contribution. General government spending was above target at 20.2% of GDP.

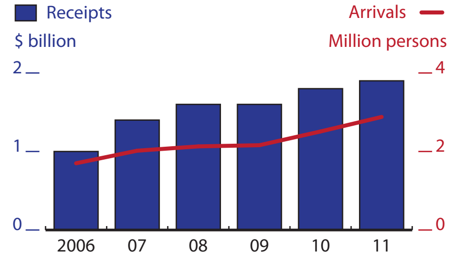
Concessional assistance from the People's Republic of China (mainly for infrastructure) as well as private investment (especially in hydropower) played a greater role in financing infrastructure last year than in 2010.

In the external accounts, the rise in shipments of garments, footwear, and milled rice propelled merchandise exports 35.8% higher in US dollar terms in 2011. Imports increased by an estimated 25.9%, largely reflecting purchases of oil, raw materials for garments, and consumer goods. The current account deficit (excluding official transfers), at an estimated 7.1% of GDP, was covered by inflows of foreign direct investment (FDI) and official loans. Net FDI rose by an estimated 11% to $846.2 million, with a sharp increase for the garment industry. Gross official reserves of $3.0 billion represented about 4.5 months of imports (Figure 3.23.6).

A debt sustainability analysis published in February 2012 by the International Monetary Fund and the World Bank upgraded Cambodia from moderate risk of debt distress to low risk. External public debt at end-2011 was manageable at 29% of GDP; domestic debt was less than 1% of GDP. In recent years, the People's Republic of China has become an important creditor, accounting for about two-thirds of total bilateral disbursements in 2010, for example.

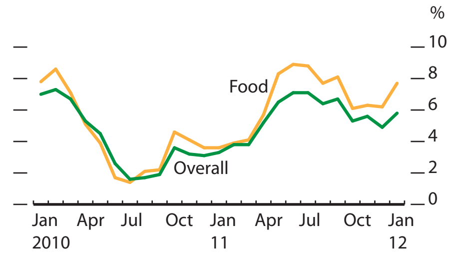
The Ministry of Economy and Finance estimated that poverty incidence declined to 25% as of early 2012, from about 30% in 2007, although there are concerns over apparent increases in income inequality. The government adopted a national social protection strategy in 2011, foreshadowing both an expansion of targeted programs such as free health care for the poor and the pilot testing of conditional cash transfers and labor-intensive public works.

3.23.3 Tourism indicators



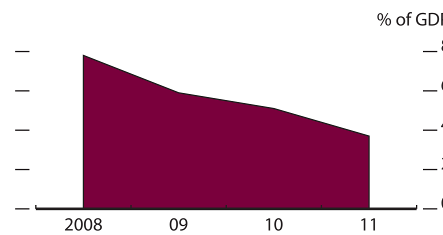
Source: Ministry of Tourism.

3.23.4 Monthly inflation



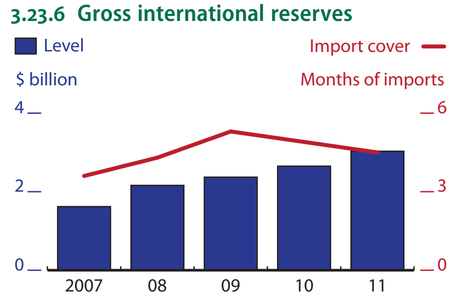
Source: National Institute of Statistics. http://www.nis.gov.kh (accessed 21 March 2012).

3.23.5 Government deposits



Source: Ministry of Economy and Finance.

3.23.6 Gross international reserves



Source: National Bank of Cambodia.

Economic prospects

Export-led sectors will remain the main sources of growth during the forecast period, with some new manufacturing industries beginning to emerge, such as automotive parts and assembly of small electric motors. The subdued economic outlook for the EU and US, Cambodia's main export markets, suggests that GDP growth will edge down to 6.5% in 2012 (Figure 3.23.7). In 2013, growth is seen picking up to 7.0%, tracking the expected upturn in the global outlook.

Demand for garment and footwear imports in the EU and US is expected to slow this year, mitigated to some extent by Cambodia's privileged import access to the EU and the development of some high value-added garment production. Given these trends, the growth in industry overall is projected to slow to 11.4%, before picking up to 12.5% in 2013.

Construction is expected to strengthen, stimulated by FDI in property. The extent and timing of exploitation of oil and gas reserves in Cambodia remain unclear, but it is not anticipated to have an impact on GDP before 2015.

Growth in services is expected to edge up to 5.3% in 2012 and 5.6% in 2013 largely on the back of continued increases in tourist arrivals supported by gradual improvement in real estate.

Assuming favorable weather, agriculture is forecast to register higher growth of 3.8% in 2012, partly a result of the base effect of last year's floods on the rice crop. It also reflects government support for agriculture, in particular rice production.

Fiscal consolidation is expected to continue, as envisaged in the 2012 budget. The fiscal deficit (excluding grants and other expenditure adjustments) is targeted at 5.7% of GDP, to be achieved largely by an ambitious domestic revenue target of 13.7% of GDP. Government spending is budgeted at 19.4% of GDP. The budget anticipates that domestic financing of the deficit will be as low as 0.2% of GDP. This indicates an important step toward rebuilding fiscal flexibility, necessary to give the government the leeway to spur the economy if needed.

About $150 million will be spent on flood reconstruction over the next 2 or 3 years, building on an estimated $60 million of flood-related humanitarian and infrastructure spending in 2011.

Inflation in 2012 and 2013 is forecast to ease to about 5% on a year-average basis (Figure 3.23.8), assuming relatively low domestic financing of the budget deficit. (High levels of domestic financing would involve the injection of large amounts of riels that could put upward pressure on inflation.) Rising global oil prices early in 2012 put the inflation forecast for this year at risk.

The trade deficit in 2012 is set to widen slightly due to softening external demand. Increases in tourism receipts will keep the services account in surplus. The current account deficit (excluding official transfers) is projected to widen to 7.6% of GDP in 2012 before narrowing a little as the global economy picks up (Figure 3.23.9).

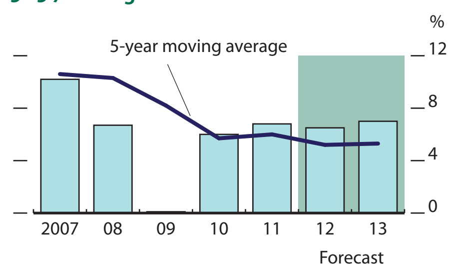
As for policy reforms, the Public Debt Strategy approved by the Prime Minister in February 2012 is a step forward in strengthening the debt strategy and debt management capacity. The government will set an annual borrowing target and aim for concessional loans with tenors

3.23.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.5	7.0
Inflation	5.0	5.0
Current account balance (share of GDP)	-7.6	-7.0

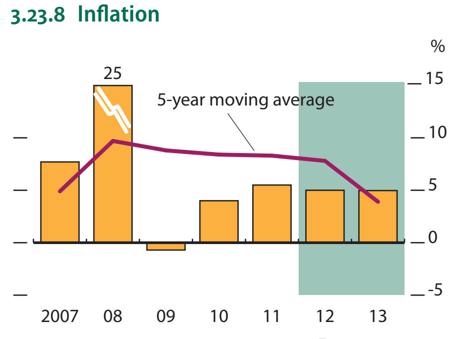
Source: ADB estimates.

3.23.7 GDP growth



Source: Asian Development Outlook database.

3.23.8 Inflation

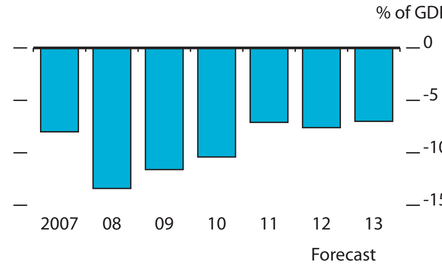


Source: Asian Development Outlook database.

of 20–40 years. Yet despite the positive debt sustainability assessment, the country remains vulnerable to uncertain contingent liabilities on major infrastructure investments, mainly public–private hydropower partnerships.

A Public Procurement Law, promulgated in January, laid the foundation for improving this element of public financial management. An overhaul is planned of policies and regulations covering public–private partnerships, which should help mobilize private sector finance for development projects and improve business governance and transparency. Three state-owned enterprises are scheduled to be the first listings on the securities exchange.

3.23.9 Current account balance



Source: Asian Development Outlook database.

Policy challenge—skills shortages

Skills shortages are hindering Cambodia's development. The share of firms reporting skills as a major constraint to growth in the World Bank's Investment Climate Surveys increased from 6.5% in 2003 to 15.5% in 2007. In a survey of 78 employers by a consulting firm in 2011, 73% said that university graduates do not have suitable skills and 62% said the same about vocational training graduates. About one-third of the employers surveyed found it difficult to train or upgrade their workforce. The situation has worsened over the past few years as wage rates have risen, pushing manufacturers up the value-added chain and requiring higher levels of skills.

Improvements in early childhood nutrition and better primary and lower secondary schooling would provide children with a firmer base on which to build their educational and skills training. After that, what is required is a concerted approach to improving human capital, with all stakeholders involved—businesses, the government, development partners, and civil society.

On the supply side, the challenge is to strengthen training programs, building in responsiveness and flexibility to labor market needs. This calls for expansion both of formal programs that are more relevant to industry and of nonformal training that can help those with incomplete education enter the job market. The overall response should aim to manage resources in ways that create incentives for good performance and accountability for results, teach soft and technical skills, and bring schools and industry closer together to promote quality and relevance to market demand.

On the demand side, the focus should be on improving information flows and strengthening institutional capacity, particularly in the National Training Board and Employment Agency. Employers lack channels both to communicate their demands for specific skills and to influence skills development policies.

Indonesia

Southeast Asia's biggest economy in 2011 grew at its fastest rate since before the 1997–1998 Asian financial crisis. The pace will likely ease in 2012 on weaker external demand, before accelerating again in 2013 on the expected recovery in trade. Inflation, which receded in 2011, is forecast to quicken when the government raises administered fuel prices. The external current account is projected to slip into deficit this year as exports soften while robust investment keeps capital-equipment imports high. Addressing a major challenge to development, the government is stepping up efforts to improve infrastructure.

Economic performance

Growth of 6.5% in 2011, the highest in 15 years, was based on sustained private consumption, stronger investment, and expansion of net exports (Figure 3.24.1).

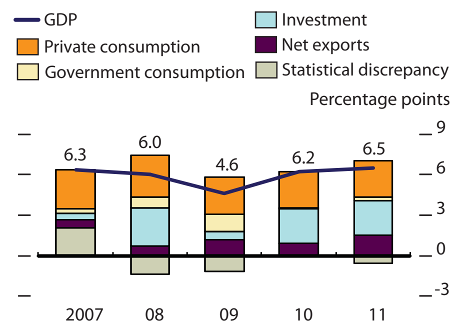
Private consumption grew by 4.7%, contributing 2.7 percentage points of total growth. It was driven by rising incomes and employment and by easing inflation. In a notably positive development, fixed investment grew by 8.8% and contributed 2.1 percentage points of GDP growth. Public investment was constrained by weakness in implementing capital works, although private investment in construction and machinery was robust, supported by increases in foreign direct investment (FDI) and in bank lending. The ratio of nominal fixed capital investment to GDP rose to 32.0% in 2011, up by 7.1 percentage points over 5 years (Figure 3.24.2). Net exports contributed 1.5 percentage points of growth.

From the supply side, economic growth was led by services and manufacturing. Services grew by 8.5% to account for more than half the total GDP increase. Retail and wholesale trading, as well as transport and communications, showed double-digit expansions, while financial services benefited from a stronger performance in banking.

Manufacturing registered its best performance in 7 years: expanding by 6.2% and contributing 1.6 percentage points of overall growth, this outturn was based on the country's large and growing domestic market, alongside a better performance from exports. Subsectors to report significant production gains in 2011 included iron and basic steel, food processing, textiles and footwear, and transport equipment (Figure 3.24.3). By contrast, mining and quarrying recorded weak growth of 1.4%, reflecting years of underinvestment and production problems in crude oil and natural gas.

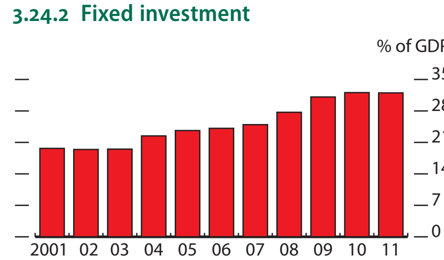
Agricultural output rose by a modest 3.0%. An increase in production of estate crops, such as palm oil and rubber, was partly offset by a decline in food crops. Paddy rice output fell by 1.6% during the year, owing to dry weather in the second half.

3.24.1 Contributions to growth (demand)



Source: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

3.24.2 Fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

About 1.5 million new jobs were generated in 2011, easily exceeding the number of new entrants to the labor force (843,000). The quality of employment also improved: in the 12 months through August 2011 formal employment climbed by 16.0%, or 5.7 million positions. Most jobs were in construction, manufacturing, and services. Employment in the informal sector fell by 5.9%, or 4.2 million, as workers left the agricultural labor force. But 62% of the employed labor force (about 68.2 million people) still work in the informal sector, where wages and job security are low.

Poverty incidence fell to 12.4% in September 2011, from 13.3% in March 2010. (It was 17.6% just before the Asian financial crisis.)

Inflation slowed from 7.0% year on year at the start of 2011 to 3.8% at year-end as food price rises moderated (Figure 3.24.4). A good harvest in the first half was followed by government moves to suspend import duties on some food items and to improve food distribution. Year-average inflation was 5.4%, up slightly from 2010.

Bank Indonesia raised its policy interest rate in February 2011 by 25 basis points to 6.75% to damp inflation expectations. During October 2011–February 2012, after inflation trended down and the global economic outlook dimmed, the central bank lowered this rate by 100 basis points. Broad money (M2) growth accelerated to 16.4% and commercial banks' credit expanded by 24.6% in 2011, slightly above Bank Indonesia's target of 23%. Credit for investment jumped by 33.2%, reflecting the improving economic conditions and declining interest rates.

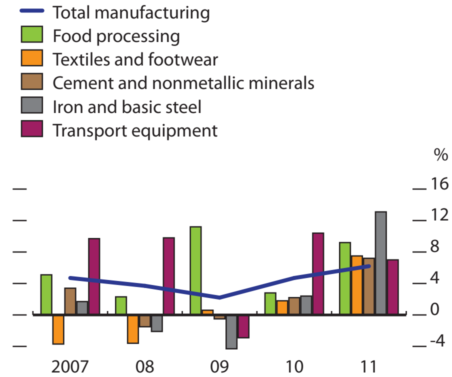
Merchandise exports rose by 27.5% to $201.5 billion in 2011 (Figure 3.24.5), although the pace eased in the fourth quarter. Exports of hydrocarbons rose by nearly 34%—declining oil exports were more than offset by rapid expansion in gas exports, reflecting rising gas prices and output. Non-oil and gas exports increased by 26.1%, with large gains for coal, palm oil, and rubber. In the other direction, strong demand for raw materials, machinery, and consumption goods pushed up merchandise imports by 30.3% to $166.1 billion.

Despite the larger trade surplus (which rose because of a higher export base), the surplus on the current account fell to the equivalent of 0.2% of GDP. That was attributable to a smaller surplus in transfers (remittances from workers abroad declined) and wider deficits in services (higher outlays on freight and business services) and in the income balance (a result of repatriation of investment income by foreign companies).

The capital and financial account turned into deficit in the second half, owing to portfolio capital outflows caused by global financial market anxieties. Net portfolio investment of $4.2 billion in 2011 was down sharply from 2010 (Figure 3.24.6). FDI inflows, though, shot up by 31.9% to a record $18.2 billion, reflecting improvements in the domestic investment environment. The overall balance of payments maintained a healthy surplus and gross international reserves rose to $110.1 billion, equal to 6.4 months of imports and government debt payments combined.

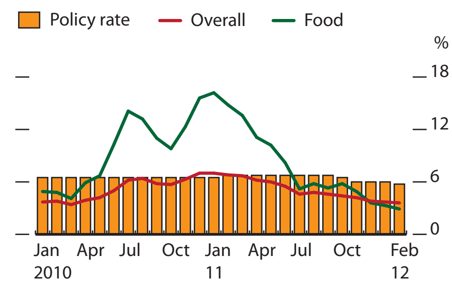
In the first 8 months of 2011, the rupiah appreciated by about 5% against the US dollar, but it turned weaker when global economic concerns heightened, ending the year little changed.

3.24.3 Growth of selected manufacturing subsectors



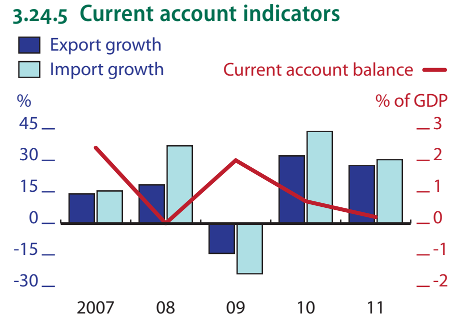
Sources: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

3.24.4 Inflation and policy rate



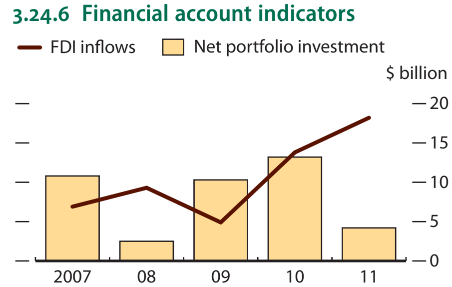
Sources: Asian Development Outlook database; CEIC Data Company (accessed 13 March 2012).

3.24.5 Current account indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2012).

3.24.6 Financial account indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2012).

A strengthening bond market saw the yield on 5-year rupiah government bonds fall by 139 basis points to 5.4% during 2011. The government stepped in to stabilize the market by buying bonds when foreign investors cut their holdings in August–November's market turbulence. Over the year, the stock market edged up 3.2%.

The government aimed for a budget deficit equal to 2.1% of GDP, but the outcome was around half that, at 1.1%. One reason was that public capital spending fell short of target because of chronic weakness in implementing capital projects. Another was buoyant revenue: tax receipts increased to 11.8% of GDP (from 11.2% in 2010) owing to a widening tax net, improving tax administration, strong economic activity, and high commodity prices.

Subsidies for fuel and electricity, however, remained a heavy burden on the budget, at 3.4% of GDP, and their cost exceeded the amount invested in public capital works. Still, the ratio of national government debt to GDP fell to 24.3% in 2011, maintaining a declining trend (Figure 3.24.7).

Reflecting the country's improved macroeconomic performance, two major rating agencies raised Indonesia's sovereign ratings to investment grade: Fitch to BBB minus in December 2011 and Moody's to Baa3 in January 2012.

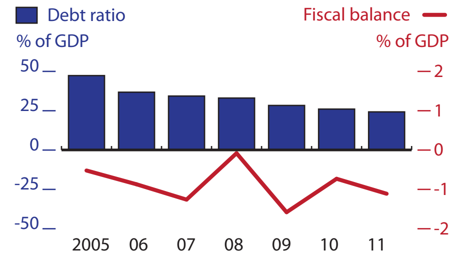
Economic prospects

Forecasts assume the government will maintain its efforts to improve both the investment climate and public financial management, especially for budget execution. The forecasts also assume that the authorities will pursue major policies outlined in the master plan for economic development 2011–2025 (known by its Indonesian acronym MP3EI), published last year. The plan calls for raising public investment in infrastructure, reducing bottlenecks, and closing the development gap between eastern and western regions of the country.

Private consumption is forecast to remain strong this year and next. Surveys of households conducted by Bank Indonesia show high consumer confidence (Figure 3.24.8), driven mainly by optimism about growth in jobs and incomes. Consumption is underpinned by an expanding middle class (those with incomes of $2–20 a day in 2005 purchasing power parity terms, a group increasing by about 7 million a year) and rising labor force participation.

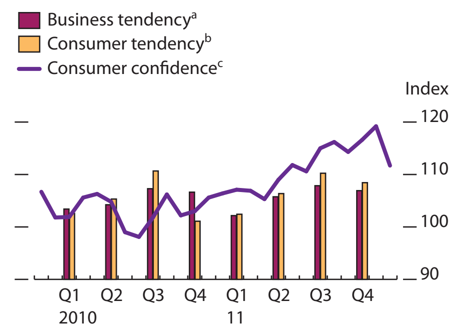
Private investment is expected to maintain its upward trend, given the country's solid record of economic growth over recent years (averaging 5.7% since 2004), upgrades in sovereign ratings, and an improved investment environment. Indonesia's ranking as an investment destination rose two places to seventh in the 2011 *World Investment Report* by the United Nations Commission of Trade and Development. A Bank Indonesia Business Survey conducted in the fourth quarter of 2011 indicated a steady rise in planned business activity and investment in the first half of 2012, and the Business Tendency Survey conducted in that quarter by the statistics office also suggested optimism over the near-term outlook (Figure 3.24.8).

3.24.7 Fiscal indicators



Sources: Directorate General of Debt Management. http://www.dmo.or.id; Republic of Indonesia Ministry of Finance. http://www.fiskal.depkeu.go.id (both accessed 13 March 2012).

3.24.8 Business and consumer confidence indexes

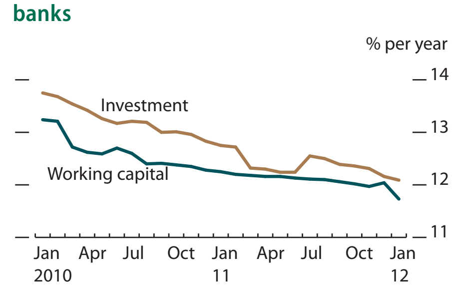


[a] From a quarterly Statistics Indonesia survey among business executives. [b] From a quarterly Statistics Indonesia survey among middle- and upper-income households. [c] From a monthly Bank Indonesia survey among households.

Note: A score above 100 means that respondents are optimistic and vice versa.

Source: CEIC Data Company (accessed 13 March 2012).

3.24.9 Average lending rates of commercial banks



Note: Refers to rupiah credit.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 13 March 2012).

The fiscal stance will be accommodative to mitigate the impact on economic growth of the global slowdown. In late March 2012, Parliament passed a revision to the 2012 budget, widening the fiscal deficit to 2.2% of GDP from an originally planned 1.5%. The revised budget contains three key components: a provision to increase administered domestic fuel prices if the average Indonesian crude oil price exceeds $120.80 over a 6-month period; an additional $2.8 billion of social spending if fuel prices are raised; and a further $1.9 billion in capital spending. Public infrastructure investment is expected to surge by 48.6% in 2012 from that spent in 2011. A budget deficit recorded in January 2012, unlike recent years' surpluses for this month, indicates improved budget execution.

Investment in infrastructure by the private sector and state-owned firms could start to increase, as outlined in the MP3EI. A Land Law for Public Use (approved by Parliament in December 2011) should help in acquiring land for public infrastructure, easing a serious constraint. Domestic commercial banks, which have excess liquidity, have expressed interest in financing infrastructure development, and the sovereign investment-grade ratings are expected to facilitate a greater volume of long-term financing.

Lending interest rates have come down (Figure 3.24.9, above) since Bank Indonesia lowered its policy rate. Credit to the private sector is projected to grow by at least 25% this year, financing increases in investment and consumption.

Manufacturing output looks set to increase further during the forecast period, based on announcements by companies of planned new facilities. The expansion has spread to industries such as metal products and machinery, which are more export oriented than transport, storage, and communications, sectors that previously attracted most investment. This diversification of manufactured products contributed to the solid increase in output last year (Figure 3.24.10).

Exports, though, face headwinds this year as global trade slows. GDP growth is therefore forecast to ease to 6.4%, before stepping up in 2013 (Figure 3.24.11) when world trade and economic growth pick up and infrastructure investment gathers momentum.

Inflation during the forecast period depends in part on the timing and size of increases in fuel prices. The year-average rate for 2012 is projected at 5.5% (Figure 3.24.12), on the assumption that fuel prices will be lifted later this year. If fuel prices are increased later than anticipated, inflation would likely be lower than forecast this year and higher than projected in 2013.

Slower growth in exports will likely produce a small current account deficit in 2012. Merchandise exports are projected to increase by about 13.5% and imports by 18.5% (strong investment will spur imports of capital equipment). The income deficit will widen, consistent with strengthening FDI flows and related repatriation of corporate earnings. In 2013, the current account is seen returning to a small surplus as external demand recovers (Figure 3.24.13).

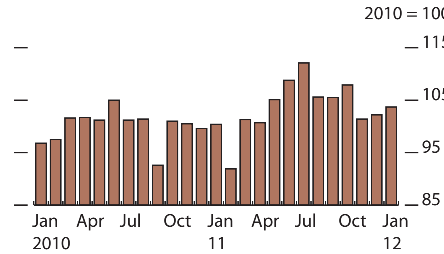
Inflows of foreign direct and portfolio investment are expected to keep the overall balance of payments in surplus through the forecast period. The rupiah could soften this year against the US dollar in light of the current account deficit and higher inflation.

3.24.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.4	6.7
Inflation	5.5	5.0
Current account balance (share of GDP)	-0.1	0.2

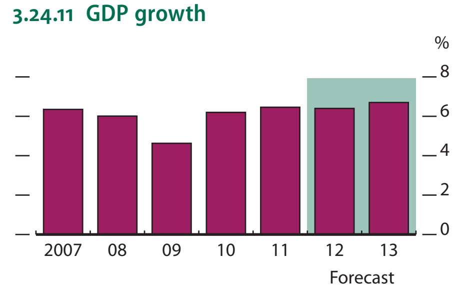
Source: ADB estimates.

3.24.10 Manufacturing production index



Source: CEIC Data Company (accessed 13 March 2012).

3.24.11 GDP growth



Source: Asian Development Outlook database.

Uncertainties in the global economic outlook mean that risks to the forecasts are tilted to the downside. A sharper deterioration than anticipated in major export markets would translate into even lower export growth. Further, Indonesia is vulnerable to financial-market volatility because of its relatively open capital account and heavy foreign presence in its stock and bond markets (about two-thirds of equities and one-third of sovereign bonds are foreign held).

The government's gross financing needs remain high, despite its low budget deficit and declining debt-to-GDP ratio. The share of financing from market sources is expected to increase to about 85% this year, from 60% in 2009, in line with official policies to develop the capital market. This suggests the financing of the budget could be disrupted in the event of large capital outflows.

Anticipating such risks, the government included provisions in its 2012 budget that enable it, in an economic emergency, to get approval from Parliament within 24 hours, to raise spending above the budgeted level, and to switch spending priorities. That is in addition to the additional capital and social spending added to the budget in March that should provide a buffer to weaker external demand. Contingency plans also include the bond stabilization program that provides for the government to tap funds from its current budget, accumulated budget surpluses, and state-owned enterprises to steady a volatile market.

Moreover, the central bank has upgraded macroprudential measures to reduce short-term and speculative capital inflows and mitigate the risks of sudden outflows. These include gradually replacing short-term Bank Indonesia certificates with government bonds for liquidity management, reinstating limits on short-term offshore borrowing by banks to a maximum of 30% of their capital, increasing banks' foreign currency reserve requirements, and requiring an underlying economic exchange for any foreign currency transaction above $100,000.

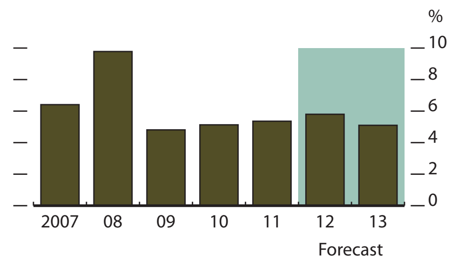
Policy challenge—strengthening infrastructure

Lagging development of infrastructure—transport and telecommunications networks, electricity, and water supply—is a prime constraint on economic growth. The quality of infrastructure is ranked below that of, for example, Malaysia and Thailand (Table 3.24.2). Indonesia's logistics costs (including transportation, warehousing, and distribution) are about 14% of total production costs, much higher than Japan's roughly 5%.

The government has made infrastructure development a key priority in both its Medium-Term Development Plan 2010–2014 and the longer-term MP3EI. Several transport projects financed through the budget are scheduled to get under way this year, including expansion of Jakarta's main airport, construction of highways and ports, and the building of transport infrastructure in eastern provinces.

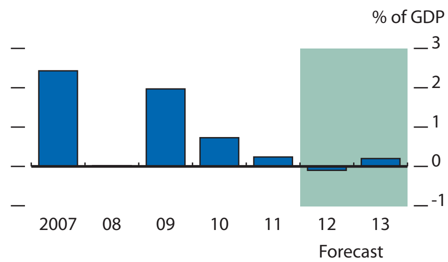
Indeed, budget allocations for infrastructure have increased significantly since 2010, but the execution of capital projects has lagged (Figure 3.24.14) because of capacity and other constraints. In efforts to address this issue, officials are simplifying procedures and strengthening procurement capacity in the spending agencies: the Ministry of Public

3.24.12 Inflation



Source: Asian Development Outlook database.

3.24.13 Current account balance



Source: Asian Development Outlook database.

3.24.2 Rank in Global Competitiveness Index

	2010–2011 (out of 139)	2011–2012 (out of 142)
Overall ranking		
Singapore	3	2
Malaysia	26	21
Thailand	38	39
Indonesia	44	46
Philippines	85	75
Infrastructure		
Singapore	5	3
Malaysia	30	26
Thailand	35	42
Indonesia	82	76
Philippines	104	105

Source: World Economic Forum. 2011. *The Global Competitiveness Report 2011–2012*. http://www.weforum.org/reports/global-competitiveness-report-2011-2012 (accessed 22 March 2012).

Works, for example, is introducing electronic bidding and procurement systems. Further, a new task force to accelerate budget execution reports directly to the President. Coordination between the central and local governments will also need to improve and local governments' weak capacity to implement infrastructure projects has to be addressed.

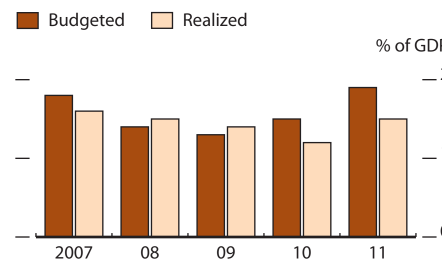
As for private participation in infrastructure development, the Land Law for Public Use will provide greater certainty on land acquisition for infrastructure projects. Moves to refine regulations and institutions to support public–private partnerships are starting to produce results. Agreements were signed in October 2011 for private investors to build a $3 billion power plant in Central Java, guaranteed by the government. The Rajabasa and Muaralaboh geothermal projects, involving total investment of $1.4 billion, were approved under a similar arrangement in March 2012.

Also in March, the government issued a blueprint for the development of a national logistics system that aims to attract considerable private sector participation.

However, to ensure sustained private investment in infrastructure, further efforts are needed to improve governance, develop a more consistent legal and regulatory framework, and address government capacity constraints in preparing projects for private participation.

The subdued external economic environment in 2012 should provide an incentive for a stronger push on infrastructure development to support growth in the near term, as well as raise the country's potential in the medium term.

3.24.14 Government capital expenditure



Source: Republic of Indonesia Ministry of Finance. http://www.fiskal.depkeu.go.id (accessed 13 March 2012).

Lao People's Democratic Republic

Resource-based industries, manufacturing, and services generated robust growth in 2011, and are expected to drive similar growth rates during the forecast period. Inflation, after speeding up last year, is projected to moderate. The country signed agreements that bring it closer to joining the World Trade Organization. However, generating well-paying jobs remains a major challenge.

Economic performance

Despite severe flooding that damaged agriculture in 2011, the economy grew by 7.8% (Figure 3.25.1), mainly owing to expansion of hydropower, manufacturing, mining, and services.

Typhoons in the second half of the year brought floods that took down rice output by 11% to about 2.9 million tons. Production of corn, beans, and vegetables also fell, although sugarcane, fisheries, and poultry performed better than in 2010. Output of timber declined as the government curbed illegal logging and restricted logging quotas. Agriculture as a whole, which accounts for just under one third of GDP, was virtually flat in 2011.

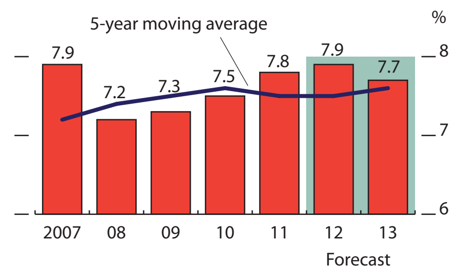
By contrast, industry expanded by 15.6%. Production of copper from the country's two biggest mines—Phu Bia and Sepon—rose by about 5% to 139,000 tons. Silver production also gained, by about 6% to 538,000 ounces, though output of gold fell by about 22% to 128,000 ounces.

Hydropower output rose by 18.5% in 2011, spurred by new plants coming online, including the 615 megawatt Nam Ngum 2 in April 2011, and by heavy rainfall during parts of the year. Most of the electricity generated is exported to Thailand. Investment in mining and power plants contributed to growth: several mines, including the Ban Houayxai gold and silver mine as well as eight hydropower plants and a lignite power plant were being built. Other construction focused on housing; commercial buildings; and hotels in Vientiane, Luang Prabang, and Savannakhet. Construction overall increased by about 6%.

Garment manufacturing benefited from the European Union's relaxation, from January 2011, of rules of origin for imports of garments from certain developing countries, including the Lao People's Democratic Republic (the Lao PDR) (Figure 3.25.2). Garment exports to the European Union and the United States, the two main markets, rose by about 17% to $225.6 million.

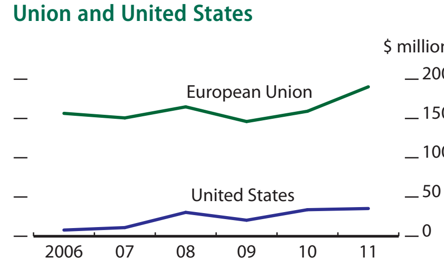
The services sector grew by 7.9% last year. Tourist arrivals went up by 9% to 2.7 million (Figure 3.25.3), supporting the hotels and restaurants as well as transport subsectors. The rollout of third-generation

3.25.1 GDP growth



Source: Asian Development Outlook database.

3.25.2 Garment exports to the European Union and United States



Note: Using import data from US OTEXA and Eurostat. Data from Eurostat were converted to US dollars using €/$ average exchange rate for the year.

Sources: Office of Textiles and Apparel. http://otexa.ita.doc.gov (accessed 20 March 2012); Eurostat. http://epp.eurostat.ec.europa.eu (accessed 21 March 2012).

This chapter was written by A. Barend Frielink and Soulinthone Leuangkhamsing of the Lao PDR Resident Mission, ADB, Vientiane.

mobile telephone and internet services contributed to growth of telecommunications and banking continued to expand.

Inflation peaked at 9.8% in May (Figure 3.25.4) and averaged 7.6% for the year (up from 6.0% in 2010). Rising global oil prices drove up domestic fuel costs, and the disruption to supplies of food during the floods pushed up prices of food. Higher inflation in neighboring countries that supply consumer goods—the People's Republic of China (PRC), Thailand, and Viet Nam—added to pressure on prices.

Growth in credit moderated from very high rates in recent years to a still high 34.2% in December 2011 (Figure 3.25.5). The deceleration stemmed from reduced direct lending by the central bank for infrastructure projects and steps the bank took to curb lending for real estate speculation. A shortage of longer-term bank deposits constrained commercial bank lending to the private sector.

The central bank also maintained its policy of keeping the kip broadly stable against the US dollar and Thai baht. During 2011 the kip appreciated by 2.7% against the US dollar and by 1.6% against the baht. Dollarization has gradually declined from 79% in 1999 to about 45% last year.

Strong flows of revenue to the government from mining and hydropower, coupled with reduced off-budget spending, brought down the overall fiscal deficit to about 2.0% of GDP in FY2011 (ended 30 September 2011) from 5% the previous year. A value-added tax introduced in 2010 supported growth in total revenue, which is estimated to have reached the equivalent of 19.4% of GDP (including grants). Government spending is estimated at 21.4%.

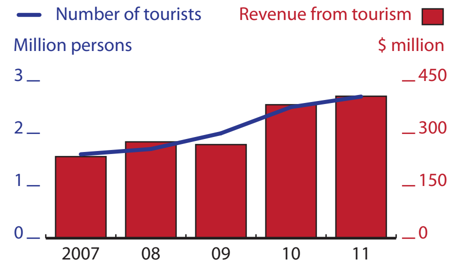
Merchandise exports, mainly minerals, hydropower, garments, and wood products, rose by an estimated 24.0% to $2.7 billion in 2011. Imports increased by 19.4% to $4.3 billion, bolstered by purchases of capital equipment for the resource industries and two Airbus aircraft for Lao Airlines. After dividend and profit repatriation and interest payments by resource-based companies, the current account deficit was estimated at 15.9% of GDP.

Accounting for foreign direct investment and other capital flows, gross international reserves fell to $679 million in 2011, sufficient for about 2.5 months of nonresource imports.

The Lao PDR has moved closer to joining the World Trade Organization, after reaching bilateral agreements with major trading partners. (It has sought membership in that body since 1997 to foster trade and investment.) Under the market access agreement signed last year with Australia, for example, the government agreed to an average ceiling on import tariffs of about 25%, and as low as 5% on some goods. It committed to allow market access for suppliers of a range of services and to allow majority foreign ownership of joint ventures.

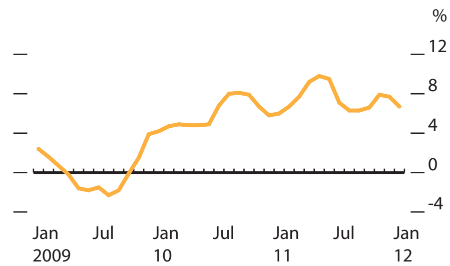
In another market-opening development, the government sold stakes of about 30% in two state-owned companies—power company EDL-Generation Co. and Banque Pour Le Commerce Exterieur Lao—through initial public share offerings, and listed the shares on the new Lao Securities Exchange last year. Further such listings are planned.

3.25.3 Tourism indicators



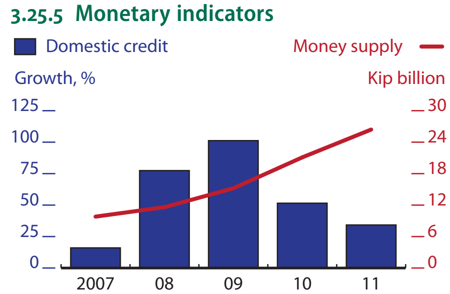
Source: Ministry of Information, Culture and Tourism.

3.25.4 Inflation



Source: CEIC Data Company (accessed 21 March 2012).

3.25.5 Monetary indicators



Sources: Bank of the Lao PDR; *Asian Development Outlook* database.

3.25.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.9	7.7
Inflation	6.7	6.0
Current account balance (share of GDP)	-21.0	-22.0

Source: ADB estimates.

Economic prospects

Growth looks likely to continue in 2012–2013 at similar rates to last year. Construction is gathering momentum on the $3.7 billion Hongsa lignite thermal power plant (1,878 megawatts) and associated coal mine. Work will get under way this year on Nam Ngum 3 (440 megawatts), joining eight other hydro plants under construction. Expansion of Theun Hinboun (280 megawatts) is due to be completed in July 2012.

The Ban Houayxai mine is scheduled to start production in the first half of 2012, at a full-year rate of 100,000 ounces of gold and 700,000 ounces of silver, and the Phu Kham copper–gold project, one of the biggest in the country, is being expanded. A potash mine and processing plant costing $94 million is expected to be completed this year and a company from Viet Nam has started work on a larger potash project (costing $450 million) to be completed by 2015. Most fertilizer from these potash plants will be exported.

In the capital Vientiane, the government is investing more than $180 million on building facilities for the 2012 Asia–Europe meeting of senior officials from 50 countries to be held in November 2012. The PRC is providing loans for conference facilities and airport expansion.

Tourism will get a lift from international promotion of 2012 as Visit Laos Year and from the ASEAN University Games to be held in December 2012. Lao Airlines has launched flights between Vientiane and Singapore after acquiring the Airbus planes in late 2011.

Rice production is expected to recover from last year's flood-suppressed level. Agricultural output is seen increasing by 2–3% in 2012, depending on the weather. The government is repairing irrigation systems damaged by the floods and building new irrigation systems to support dry-season crops.

Fiscal policy is more expansionary in FY2012, and the fiscal deficit is projected to widen to 4.6% of GDP. The government has budgeted to increase spending considerably, in part to repair the flood-damaged infrastructure. The central bank is targeting 25% growth in M2 money supply and aims to curtail expansion of credit to 28% (such targets have been missed in recent years, though).

Inflation is forecast to moderate to average 6.7% this year and 6.0% in 2013. Lower global food prices and a better domestic harvest will ease the pressures on food, which has a large share in the consumer price index. There will be some upward impact on prices from an increase of about 18% in administered electricity tariffs in the first half of 2012.

Sluggish global economic growth is expected to weigh on prices of copper, holding back merchandise export growth to about 19% in 2012. Imports of capital equipment needed for new mining and power projects will underpin an increase of about 17% in merchandise imports. The current account deficit is forecast to widen to 21.0% of GDP.

External public debt rose to an estimated $3.7 billion dollars in 2011, although as a ratio to GDP it fell to about 47%. An external-debt sustainability analysis by the International Monetary Fund in 2011 found that the country still faces a high risk of debt distress, and that the projected rate of debt accumulation could increase in the next few years, reflecting borrowings mainly from the PRC.

3.9.1 Policy challenge—generating more jobs

Poverty incidence declined from 46% of the population in 1993 to a still high 27% in 2008. Consequently, major development goals are to sustain growth of income and employment, and better distribute income and wealth.

Central to these tasks is raising productivity and incomes in agriculture, which employs about three-fifths of the workforce. Rural areas are home to the majority of the poor. As improved productivity reduces the number of workers in agriculture, however, industry and services must grow if the surplus workers are to find jobs.

Investment in recent years has focused on mining and hydropower. They have indeed driven much of the growth, but, being capital intensive, have not generated enough jobs to take in all the workers leaving agriculture.

Industries that could create many well-paid jobs include:

Agribusiness. Processing crops like rice, corn, and natural rubber adds value and is labor intensive. As links strengthen between the Lao PDR and its neighbors Cambodia, the PRC, Myanmar, Thailand, and Viet Nam, market access for agribusiness production will expand.

Tourism. This group of countries also offers a cluster of tourism destinations that could be developed and promoted to achieve faster growth. Services associated with tourism, such as hotels, have a strong employment response to growth in output.

Services. It is efficient to cluster development of services in towns and cities to capture economies of scale and agglomeration. Moves in this direction require the government to address issues including inadequate urban planning and provision of water and sewerage systems.

More broadly, development of these and other industries depends on bringing down the high cost of finance, expanding education and skills training, building transport infrastructure, and addressing weaknesses in governance.

Malaysia

Strong private consumption drove economic growth in 2011, supported by government spending and, less so, by fixed investment. The weaker global environment is forecast to slow growth in this highly open economy in 2012, but the better global backdrop next year should help lift its performance. Moderating growth this year suggests that inflation will also ease. The external current account surplus will remain buoyant.

Economic performance

Expansion of 5.1% in 2011 was fueled mainly by private and government consumption on the demand side and by an expansion of the services sector on the production side. Slower global trade and growth weighed on exports and manufacturing.

Private consumption rose by 6.9%, accelerating from 2010 and contributing about two-thirds of total GDP growth in 2011 (Figure 3.26.1). This reflected a robust labor market (employment increased by 3.2% and unemployment fell to an 11-year low of 3.1%), favorable prices for agricultural commodities (supporting farm incomes), and availability of credit (household borrowing rose by 12.5%). Government consumption, too, made a significant contribution to growth. It surged by 16.8% as the government raised outlays on supplies and services, increased public service wages, and paid a 1-month bonus.

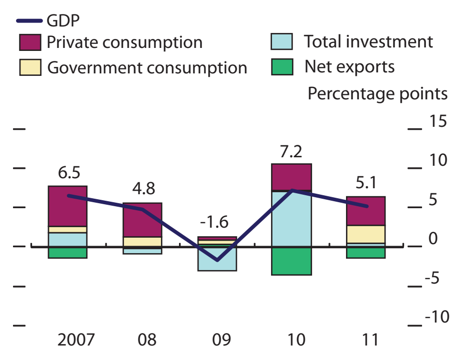
Fixed capital investment growth moderated to 6.0% in 2011. While private investment was strong for much of the year, government investment fell, reflecting the phasing out in 2010 of a fiscal stimulus package. Gross fixed capital investment as a ratio to GDP was flat at around 20%, well below levels seen in the mid-1990s (Figure 3.26.2). This reflects, in large part, rising costs of production and limited progress in attracting higher valued-added industries.

Imports of goods and services in real terms rose faster than exports, holding back GDP growth from the demand perspective.

In supply-side terms, services contributed the vast bulk of growth, expanding by 6.8%. The robust private consumption drove a solid gain in retail and wholesale trading. Finance and insurance services benefited from strength in bank lending and insurance sales, and real estate services from an upturn in the housing market.

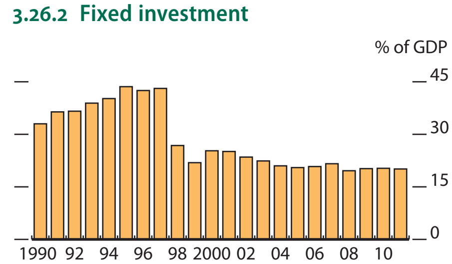
Manufacturing grew by only 4.5% as demand weakened in major industrial countries for manufactured products, particularly electronics. Supply disruptions caused by the March earthquake and tsunami in Japan and second-half floods in Thailand also dented manufacturing output (Figure 3.26.3). The electronics and electrical subsector contracted by 2.4% last year.

3.26.1 Contributions to growth (demand)



Source: Department of Statistics Malaysia. http://statistics.gov.my; CEIC Data Company (both accessed 16 March 2012).

3.26.2 Fixed investment



Source: CEIC Data Company (accessed 20 March 2012).

This chapter was written by Gary Krishnan of the Southeast Asia Department, ADB, Manila.

Construction increased by a modest 3.5%, reflecting the end of the fiscal stimulus in 2010. The mining subsector (mainly oil), contracted by 5.7%, a result of maintenance shutdowns and output declines in mature fields.

The performance of agriculture—5.6% growth—was the strongest in 8 years. This was largely based on a sharp increase in crude palm oil production, which accounts for about one-third of the sector. Palm oil output rose by 11.3% to 18.9 million tons owing to good weather and firm international prices.

Higher food costs and increases in administered prices of electricity, fuel, and sugar nudged up inflation to 3.5% year on year in June (Figure 3.26.4). On a year-average basis, it accelerated to a 3-year high of 3.2%. House prices also turned up, by 8.6% in the first 3 quarters, a pace more than double the average of 2000–2010.

To lean against inflation, Bank Negara Malaysia, the central bank, raised its policy interest rate in May 2011 by 25 basis points to 3.0%. It also lifted the reserve requirement for banks from 1.0% to 4.0% to drain excess liquidity from the banking system.

The government boosted public expenditure by about 13% in 2011 (it had declined slightly in the prior year). Revenue rose by 15%, propelled by the surge in oil prices, so that the federal budget deficit narrowed slightly to 5.3% of GDP (Figure 3.26.5). The ratio of federal government debt to GDP edged higher to 53.5%.

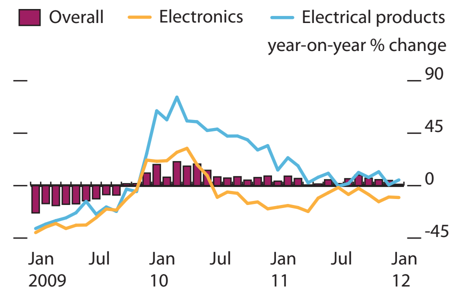
Growth in M2 money supply rose by 14.6% year on year in December 2011, double the rate of the prior-year month. Credit to the private sector accelerated to 12.2% in 2011.

The external position remained strong. Merchandise exports climbed by 14.5% to US$227.5 billion, largely a result of higher prices for export commodities. The value of palm oil shipments jumped by 32.6% and that of minerals (mainly oil) by just over 22%. By contrast, the weakness in global demand for electronics and electrical products, alongside supply disruptions, took down their exports by 5.4%. After a 13.9% increase in imports to US$178.7 billion, the trade surplus rose to US$48.8 billion (Figure 3.26.6). The current account surplus as a share of GDP remained large at 11.5%.

In the capital and financial accounts, net portfolio investment of US$9.9 billion in 2011 was lower than in 2010 owing to global investor risk aversion caused by the eurozone and the United States fiscal and debt concerns in the second half of the year. Inward direct investment rose by nearly 19% to US$10.8 billion, exceeded by outward direct investment that rose by 11% to US$14.8 billion. Other investment outflows moderated and the overall balance of payments recorded a surplus of US$31.0 billion. That lifted international reserves to $138.4 billion at end-2011, sufficient to finance about 8 months of retained imports and 4.1 times short-term external debt. The ringgit depreciated against the US dollar by about 3% during the year.

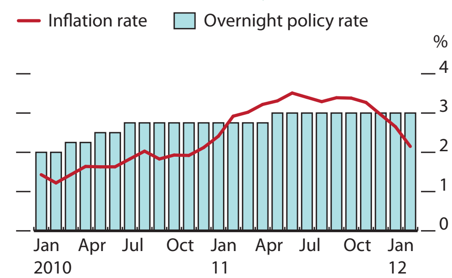
Concerned about high levels of household debt (equivalent to 76.6% of GDP in 2011), the central bank moved to damp speculation in housing and to tighten credit card issuance. For housing loans, it imposed a 70% loan-to-value ratio on individual borrowers with more than two housing loans, and ruled that housing loan approvals be based on net rather than gross household income. Capital charges on commercial banks were

3.26.3 Manufacturing production index



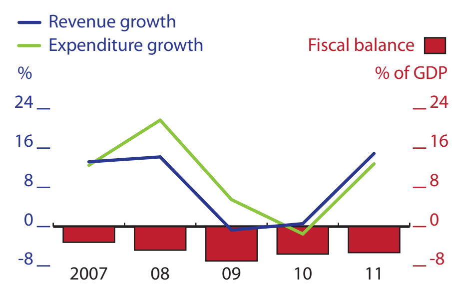
Source: CEIC Data Company (accessed 20 March 2012).

3.26.4 Inflation and policy interest rate



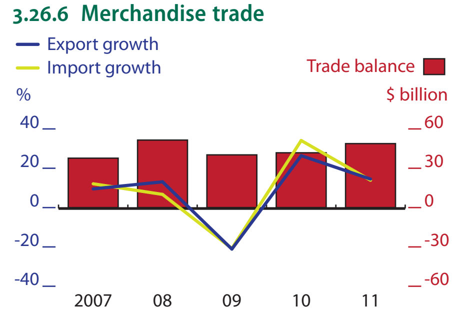
Source: CEIC Data Company (accessed 20 March 2012).

3.26.5 Fiscal indicators



Source: Asian Development Outlook database.

3.26.6 Merchandise trade



Source: Asian Development Outlook database.

increased for housing loans with loan-to-value ratios exceeding 90%, and on personal loans of more than 5 years.

On credit cards, the central bank put limits on the number of cards and the amount of credit available for people earning less than RM36,000 (US$11,760) a year. That comes on top of a RM50 annual tax on credit cards.

3.26.1 Selected economic indicators (%)

	2012	2013
GDP growth	4.0	5.0
Inflation	2.4	2.8
Current account balance (share of GDP)	12.1	11.9

Source: ADB estimates.

Economic prospects

Given the country's close integration with the world economy—exports and imports of goods and services are equivalent to over 100% of GDP—weakness in the global outlook clouds Malaysia's prospects in 2012. Growth is seen moderating to about 4.0%, then quickening in 2013 as the external environment improves (Figure 3.26.7).

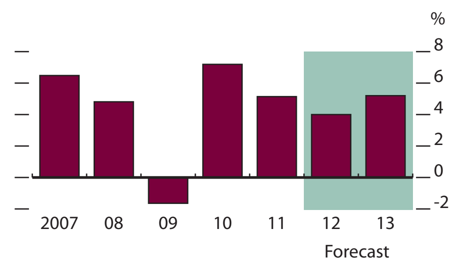
Domestic demand will again anchor growth. Private consumption will get support from government decisions in the 2012 budget to raise wages for the public sector and to make a one-time cash payment to low- and middle-income groups (53% of all households). Government plans to introduce a minimum wage in 2012 are expected to lift incomes for the low paid.

Still, the labor market is likely to soften, particularly in trade-exposed industries. Job vacancies in January 2012 declined steeply from the prior-year period. Consumer sentiment weakened late in 2011 (Figure 3.26.8).

Private investment in export-oriented industries such as electrical and electronics products will be subdued by the weak global outlook this year, although investment will likely be relatively buoyant in industries that depend on domestic demand.

The government is pressing ahead with its Economic Transformation Programme, launched in 2010, to develop higher value-added industries and infrastructure in partnership with private investors. According to government officials, investment totaling US$58 billion has been committed through 2020 under the program. Several large projects associated with this initiative will start construction during the forecast period, including an $11.5 billion mass rapid transit rail system in Kuala Lumpur and redevelopment of the Sungai Besi military airbase and a large site near the center of the capital for residential and commercial purposes.

3.26.7 GDP growth



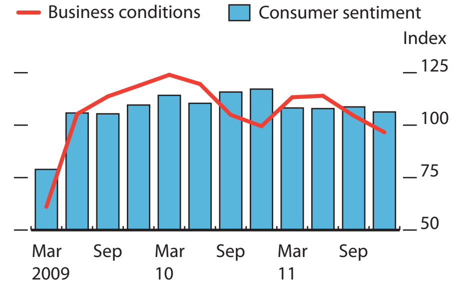
Source: Asian Development Outlook database.

The leading index of economic activity in January 2012 suggested slower economic growth in the near term, and the forward-looking Business Conditions Index, compiled from a survey of manufacturers, fell late last year (Figure 3.26.8).

From the production side, services are likely to continue to drive growth in 2012. The government is relaxing some restrictions on foreign investment in 17 services subsectors, including accounting, education, legal, and medical services, following a similar easing for 27 services subsectors in 2009. Tax breaks have been offered to encourage treasury management, as well as Islamic and other financial services.

Construction will gain from work on major projects and on a US$2.0 billion off-budget government program to upgrade infrastructure. The impact on construction from the curbs on credit for speculation in housing and an increase in the tax on profits from

3.26.8 Confidence indexes



Note: The business conditions index is derived from a quarterly survey of over 350 manufacturing firms. The consumer sentiment index is from a quarterly survey of over 1200 households in peninsular Malaysia. Above 100 indicates expansion for manufacturing and optimism among consumers.

Source: CEIC Data Company (accessed 20 March 2012).

selling properties within 5 years of acquisition is expected to be modest. Sluggish external demand will weigh on manufacturing and on trade-related services. Growth of agriculture will decelerate from the rapid pace seen last year.

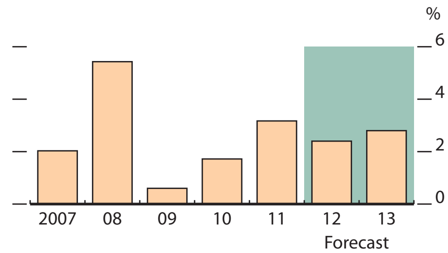
Fiscal policy is targeted at stimulating domestic demand again this year. The federal deficit is expected to be broadly similar to that recorded for 2011 as a share of GDP. The central bank has signaled that it has the flexibility to increase monetary stimulus if the global economy deteriorates.

Inflation is forecast to recede to 2.4% (Figure 3.26.9) in light of moderating domestic demand and generally lower prices for imported commodities. This forecast assumes that subsidies on electricity, food, and fuel will not be cut ahead of national elections due in 2013. The ringgit appreciated by 3.4% against the US dollar in the first quarter of 2012, helping to damp inflation. In 2013, inflation is seen picking up to 2.8%, in line with domestic demand.

Growth in merchandise exports is expected to be subdued in 2012 owing to torpid global trade and softer prices for export commodities, including palm oil. Similarly, imports will increase at a modest rate, in tandem with weakness in manufacturing industries and more moderate growth in private domestic demand. The current account will continue to record substantial surpluses through the forecast period.

Lower than expected growth in global trade would put the 2012 growth forecast at risk, given the country's reliance on exports. Domestically, the high level of household debt poses a risk if the labor market is weaker than anticipated.

3.26.9 Inflation



Source: Asian Development Outlook database.

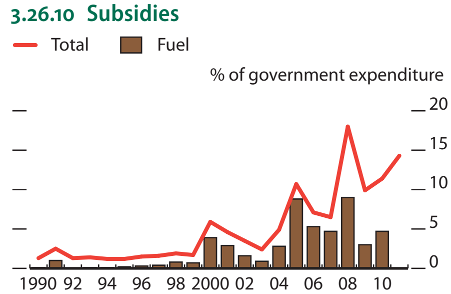
Policy challenge—reining in subsidies

The cost of government subsidies on fuel, staple foods, electricity, health, and education has climbed from 1.3% of total government spending in 1990 to 14.3% in 2011 (about 4% of GDP). Fuel subsidies alone amounted to 4.7% of total government spending in 2010 (Figure 3.26.10). Mainly for this reason, Malaysians consume 450 liters of fuel a head each year, 4.5 times as much as Thais and nine times Indonesians, according to the government.

Subsidies suppress inflation, but also contribute to the chronic fiscal deficit, reduce budget funding available for social and economic development, and distort resource allocation. The vast bulk of the subsidies benefit consumers, students, and companies in general, rather than the poor, because of inadequate targeting.

The government started to gradually reduce subsidies in 2010 on gasoline, cooking gas, electricity, and road tolls, and committed to better target remaining subsidies to lower income groups. It offered partial compensation for the upward impact on inflation, including cash rebates to owners of motorcycles and small cars (below 1,000cc). Budget savings estimated at about US$33 billion in the 5 years that subsidies were to be phased down were to have been applied to reining in the fiscal deficit. However the phase-down plan has since been suspended and it is unclear when it will resume.

3.26.10 Subsidies



Sources: Ministry of Finance. *Economic Report 2011/2012*. http:// www.treasury.gov.my; CEIC Data Company (accessed 20 March 2012).

Myanmar

Economic growth picked up in FY2011, based largely on foreign investment in energy and exports of commodities and natural gas. That trend is forecast to continue, assisted by policy reforms and higher gas exports in 2013. Inflation is expected to quicken, after receding in 2011. The government has taken steps to revitalize the economy, but the agenda of required reforms is long.

Economic performance

GDP growth edged up to an estimated 5.5% in FY2011 (ended 31 March 2012), from an average of 4.9% over the previous 4 years, based mainly on investment in hydropower, natural gas, and oil. Agriculture remained subdued owing to flooding and currency appreciation that hurt exports.

International tourist arrivals rose by an estimated 26% (Figure 3.27.1), in part a response to initial political and economic reforms after national elections in November 2010.

(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.)

The exchange rate of the kyat on the unofficial market appreciated to about MK800/$1 in 2011, maintaining an upward trend from MK1,000 in 2009. The appreciation was driven largely by foreign investment. (The official exchange rate was maintained at MK5.4/$1 in FY2011.)

One outcome of the stronger market exchange rate was to reduce rice exports, which created a surplus in the domestic market and brought down rice prices. That helped slow inflation to 4.2% on average in FY2011, from 7.3% in the previous fiscal year.

Exports of gas increased by nearly 15% to an estimated $3 billion (Figure 3.27.2). Gemstone and jade exports, however, likely declined after doubling in FY2010. Higher levels of imports, particularly construction materials and machinery, widened the current account deficit to an estimated 2.7% of GDP in FY2011, from 0.9% in FY2010.

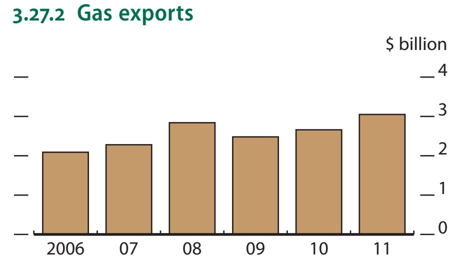
Increased foreign investment in energy and hydropower, estimated at $2.8 billion in FY2011, lifted international reserves to about $8 billion by March 2012, equivalent to 9.4 months of imports (Figure 3.27.3). Foreign investment in other industries is insignificant owing to barriers to entry and a poor business environment. Total external debt is estimated at $11 billion, with about half in arrears.

The consolidated fiscal deficit—covering the central government and state economic enterprises—is estimated at 5.5% of GDP in FY2011 (Figure 3.27.4). Revenue collection remained low because of weak tax administration and a reduction of export taxes implemented to support

3.27.1 Tourism indicators

Source: Ministry of Hotels and Tourism.

3.27.2 Gas exports



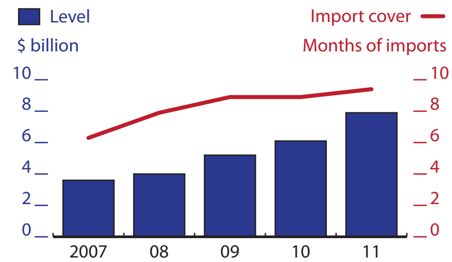
Note: In fiscal years.
Source: Department of Energy Planning, Ministry of Energy.

This chapter was written by Alfredo Perdiguero of the Thailand Resident Mission, ADB, Bangkok.

agricultural exports. The phasing down of construction of the new capital Naypyidaw helped rein in growth of government spending.

The monetary authorities lowered administered bank interest rates by 4 percentage points from 17% to 13% for lending and from 12% to 8% for deposits in FY2011, though banks were also given some flexibility in setting deposit rates. Yields on Treasury bonds made them attractive investments for banks, which reduced central bank monetization of the fiscal deficit in FY2011.

3.27.3 Gross international reserves



Source: *Asian Development Outlook* database.

Economic prospects

The government that took office in March 2011 has an opportunity to rejuvenate the economy after more than 50 years of stagnation. In a promising start, the authorities took steps to unify the multiple exchange rates and are preparing other reforms, including a new national development plan.

New currency arrangements from 1 April 2012 involve a managed float of the kyat with a reference exchange rate of MK818/$1. The government plans to establish a formal interbank market and relax exchange restrictions on current international payments and transfers. Fiscal policy in FY2012 targets a modest fiscal deficit equivalent to 4.6% of GDP.

Among planned reforms is a land law giving farmers the right to own, sell, and mortgage their land. Credit to the farm sector remains inadequate, even though the Myanmar Agriculture Development Bank has doubled its funding for farmers in each of the past 2 years. A microfinance law was approved in November 2011 to expand microcredit to farmers.

The government is preparing a foreign investment law that is expected to offer tax breaks to investors and allow them to lease private land and repatriate investment proceeds using market exchange rates. Special economic zones in Dawei in southern Myanmar, Thilawa near Yangon, and Kyaukphyu on the west coast will be established to attract industry.

While the government last year ordered that work be suspended on the large Myitsone hydropower project owing to environmental concerns, investment is picking up on other hydropower and coal-powered plants, gas fields, and oil and gas pipelines.

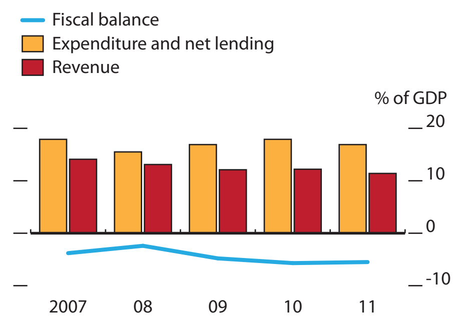
Gas production and exports are scheduled to increase sharply in FY2013 when the Shwe and Zawtika gas fields and pipelines to the People's Republic of China (PRC) and Thailand, now under construction, come on line. However, a market-determined exchange rate will threaten the viability of state economic enterprises that long benefited from importing inputs at the official exchange rate, abolished on 1 April this year.

GDP is forecast to grow by about 6.0% in FY2012 and 6.3% in FY2013 (Figure 3.27.5). Inflation is seen quickening to just over 6% (Figure 3.27.6). The authorities raised administered electricity prices in late 2011 and fuel prices in early 2012. A government plan to help farmers by supporting rice prices is likely to lead to higher retail prices of rice.

Relaxing foreign exchange controls is expected to propel imports upward and contribute to widening the current account deficit (Figure 3.27.7).

Easing of economic sanctions imposed on Myanmar by industrial

3.27.4 Fiscal indicators



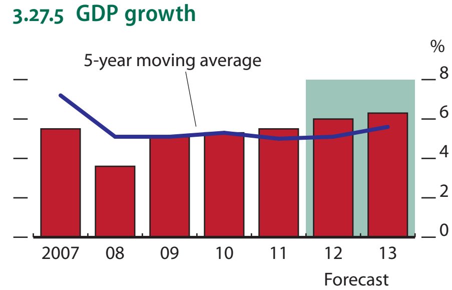
Source: *Asian Development Outlook* database.

3.27.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.0	6.3
Inflation	6.2	6.3
Current account balance (share of GDP)	-4.8	-5.0

Source: ADB estimates.

3.27.5 GDP growth



Source: *Asian Development Outlook* database.

countries would lead to higher levels of trade and investment, as well as the resumption of assistance and concessionary financing both from these countries and from international financial institutions.

Policy challenge highlights

A key challenge is to maintain macroeconomic stability as the country opens to increased flows of trade and investment.

As for policy reforms, the agenda is extensive, given the low level of economic and social development. Per capita GDP is one of the lowest in Southeast Asia at about $715 (Figure 3.27.8), and 26% of the country's 60 million people live in poverty. Myanmar's ranking on the United Nations Human Development Index is near the bottom of the list (149 of 187 countries). The country needs to embark on a comprehensive and well-sequenced program of reforms if it is to realize its potential.

Public institutions, the financial system, and workforce skills are focuses for strengthening. Developing the private sector depends on opening more areas to its participation and upgrading the regulatory, legal, and policy environment.

The government needs to generate adequate fiscal resources to expand infrastructure (75% of the population do not have access to electricity) and improve health, education, and social protection systems. A simpler and broader tax structure and greater emphasis on direct (rather than indirect) taxes would bolster fiscal resources and be fairer to the poor.

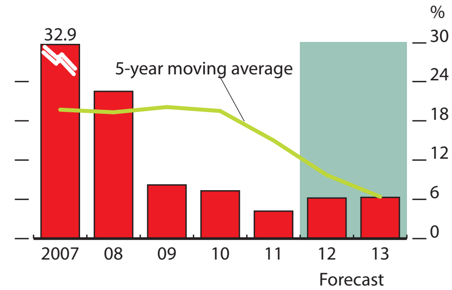
Extending transport networks to link Myanmar more closely with neighbors would enable its businesses to participate in East and Southeast Asian, as well as global, production chains.

Unifying the exchange rate will expose the inefficiencies and losses of state enterprises, which dominate parts of the economy. That is likely to require reforms to put state enterprises on a more commercial basis, including privatizing some and possibly closing others. Thus, temporary and transparent subsidies will have to be introduced to minimize the impact on the poor as state enterprises raise prices and lay off employees.

Expanded access to formal finance is another key challenge that will require a phasing out of bank deposit-to-capital ratios and an easing of collateral requirements. Upgrading the central bank would involve granting it operational autonomy and strengthening its capacity to supervise the financial sector. Consolidating the domestic banking sector and developing partnerships with foreign banks would strengthen the banking system.

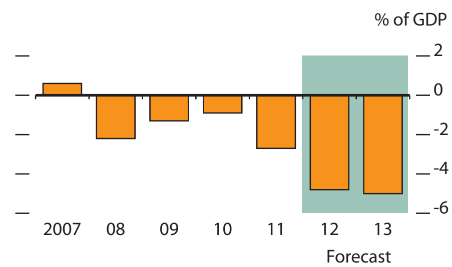
Agriculture, which employs over half the population, has great potential for improvement. The distribution of land ownership certificates under the new land law is a step forward, but will require careful implementation to ensure that the poor benefit. This measure should be complemented by an expansion of credit to farmers, increased public investment in rural infrastructure, and better seeds, fertilizers, extension services, and post-harvest facilities.

3.27.6 Inflation



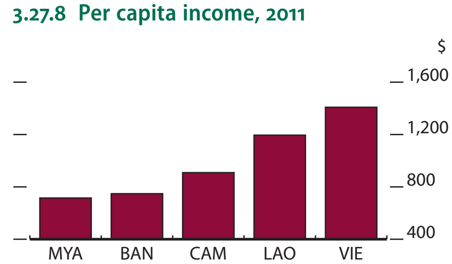
Sources: Asian Development Outlook database; ADB estimates.

3.27.7 Current account balance



Sources: Asian Development Outlook database; ADB estimates.

3.27.8 Per capita income, 2011



BAN = Bangladesh; CAM = Cambodia; LAO = Lao People's Democratic Republic; MYA = Myanmar; VIE = Viet Nam.

Source: Asian Development Outlook database.

Philippines

Slumping exports and a fall in government spending undercut the impact on economic growth of strong private consumption in 2011. This year, the authorities have stepped up public spending and relaxed monetary policy, laying the ground for an upturn in GDP growth that is projected to continue through 2013. Inflation is seen at moderate levels through the forecast period. Nevertheless, considerably stronger economic growth is needed to make substantial reductions in unemployment and poverty.

Economic performance

A decline in exports of electronic products and in government spending curtailed GDP growth to 3.7% in 2011. Most of the growth (Figure 3.28.1) came from a 6.1% increase in private consumption, which was again supported by remittances from overseas Filipino workers (up by 7.2% to $20.8 billion, or by 3.0% in peso terms) and by lower lending rates.

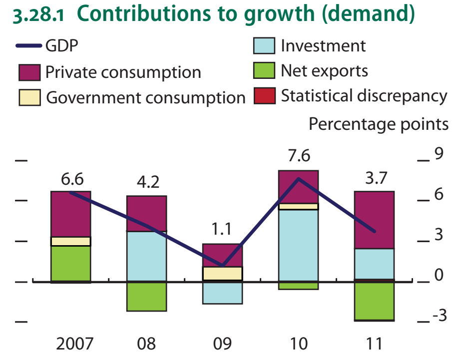
Fixed capital investment decelerated because of sluggish public construction and slower growth in private investment. As a share of GDP, fixed capital investment declined to 19.3% from a 7-year peak of 20.5% in 2010.

Government consumption and capital spending fell, reflecting a high base in 2010 (when expenditure had risen ahead of national elections) and the introduction of governance reforms in 2011 (which delayed spending by government agencies). As the economy softened, the government accelerated budget disbursements late in the year, mitigating the impact on the economy of a steep slide in exports.

Lower than planned government spending, coupled with some improvement in tax revenue, narrowed the fiscal deficit to 2.0% of GDP (Figure 3.28.2), well within the 3.0% deficit target. Expenditure rose by just 2.3% (in nominal terms), with significant shortfalls in infrastructure outlays. The tax-to-GDP ratio rose slightly to 12.3%. One impact of these developments was to reduce national government debt to the equivalent of 50.9% of GDP, the lowest since 1998.

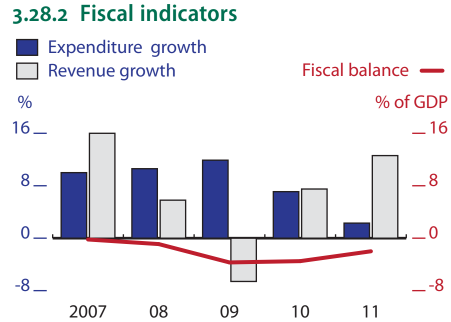
From the production aspect, services grew by 5.0% in 2011 and provided three-fourths of total GDP growth. Retail trade, business process outsourcing (BPO), and financial and real estate services were the main contributors. Industry grew by only 1.9% owing to weak public construction and subdued manufacturing, caused mainly by a slump in electronics exports. Some other manufacturing subsectors, such as food, chemicals, and furniture, drew support from the expanding domestic consumption. Private construction growth eased from the rapid pace in 2010. Agriculture, after 2 years of contraction due to bad weather, recovered by 2.6%.

3.28.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 March 2012).

3.28.2 Fiscal indicators



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 14 March 2012).

This chapter was written by Norio Usui and Teresa Mendoza of the Philippines Country Office, ADB, Manila. The policy challenge section is sourced from N. Usui. *Taking the Right Road to Inclusive Growth: Industrial Upgrading and Diversification in the Philippines.* Asian Development Bank, forthcoming.

Employment improved by 3.2% in 2011, or about 1.2 million new jobs, although most were part time. The new jobs slightly exceeded the increase in the labor force. The unemployment rate eased to 7.0% from 7.4%, but the rate of underemployment rose to 19.3% while other labor market indicators remained weak: youth unemployment was high at 16.3% and employment in manufacturing was low at 8.3% of total employment. About 20% of the unemployed were college graduates, indicating a mismatch between their skills and the needs of the labor market.

Higher global oil and food prices lifted average inflation to 4.8%, just within the central bank's 3–5% target range. A good harvest helped slow inflation from October (Figure 3.28.3). Earlier concerns over inflation prompted Bangko Sentral ng Pilipinas to lift its policy interest rates by 50 basis points in early 2011, to 4.5% for overnight borrowing and 6.5% for overnight lending. It also raised bank reserve requirements, by 2 percentage points to 21.0%. As inflation moderated, the central bank kept policy rates steady for the rest of the year. The pace of lending to the private sector almost doubled to 15.7%, and growth in total domestic credit rose sharply to nearly 15%.

A slump in exports widened the trade deficit in 2011, eroding the current account surplus (Figure 3.28.4). Merchandise exports fell by 6.9% to $47.2 billion, reflecting soft global demand coupled with supply chain disruptions in electronics caused by the March earthquake in Japan and floods in Thailand later in the year. Electronic products (mainly semiconductors), which make up about half of total exports, plunged by 23.4%, although the impact was cushioned by double-digit growth in shipments of clothing, chemicals, and agricultural commodities. Exports of minerals also posted strong gains, helped by high world mineral prices.

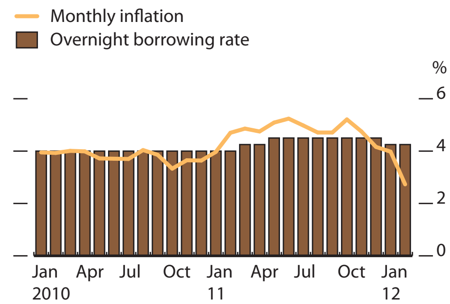
Imports rose by 1.6% to $62.7 billion, with substantial increases in oil (reflecting much higher oil prices), and in durable consumer goods and industrial machinery. By contrast, imports of electronics fell, in line with electronics exports, and imports of automobiles were disrupted by the flooding in Thailand that closed factories there.

Trade in services produced a larger surplus, mainly owing to income from BPO. Remittances also contributed to the current account surplus. Net inflows of portfolio investment rose by 26.6% to $5.5 billion and inflows of foreign direct investment (FDI) were broadly steady at $1.3 billion, producing a surplus in the capital and financial account (Figure 3.28.5).

Relatively low levels of FDI reflect deficiencies in the investment environment. The country's ranking in the World Economic Forum's *Global Competitiveness Report 2011–2012* rose by 10 places to 75 (of 142 countries), mainly due to the lower public deficit and debt, improved credit ratings, and moderate inflation. However, the Philippines scored low marks for infrastructure, quality of public institutions, and corruption, so that its overall competitiveness ranking lagged behind neighbors such as Indonesia (46) and Viet Nam (65).

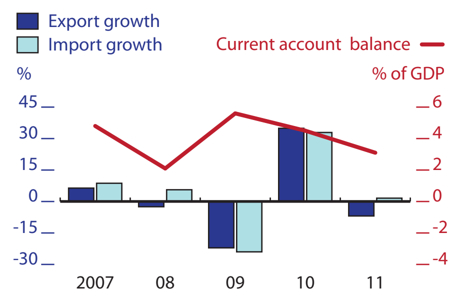
Gross international reserves increased by 21% to $75.3 billion, cover for 11.1 months of imports. Domestic financial markets strengthened, with stock prices up by 4% over the year and yields declining on government bonds. The peso ended 2011 little changed against the United States (US) dollar from a year earlier.

3.28.3 Inflation and policy interest rate



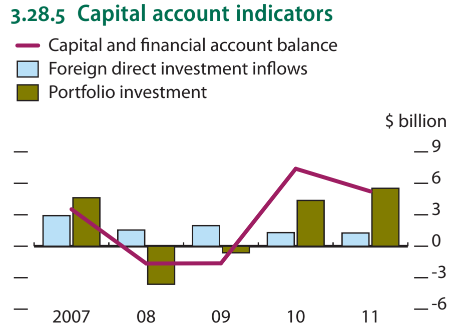
Source: CEIC Data Company (accessed 16 March 2012).

3.28.4 Current account indicators



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 23 March 2012).

3.28.5 Capital account indicators



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 23 March 2012).

Economic prospects

Forecasts for 2012 and 2013 assume that the government will raise spending, follow through on its commitment to improve the business environment, and carry out some of the planned public–private partnerships, which include airports, highways, and water supply operations (they were delayed in 2011).

GDP growth is forecast to recover to 4.8% in 2012 (Figure 3.28.6), underpinned by strong private consumption and a pickup in public and private investment. Household consumption will benefit from inflows of remittances, lower average inflation, and positive consumer sentiment. Remittances in US dollars will increase by about 5% in 2012, the central bank projects.

Business sentiment is positive, too, according to a survey by the central bank in the first quarter of 2012 (Figure 3.28.7). Respondents cited increasing orders, new contracts and projects, and higher government spending. Investment commitments approved by state agencies rose by 37.6% in 2011. Bank credit has been on an upward trend and the stock market index reached a record high in March 2012, spurred by expectations of better corporate earnings.

Sovereign rating upgrades support the investment outlook. Moody's raised the country's foreign and local currency long-term bond ratings in 2011 from Ba3 to Ba2 (two notches below investment grade), while Fitch lifted the long-term foreign currency rating from BB to BB plus (one notch below investment grade). Standard & Poor's late last year raised the rating outlook to positive from stable (its long-term foreign currency rating is two notches below investment grade).

Fiscal policy is set to be more expansionary in 2012. Budget allocations for social services and infrastructure are up sharply from 2011 (Figure 3.28.8) and the budget deficit target is widened to 2.6% of GDP from last year's actual deficit of 2.0%. The pickup in budget spending that started late last year continued into January 2012, and in that month the government released to its agencies a large portion of the 2012 infrastructure budget, signifying early project implementation.

Monetary policy has been relaxed to support growth. Early in 2012, the central bank cut policy rates by 50 basis points to the low levels set during the 2009 global recession—4.0% for overnight borrowing and 6.0% for overnight lending. It also reduced bank reserve requirements by 3 percentage points, though this was primarily to offset the impact of other changes in the reserve requirements.

The drag on economic growth exerted by weakness in net exports is expected to diminish in 2012. Modest growth is seen for merchandise exports (about 5%), on a pickup in economic growth in the US and Japan (which together take about a third of exports) and solid growth in Southeast Asia (about a sixth). Problems in Europe and moderating growth in the People's Republic of China (each absorbing about one-eighth of exports) will temper export growth.

Reversing an 8-month slide, exports in January 2012 rose by 3.0% year on year (21% month on month). Electronics exports picked up, and the outlook for semiconductor sales to the US showed improving signs.

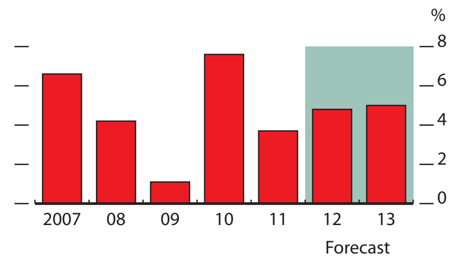
Merchandise imports will likely rise faster than exports, given robust consumer demand and the expected lift in investment. The current

3.28.1 Selected economic indicators (%)

	2012	2013
GDP growth	4.8	5.0
Inflation	3.7	4.1
Current account balance (share of GDP)	2.1	2.3

Source: ADB estimates.

3.28.6 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 March 2012).

3.28.7 Confidence indexes

Note: These indexes are computed as the percentage of households (or firms) answering affirmatively less the percentage of households (or firms) answering negatively for a given indicator. A positive index shows a favorable view.

Sources: Bangko Sentral ng Pilipinas. 2011. *Consumer Expectations Survey Fourth Quarter 2011*. December; 2012. *Business Expectations Survey First Quarter 2012*. February. http://www.bsp.gov.ph account surplus is forecast at 2.1% of GDP, after taking into account increases in remittances and income from BPO.

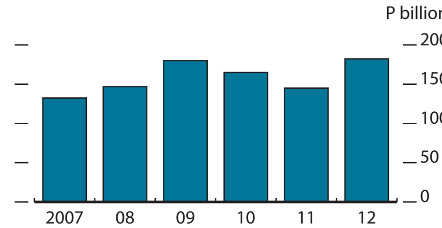
Services will remain the main contributor to growth on the supply side. BPO export revenue rose by an estimated 22% to $11 billion in 2011, and this industry continues to expand. Construction will benefit from the anticipated ramping up of infrastructure projects.

In 2013, GDP growth is projected to quicken to about 5% on expectations of a more favorable external environment and gathering momentum in infrastructure investment.

Inflation is forecast to be lower in 2012 than last year (Figure 3.28.9), assuming global food and oil prices on average change little this year relative to 2011. The peso is expected to be broadly stable against the US dollar.

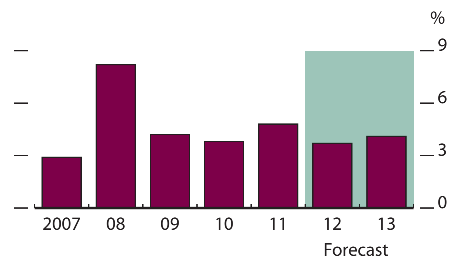
The government aims to rein in the 2013 budget deficit to 2.0% of GDP, which is likely to require a sizable increase in revenue. Thus, in addition to efforts on tax administration, the authorities are seeking higher tax revenue from alcohol and tobacco products and an overhaul of incentives to attract direct investment. Revenue increases are also needed if the country is to achieve key Millennium Development Goals. The Philippines is making slow progress on the goals related to poverty, primary education, and maternal and child health.

3.28.8 Government infrastructure outlays



Source: Department of Budget and Management. Various years. *Budget of Expenditures and Sources of Financing*. http://www.dbm.gov.ph

3.28.9 Inflation



Source: Asian Development Outlook database.

Policy challenge—securing inclusive growth

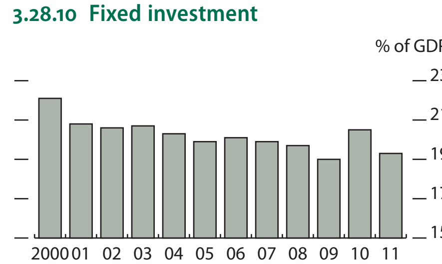
Economic growth in 2000–2011 averaged 4.7%, well above 2.9% in the 1990s and 1.7% in the 1980s. The pickup in growth was driven mainly by private consumption, backed by remittance inflows, and on the production side by services. Inflation has generally been moderate at an average of 5.1% in 2000–2011, and the external position has strengthened. Despite this better performance, however, structural weaknesses have frustrated the achievement of inclusive growth.

Weak link between growth and development. Unemployment and underemployment remained high in 2011. Many workers are in low-productivity jobs and real average wages have declined. With a Gini coefficient of over 40, income inequality is also high. The incidence of poverty fell from 33.1% in 1991 to 24.9% in 2003, but then turned up to 26.4% in 2006 and stayed around that rate in 2009. About 9.5 million Filipinos, or nearly 10% of the population, work abroad because of a lack of good jobs at home.

Rising growth and declining investment. Although growth quickened in 2000–2011, fixed investment as a share of GDP declined to 19% in the most recent years (it was 19.3% in 2011, for example), from slightly above 20% in 2000 (Figure 3.38.10). In Indonesia, by contrast, the investment rate has climbed from about 19% to 32% over the same period.

Limited diversification of exports. Merchandise exports are highly concentrated in electronics (60% of total exports in 2010), particularly semiconductors (about 77% of total electronics exports). This structure makes the economy vulnerable to downturns in global electronics demand and to disrupted electronics production chains, as happened in 2011. Philippine merchandise exports fell in the second half of 2011, while exports generally increased in other Southeast Asian countries.

3.28.10 Fixed investment



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 March 2012).

The root cause—industry has stagnated. The main growth engine of high-performing Asian economies has been dynamic structural transformation: output shifts from low-productivity goods into high-productivity ones, particularly manufactures; labor moves from agriculture to industry; and exports become more diversified. Industry in these economies has maintained productivity gains by upgrading technology and manufactured products. This transformation sustains growth and generates better-paying jobs to reduce poverty.

But in the Philippines, industry's share of GDP declined from 39% in 1980 to 32% in 2011. Manufacturing accounted for just 22.4% of GDP and 8.3% of employment that year. Growth has instead relied on services (Figure 3.28.11), a trend accelerated by rapid expansion of BPO services over the past 7 years (Figure 3.28.12).

Sluggish growth in industry has suppressed economy-wide labor productivity, which rose by only 10% over the past 30 years (Figure 3.28.13). Labor productivity in services has been less than half that of industry over this period. This implies that, although services has made the greatest contribution to economic growth and job creation, it is not necessarily associated with a rise in high-productivity employment on aggregate.

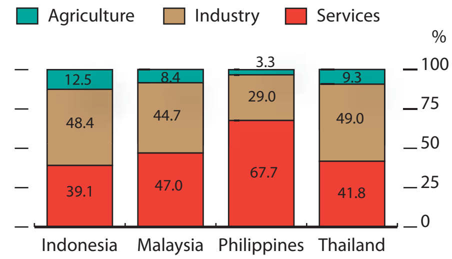
The BPO industry employs only about 1% of the labor force and it hires relatively skilled workers. Given the large, and increasing, number of underutilized workers with moderate skills, it is unlikely that BPO alone can drive inclusive growth.

Underlying reasons for the industrial stagnation can be traced to the 1980s, when global manufacturers relocated production to East and Southeast Asia. They sidestepped the Philippines largely because of domestic political instability. Later success at attracting electronics, mainly assembly work, in the 1990s raised the promise of a deepening of industrial capabilities. However, the electronics industry has not upgraded and diversified its products and its presence has not spurred significant development in fields such as machinery, chemicals, and metals processing, owing to the underprovision of infrastructure (particularly transport networks and electricity supply) and an unfriendly business environment (poor governance, weak contract enforcement and property rights, and cumbersome business regulations).

Policy actions. A first step is to resolve pervasive constraints by accelerating development of the physical, institutional, and social infrastructure; instituting good governance; and improving the business environment.

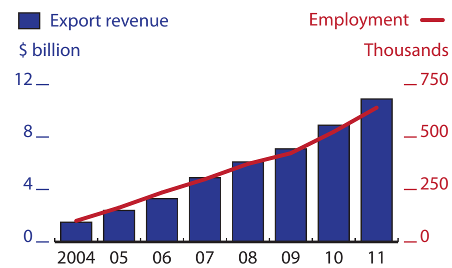
Specifically for industry, the government could consider support for diversification and value addition. Decisions on restructuring, innovation, and product mixes are matters for the private sector. Still, the government can play a strategic and coordinating role in creating incentives for industrial development and providing targeted support for selected products, with benchmarks for success and sunset clauses for phasing out support. Such measures would involve close government–private sector cooperation to identify promising products and to diagnose and address impediments to their development.

3.28.11 Sector contribution to GDP growth, 1980–2010



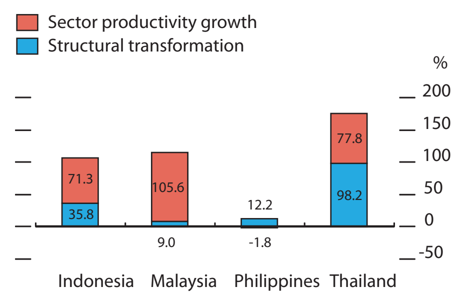
Source: N. Usui. *Taking the Right Road to Inclusive Growth: Industrial Upgrading and Diversification in the Philippines*. Asian Development Bank, forthcoming.

3.28.12 Business process outsourcing



Sources: Business Processing Association of the Philippines. 2012. *BPAP 2011 and 2012*. March. http://www.bpap.org; Senate Economic Planning Office. 2010. BPO Industry at a glance. June. http://www.senate.gov.ph

3.28.13 Labor productivity growth, 1980–2009



Source: N. Usui. *Taking the Right Road to Inclusive Growth: Industrial Upgrading and Diversification in the Philippines*. Asian Development Bank, forthcoming.

Singapore

Economic growth is volatile—slumping during the 2008–2009 global financial crisis, rebounding strongly in 2010, slowing to a more sustainable level in 2011, and decelerating further in 2012. Singapore's vital trade in manufactured goods and financial services will not fully stabilize until the world economic outlook improves, forecast for the latter part of this year and into 2013. Still, strong domestic demand is helping offset the weak external sector. In 2013, the growth rate should pick up pace as the recovery in the United States (US) strengthens and the eurozone situation improves.

Economic performance

Following a record 14.8% jump in 2010, economic growth eased to 4.9% in 2011. The main contributor to growth was domestic demand, notably private consumption and investment (Figure 3.29.1). Private consumption rose by 4.1% and accounted for 30% of overall growth. Supporting this was strong employment: the unemployment rate dipped as low as 2% after a tightening of foreign worker levies was announced in February. Investment increased by almost 10%, contributing 40% of overall growth. Gross fixed capital formation rose by only 3.3% but, because of a much diminished rundown of inventories, investment was higher. Government consumption nudged up by less than 1%.

Even though external trade was so weak, especially toward the end of the year (Figure 3.29.2), net exports still accounted for 25% of overall growth. Exports climbed by only 2.6%. The weak trade performance was in contrast to that in 2010, when net exports rose by 40% (versus 3.4% in 2011) and accounted for the bulk of a much higher overall growth rate.

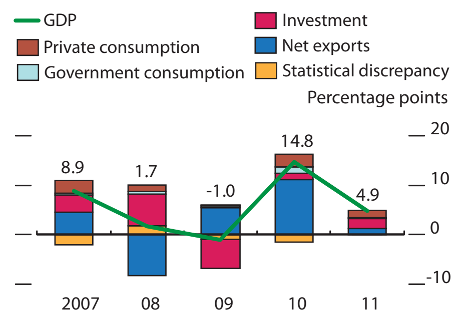
The main supply contributors to growth were manufacturing and financial services (Figure 3.29.3). Manufacturing output increased by 7.6%, a healthy rate buoyed by biomedical exports, but this was a big pullback from the exceptional 30% growth seen in 2010. The electronics subsector slumped, as global demand dropped for semiconductors and related equipment. The impact was severe in the last quarter, as falling business confidence combined with a general inventory overhang.

Despite the uncertain global context, financial services grew by 9%; they now directly account for 12% of GDP and support a large number of related subsectors. The accommodation and food services subsector rose by 6%, driven by fast-growing tourist arrivals, although the wholesale and retail trade subsector grew only marginally, reflecting the weak trade performance. Transport and storage and business services climbed strongly in the first half but fell flat in the second.

Construction activity was slow, particularly in the fourth quarter, mainly reflecting a decline in residential building. Although property

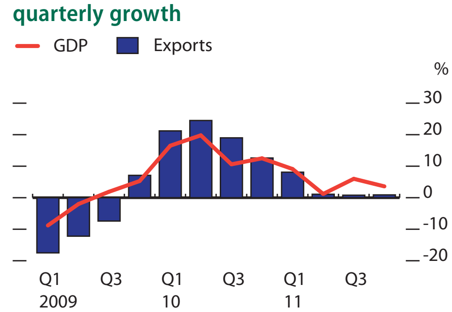
This chapter was written by Minsoo Lee of the Economics and Research Department, ADB, Manila.

3.29.1 Contributions to growth (demand)



Source: CEIC Data Company (accessed 12 March 2012).

3.29.2 GDP and merchandise exports, quarterly growth



Source: CEIC Data Company (accessed 14 March 2012).

prices have risen by more than 50% since mid-2009, they have slowed for eight consecutive quarters, in part due to government measures to curb speculation.

Inflation averaged 5.2%, double 2010's rate, mainly because of higher costs of housing, transport, and food (Figure 3.29.4). Housing costs rose by 8.3% and transport costs by 12% (reflecting tightening of certificates of entitlement designed to reduce traffic congestion). Imported inflation associated with food and fuel prices was also a contributing factor, although the general strength of the Singapore dollar helped lessen imported price pressures. Core inflation was around half the headline rate.

After the rebound of economic activity in 2010, fiscal consolidation has replaced fiscal stimulus introduced in response to the global financial crisis. Although the FY2011 budget (1 April–31 March 2012) projected a small deficit, a substantial surplus is now expected of about S$2.3 billion or 0.7% of GDP. Revenue was higher than expected owing to strong corporate income and property-related tax receipts.

Monetary policy was relatively tight during the year, designed to reduce inflation. Money supply (M2) rose by 10.0%, or slightly more than in 2010. As the year progressed, however, policy makers became increasingly concerned about the deteriorating global and domestic economic outlook. As in the past, the main lever of monetary policy was the exchange rate. The Monetary Authority of Singapore (MAS) eased monetary policy a little in October 2011 by lowering the gradient of the trading band within which the Singapore dollar is allowed to trade. The average exchange rate for the year was S$1.26/US$1, an appreciation of 8.4% from the average in 2010 (Figure 3.29.5).

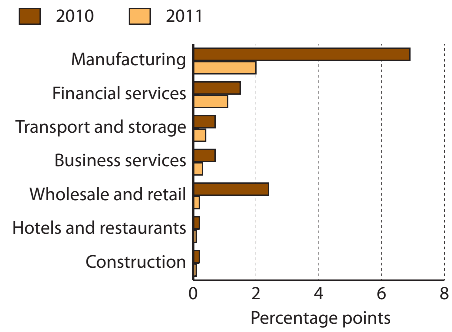
The overall balance-of-payments surplus was US$17.1 billion, the result of a decline in net outflows in the capital and financial account, and a slight increase in the current account surplus. International financial turbulence in the second half of 2011 prompted a sharp fall in Singapore's equity and currency markets, prompting the MAS to cushion the impact through injecting dollar liquidity.

Exports grew at a diminishing rate in 2011. In the case of non-oil exports and reexports, exports actually contracted in the second half; weakening external demand was compounded by the natural disasters in Japan and Thailand that severely disrupted global supply chains for electronics and other key sectors in which Singapore plays a significant role. As noted, while imports also experienced diminishing growth, they grew more rapidly than exports. Singapore nonetheless maintained a large surplus in its transactions with the rest of the world, and its international reserves increased to US$238 billion.

Economic prospects

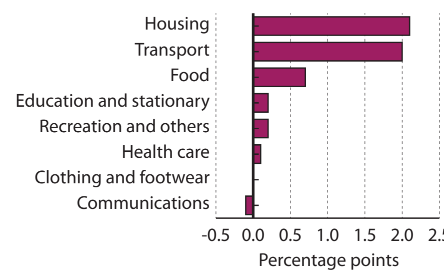
Despite strong domestic demand, economic growth is forecast to slow further in 2012 to 2.8%. Weak external demand stemming from the possibility of a recession in the eurozone, a slow US recovery, and the moderating growth in the People's Republic of China (PRC) will continue to hold back exports and investment in trade-related sectors. Growth is forecast to recover to 4.5% in 2013, assuming that the global economic outlook improves.

3.29.3 Contributions to growth (supply), selected sectors



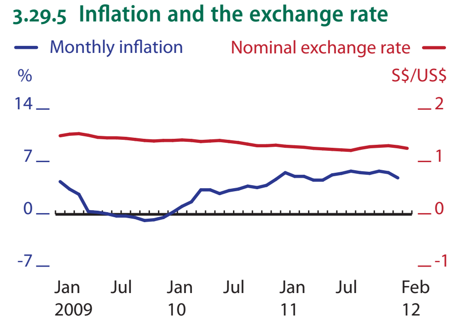
Source: Singapore Ministry of Trade and Industry. 2011. *Economic Survey of Singapore*. http://app.mti.gov.sg

3.29.4 Sources of inflation, 2011



Source: Singapore Ministry of Trade and Industry. 2012. *Economic Survey of Singapore 2011*. February. http://app.mti.gov.sg

3.29.5 Inflation and the exchange rate



Source: CEIC Data Company (accessed 14 March 2012).

Private consumption is expected to be high, with the labor force benefiting from tight supply conditions as the government endeavors to reduce the country's reliance on foreign workers. Private sector investment will likely be anemic on concern over global prospects. Public infrastructure investment, though, will remain a priority of the government, even as it continues its policy of fiscal consolidation.

The FY2012 budget announced in February indicated a surplus of 0.4% of GDP for the current fiscal year (ending 31 March 2013). The budget focuses on measures to reduce the dependence on foreign workers and to strengthen productivity and innovation, following the recommendations last year of the Economic Strategies Committee of the Prime Minister's Office. The government is in a solid position to introduce new fiscal stimuli, if they are needed, to act early against any early signs of a developing economic setback.

Manufacturing, especially its electronics subsector, will continue to run into the headwinds that have not fully dissipated from the second half of 2011 (Figure 3.29.6). The sector is highly dependent on final demand in the US and Europe, neither of which is expected to show strength this year.

Also, Singaporean electronics firms have to restructure and seek higher value-added development opportunities. Firms are continuing to hire and expand, but cautiously in light of the uncertain global outlook. Although trade within Asia, notably with the PRC, has continued to expand rapidly, it is heavily based on global value chains and final demand in advanced countries. The biomedical manufacturing subsector is, however, less sensitive than the electronics industry to variations in external demand, and appears to have strong growth potential.

Similar to manufacturing, financial services are expected to face continued headwinds during the next couple of years, but recently international equity markets have seen a big lift, including those in Singapore, one of Asia's biggest wealth management centers. Demand from the region for services such as finance, logistics, and tourism is likely to continue growing.

The conditions driving Singapore property prices higher in recent years—notably brisk demand and tight supply—are expected to continue easing, mainly because the measures taken last year by the government to cool the property market appear to have been effective (Figure 3.29.7). The continued slowdown in the economy should help cool demand further, contributing to a correction in home prices and sales volume this year.

Inflation is forecast to decline to 3.0% and 2.5% in 2012 and 2013, abetted by slow domestic and global growth. The strength of the Singapore dollar will also help contain imported inflation, as will the expected easing of world commodity prices (apart from oil). As inflation recedes, the MAS will likely take further steps to loosen monetary policy.

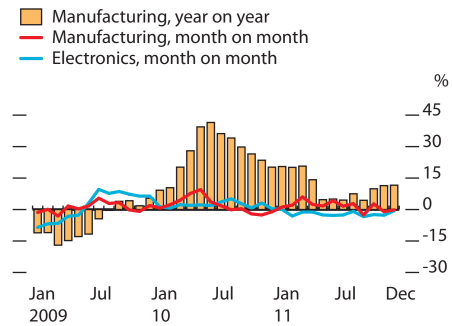
Singapore will continue to have very large current account surpluses, the equivalent of 18.0% and 16.0% of GDP in 2012 and 2013. Merchandise exports, although with subdued growth, will remain an important source of growth. The services account will likely remain in surplus, boosted by tourism receipts and strong external demand for Singapore's financial services. By contrast, the income account will remain in deficit.

3.29.1 Selected economic indicators (%)

	2012	2013
GDP growth	2.8	4.5
Inflation	3.0	2.5
Current account balance (share of GDP)	18.0	16.0

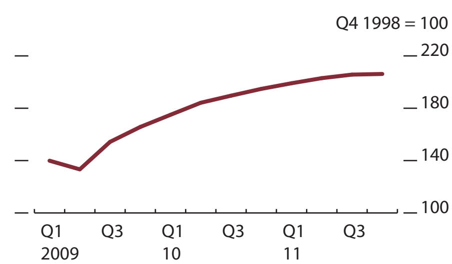
Source: ADB estimates.

3.29.6 Manufacturing growth, 6-month moving average



Source: Singapore Economic Development Board. *Monthly Manufacturing Performance - December 2011.* http://www.edb.gov.sg

3.29.7 Private residential property price index



Source: CEIC Data Company (accessed 14 March 2012).

Although income from abroad is expected to grow as local companies make increased returns on investments abroad, income payments will also mount, in line with steady profits made by foreign companies with subsidiaries in Singapore.

Forecast risks are on the downside, as the global economic outlook is so uncertain. The biggest risk lies in the eurozone and possible worsening of its sovereign debt crisis. Independently of that, a sharper than expected slowdown in the PRC would weaken Singapore's growth prospects. Yet another risk is a possible spike in oil prices caused by Middle East tensions.

Policy challenge—Foreign workers/productivity tradeoff

Foreign workers account for over one-third of the labor force (Figure 3.29.8), reflecting the aging structure of the population and declining birth rates (Figure 3.29.9). The large presence of foreign workers has enabled Singapore to expand its manufacturing, financial services, and other key sectors. Further, skilled foreign workers have helped it maintain its cost competitiveness in high-end products.

Their prevalence may, however, have lowered the wages of local low-skilled workers. There has also been concern that such a large presence may have discouraged technology adoption and lowered labor productivity. Housing pressures and other consequences are further areas of concern.

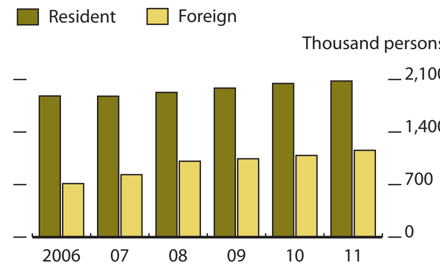
In this slow-growth period, policy makers are concentrating on ways to mitigate some of these effects, especially the intensifying competition with foreign workers for unskilled jobs. The Economic Strategies Committee has recommended restricting the number of foreign workers and targeting productivity growth of 2–3% annually, leading to an economy of highly skilled workers employed in innovative services and industry sectors.

Thus foreign worker levies, paid by employers, are being raised at 6-month intervals, starting in January 2012 through July 2013. Increases in the levies vary by sector, generally higher for low-skilled work (e.g., construction) and lower for high-skilled work (manufacturing and financial services). Dependency ratio ceilings are also being reduced, which specify the maximum proportion of foreign workers that companies can hire. Concurrently, the government is encouraging businesses to invest in productivity and to reduce their reliance on low-skilled foreign workers. Multinational and large companies should adjust to the higher levies and lower quotas without much difficulty, but small and medium-sized companies (SMEs) relying heavily on foreign workers will find it hard to restructure.

To facilitate the transition, a S$2 billion National Productivity Fund has been established. Further, the government has introduced specific initiatives to help SMEs restructure their operations, such as the SME Productivity Roadmap, which provides a systematic approach for improving productive capacity. The Continuing Education and Training system is designed to ensure that Singaporeans' skills are regularly upgraded.

Singapore has determined that it must reduce its dependence on foreign workers and transition to higher value-added activities. The structural realignment will be gradual, but potentially far-reaching.

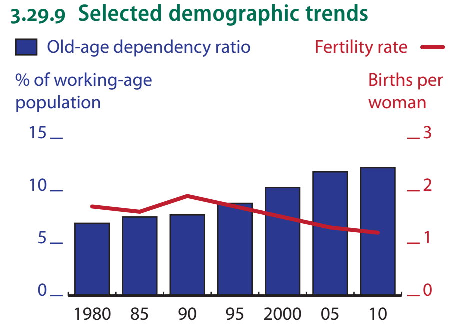
3.29.8 Labor force



Note: Resident refers to Singapore citizens and permanent residents.

Source: CEIC Data Company (accessed 14 March 2012).

3.29.9 Selected demographic trends



Source: World Bank. World Development Indicators online database (accessed 14 March 2012).

Thailand

Devastating floods disrupted manufacturing and other industries in the second half of 2011, leaving the economy virtually flat over the 12 months. This year, reconstruction and policy stimulus will spark a rebound in growth, despite sluggish exports, and inflation, which quickened in 2011, is forecast to moderate. Rebuilding factories and infrastructure, as well as investor confidence, will be a major task during the forecast period.

Economic performance

Widespread flooding in August–November 2011, the worst in more than 50 years, devastated the economy. The floods across central and northern Thailand disrupted industries, including agriculture, construction, transport, and retailing, for months. The economy contracted by 9.0% year on year in the fourth quarter (Figure 3.30.1), leaving GDP for the year just 0.1% higher than in 2010.

Manufacturing slumped by 21.8% in the fourth quarter when the floods submerged factories making automobiles, hard-disk drives, electrical appliances, semiconductors, and textiles. As Thailand is the world's 12th biggest automobile maker and accounts for 25% of global hard-disk drives, the factory closures caused economic dislocation far beyond its borders.

Earlier in the year, the Japanese earthquake and tsunami had caused supply shortages for the Thai auto and hard-disk drive industries, reducing output. For the whole year, overall manufacturing production fell by 4.3%.

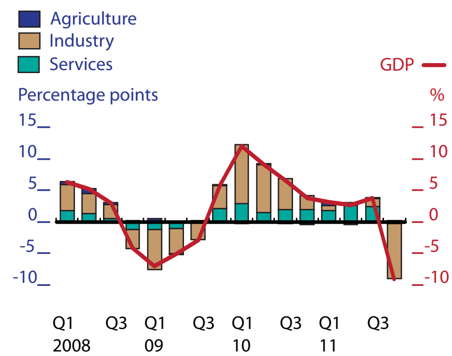
Construction was also hit on two fronts—public projects were delayed by national elections and a change of government in the third quarter, and private activity was curtailed during the flooding. Total construction activity for the year fell by 5.1%.

Services contracted in the fourth quarter, largely because of the floods, although grew by 3.8% over the whole year and were the main contributor to the marginal rise in GDP. Tourist arrivals fell by 4.7% in October–December (but still rose by 17.9% to 18.8 million in 2011 from 2010, a year in which arrivals fell because of 2 months of violent demonstrations).

Flooding reduced agricultural yields in the second half, though for the full year farm output increased by 3.8% owing to a rebound in the first half from a weak prior-year performance.

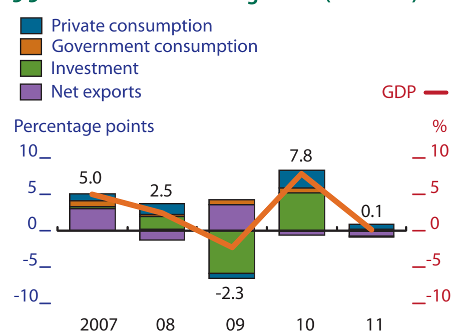
Private consumption was subdued in 2011 (Figure 3.30.2), in part a result of the floods, which dented consumer confidence and lowered incomes in affected areas. Farm incomes were hurt in the second half,

3.30.1 Contributions to growth (supply)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 20 March 2012).

3.30.2 Contributions to growth (demand)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 20 March 2012).

This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

both by the impact of flooding and lower prices for some agricultural commodities. Rising inflation contributed to weakness in private consumption, which grew by just 1.3% in 2011.

Government consumption was similarly sluggish. The government that took office in August 2011 reviewed and adjusted the budget for the fiscal year starting October 2011 (FY2012), which held up some spending.

Private fixed investment, robust for most of 2011, suffered when the floods hit, but still rose by 7.2% for the year. Public investment, by contrast, fell by 8.7% owing to a combination of the floods, postponement of decisions on public works during the election period, and the delay in completing the FY2012 budget.

Growth in merchandise exports slowed to 16.4% in US dollar terms from 28.4% in 2010. The inundation of many export-oriented factories cut merchandise exports by nearly 5.2% in the fourth quarter (Figure 3.30.3). Rice exports turned down late in the year because of the impact of floods and a new government policy to pay higher prices to farmers for rice, reducing its competitiveness in export markets.

Closure of factories during the floods and supply disruptions from the earthquake in Japan also damped growth in imports, despite much higher prices for imported oil. The surplus in goods trade fell, but the deficit in services narrowed slightly, reflecting higher receipts from tourism and insurance (from flood claims). That left a current account surplus equivalent to 3.4% of GDP, a decline of about a half percentage point from the previous year.

The capital and financial account recorded a net outflow of $7.2 billion, the effect of an increase in outward direct investment and withdrawal of portfolio investment from emerging markets in the second half of last year. Foreign direct investment into Thailand fell by 13% to $8.4 billion in 2011. Outward direct investment nearly doubled to $10.8 million, in part a result of relaxed regulations on Thai investment abroad. Gross international reserves edged up by 1.7% to $175.1 billion, cover for 10 months of imports.

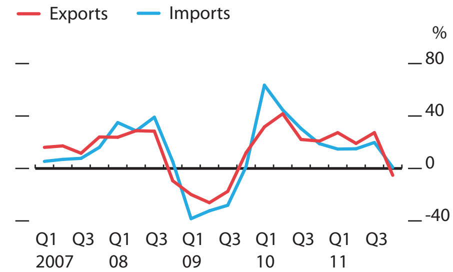
Higher oil prices and flood-induced disruptions to supplies of food and other consumer goods lifted average inflation to 3.8% in 2011. The pace of food price inflation reached a 3-year high of 10.2% in November (Figure 3.30.4).

In response to upward pressure on prices and inflation expectations, the Bank of Thailand raised its policy interest rate six times in the first 8 months of the year, to 3.5%. It then reversed course when the flooding hit, the economy contracted, and the global economic outlook deteriorated, lowering the policy rate in November and again in January 2012, to 3.0% (Figure 3.30.5). Commercial bank lending slowed toward end-2011, though still rose by 14.9% for the year. The baht depreciated by 3.9% on average against the US dollar during 2011.

The fiscal deficit narrowed to 1.5% of GDP in FY2011 and public debt declined to 40.3% of GDP. Spending on the Thai Khem Kaeng (Strong Thailand) infrastructure program fell short of target (about 86% of its budgeted funding was disbursed).

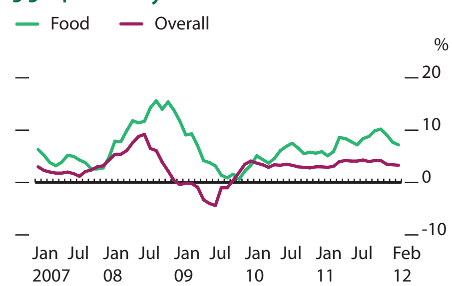
To support farmers, the new government committed to purchase unmilled rice at B15,000 ($500) a ton from October 2011—well above the market price—and budgeted B400 billion ($13.2 billion) in FY2012 for this

3.30.3 Merchandise trade growth



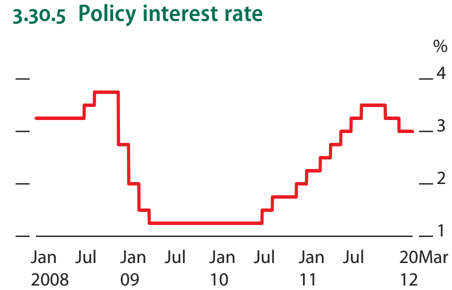
Source: Bank of Thailand. http://www.bot.or.th (accessed 28 March 2012).

3.30.4 Monthly inflation



Sources: CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 20 March 2012).

3.30.5 Policy interest rate



Source: Bloomberg (accessed 20 March 2012).

purpose. The policy drove up both the domestic price of this staple food and the price set by Thai exporters.

Overseas buyers were not, however, prepared to pay the higher prices, at a time that rice exporters in Cambodia, India, Myanmar, and Viet Nam were eager to sell, so that Thai rice exports fell by 29% in the first 2 months of 2012 from the prior-year period. The government, facing heavy costs as rice inventories build, is seeking bilateral government sales. It has had some success with Indonesia, which agreed to buy 1 million tons of milled rice annually over 5 years.

3.30.1 Selected economic indicators (%)

	2012	2013
GDP growth	5.5	5.5
Inflation	3.4	3.3
Current account balance (share of GDP)	0.5	-0.5

Source: ADB estimates.

Economic prospects

Reconstruction of flood-damaged areas and substantial policy stimulus will drive a rebound in economic growth in 2012, despite the torpid global outlook. GDP growth is expected to recover from last year's marginal 0.1% to 5.5% through the forecast period (Figure 3.30.6).

Private consumption growth will be underpinned by a tight labor market, civil service salary increases in January 2012, and a 40% boost in minimum wages in April. The government has also introduced incentives for first-time buyers of houses (tax breaks) and automobiles (cash rebates). Consequently, consumer confidence has started to pick up (Figure 3.30.7) after plunging during the floods.

Sales of consumer durables are getting a lift from the replacement of household appliances and furniture damaged during the inundations. Automobile sales, which had slumped by 62% year on year in the worst month, November, rebounded in January and February this year.

Investment will benefit from extensive private and public reconstruction work in flood-hit areas coupled with replacement of capital equipment. Small and medium-sized businesses affected by the floods have access to a $10 billion low-interest loan program set up by the Bank of Thailand.

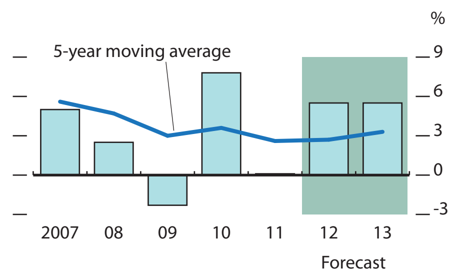
In signs of recovery, the industrial capacity utilization rate recovered to 62.3% in February, well up from 40.1% at its lowest point in November 2011 (Figure 3.30.8), and indexes for private consumption and private investment surpassed preflood levels. Tourist arrivals rose by 5.2% year on year in the first 2 months of 2012.

Half the factories flooded in 2011 had resumed full production by the end of February, but some are not expected to get back to that until the second or third quarters.

Fiscal and monetary policies have been set to spur growth. Flood-relief measures rolled out in the last quarter of 2011 included a debt moratorium and low-interest loans for farmers and low-income households; payments of B5,000 ($165) for households affected by the floods plus B20,000 ($645) for house repairs; and tax exemptions for businesses that invest in new production facilities. Businesses get a cut in the corporate income tax rate to 23% this year and 20% in 2013, from 30% in 2011.

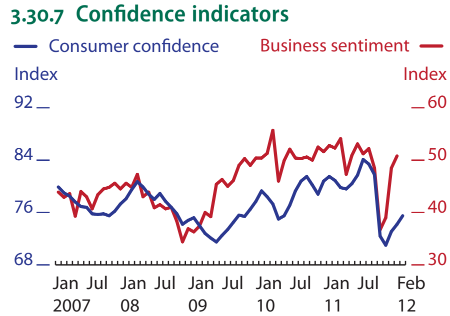
In addition to budget outlays, the authorities will spend large amounts off budget on reconstruction and flood prevention. Parliament approved an emergency decree allowing the government to borrow the equivalent of $11.3 billion by June 2013 for flood prevention and water management projects over the next few years.

3.30.6 GDP growth



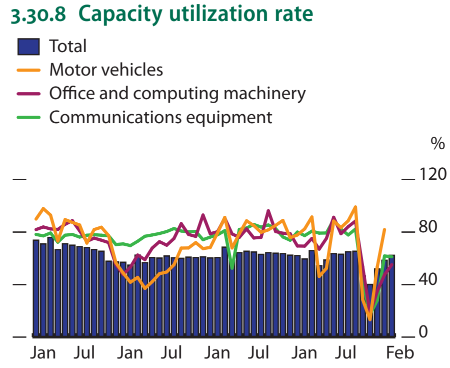
Source: Asian Development Outlook database.

3.30.7 Confidence indicators



Sources: Center for Economic and Business Forecasting; Bank of Thailand. http://www.bot.or.th (both accessed 20 March 2012).

3.30.8 Capacity utilization rate



Source: Bank of Thailand. http://www.bot.or.th (accessed 9 March 2012).

To pave the way for this borrowing, the government shifted responsibility for paying interest on about $46 billion of the debt of the Financial Institutions Development Fund from its budget to the Bank of Thailand, effective September 2013. That debt was issued during the late 1990s' Asian financial crisis to recapitalize Thai banks.

Further, the government set up a $1.6 billion disaster insurance fund to help households and businesses buy insurance (premiums charged by reinsurers rose sharply after the floods), and it outlined an ambitious infrastructure program including roads and railways that could cost up to $70 billion over 5–10 years. (Similar infrastructure initiatives by previous administrations have seen projects delayed or rolled over into later programs.)

The ramping up of spending to deal with the impact of the floods is expected to raise the fiscal deficit of the central government, including budget and off-budget spending, to about 5% of GDP in FY2012, before the gap narrows as GDP grows. Monetary policy is accommodative, with the policy interest rate at 3.0%, below inflation.

Recovery in manufacturing and agriculture will support growth in merchandise exports this year, despite sluggish world trade and uncertainties over Thai rice exports. Merchandise exports are projected to increase by 15.0%. Imports will increase faster than exports, by about 23.0% in 2012, reflecting purchases of capital equipment for reconstruction and robust consumer spending. The current account will likely slip into deficit next year, equivalent to about 0.5% of GDP (Figure 3.30.9).

Net foreign inflows into Thai bonds totaled B50 billion in the first 2 months of 2012, and the Thai Bond Market Association predicts a 20% increase for this year as international investors seek higher yields.

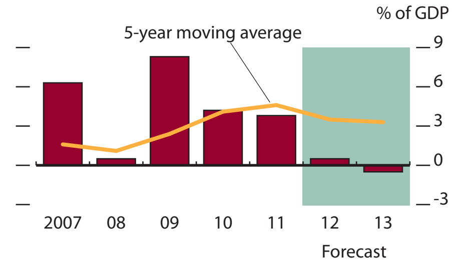
Food price inflation has receded, along with the floods. Nevertheless, upward pressure on prices will come from stronger domestic demand, rising minimum wages, heavy government spending, and a planned reintroduction of excise tax on diesel fuel. Inflation is forecast to average 3.4% in 2012 and 3.3% in 2013 (Figure 3.30.10).

Government borrowing to fund water management projects is projected to lift the public debt to 48.6% of GDP this year and 50.4% in 2013 (Figure 3.30.11). While these levels are manageable, the large outlays planned on infrastructure, coupled with cuts in corporate taxes and diminishing revenue from import taxes owing to trade agreements, suggest the debt may continue to rise without new revenue sources such as a broader personal income tax base or an environmental tax.

The anticipated rebound in growth this year depends on the government reconstructing flood-damaged infrastructure and making a significant start on longer-term projects involving flood-prevention and water management. Funding is allocated for this work, but the government's ability to implement projects poses a risk: the rate of disbursement of the capital budget has fallen to under 60% in recent years.

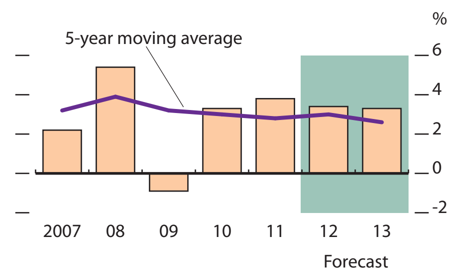
Other risks to the outlook include a deeper than assumed recession in the eurozone—the market for nearly 10% of Thai exports and source of about 27% of its tourists. Higher than projected global oil prices are also a downside risk. Flooding and drought are a perennial threat.

3.30.9 Current account balance



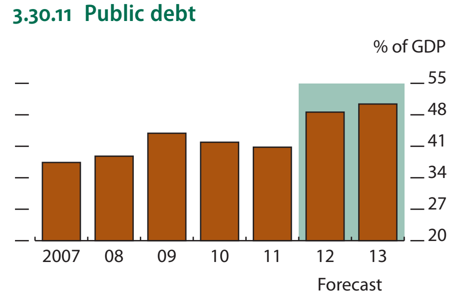
Source: Asian Development Outlook database.

3.30.10 Annual inflation



Source: Asian Development Outlook database.

3.30.11 Public debt



Source: Ministry of Finance. http://www.mof.go.th (accessed 29 March 2012).

Policy challenge—after the deluge

The expansion of industrial zones, often on former low-lying farm land, has increased chances that heavy floods will have a really severe impact on the economy, as in 2011.

Resulting prolonged closures of factories and extensive damage to a broad range of businesses (Figure 3.30.12) also raises the risk that foreign firms could become reluctant to expand manufacturing and warehousing in Thailand. Maintaining investor confidence depends on rebuilding flood-damaged infrastructure promptly, carrying out flood prevention and mitigation projects, and establishing a better institutional structure to handle crises.

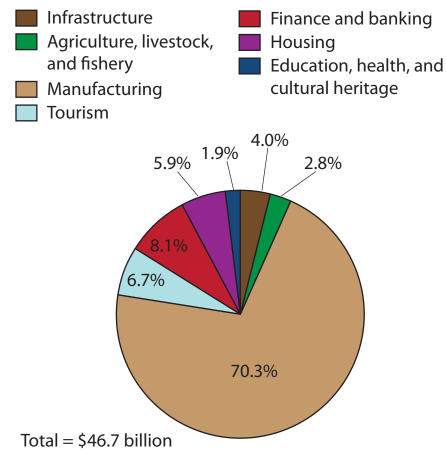
By January 2012, the government had approved a master plan for water management that, among other things, covers upgrading warning systems, flood protection and management infrastructure, and a central agency for water resource management.

Further, the cabinet cleared 246 flood management projects costing B24.8 billion ($818.5 million) during the first quarter of this year. These projects include raising highway levels in flood-prone areas and building dikes and drainage systems. Line agencies are scrambling to get as many projects as possible completed or under way before the next wet season. Officials are identifying land to be set aside as floodways.

Thailand's ability to assuage investor sentiment will also depend on the replacement infrastructure being better able to manage the impact of prolonged heavy rainfall and floods than the former structures.

Moreover, although reconstruction must be pursued quickly, it will be important to address longer-term water management issues as well, and to ensure that water-related projects in one region take into account their impact on other regions. For example, Bangkok and surrounding industrial areas at the lower reaches of the Chao Phraya river basin depend on good water management in the basin's upper reaches to prevent floods that later affect the heavily populated lower regions.

3.30.12 Flood damages and losses, 2011



Sources: Department of Disaster Prevention and Mitigation; Ministry of Finance.

Viet Nam

The policy tightening adopted to curb high inflation in 2011 also slowed economic growth. The authorities loosened monetary policy in early 2012, and signaled that further easing is likely if inflation trends down. It is indeed seen receding this year, but then edging up again next year. GDP growth is forecast to remain subdued, before picking up in 2013. Beyond macroeconomic stabilization, the government needs to address risks in the financial sector.

Economic performance

Confronted at the start of 2011 with soaring inflation and rapidly depleting foreign reserves, the government adopted a package of monetary and fiscal tightening measures—Resolution 11—that were sustained through the year. Policy tightening started to rein in inflation and damped economic growth, to 5.9% for the year (Figure 3.31.1) as investment fell and consumption growth moderated, more than offsetting an improvement in net exports.

Investment declined by 9.2% owing to high lending rates and cuts in public infrastructure investment, both elements of the policy tightening. Gross capital formation as a ratio to GDP moderated to 38.7%, the lowest in 4 years.

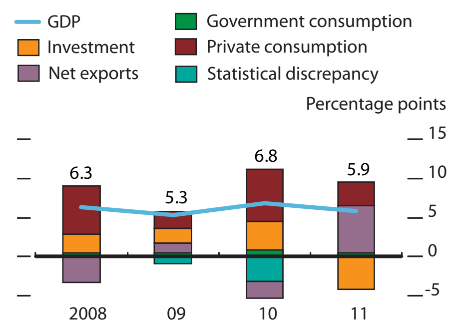
Private consumption decelerated to 4.4% as high inflation eroded real incomes. Public consumption growth slowed to 7.2%, reflecting the firmer fiscal stance. Net exports, by contrast, strengthened in 2011 as exports grew faster than imports, making a major contribution to GDP growth.

From the production side, a 7.0% expansion in services made the biggest contribution to total growth (2.9 percentage points). Wholesale and retail trading and hotels and restaurants both grew by about 7.5%, the latter supported by a 19% increase in visitor arrivals.

Stronger exports of manufactured goods underpinned an 8.3% expansion in manufacturing. However, construction fell by 1.0% due to cuts in public investment and curbs on lending for property. Better weather, strong commodity prices, and solid export demand for high-quality rice drove a 4.0% pickup in agriculture.

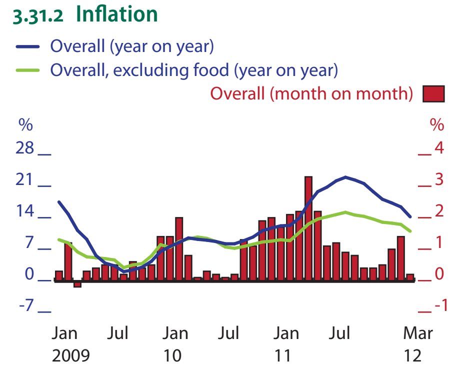
Inflation climbed to a 2011 peak of 23.0% year on year in August (Figure 3.31.2). It was driven by rising food prices, the lagged impact of high credit growth in 2010, exchange rate devaluations, and hikes in administrative prices of electricity and fuel. Food prices shot up by 34.1% year on year in August. Subsequently, food prices eased and, coupled with the impact of the policy tightening, brought inflation down, although it was still high at 14.2% in March 2012.

3.31.1 Contributions to growth (demand)



Source: General Statistics Office.

3.31.2 Inflation



Source: General Statistics Office.

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

Policy tightening by the State Bank of Viet Nam (SBV, the central bank) was a combination of curbs on credit and money supply, hikes in bank reserve requirements and interest rates, and open-market operations. The repo rate—the cost of borrowing by commercial banks from the SBV on short-term open market operations—was ratcheted up from 10% to 14% in 2011, and the refinancing rate from 9% to 15%. The reserve ratio for banks' United States (US) dollar deposits was doubled to 8.0% for terms of less than 12 months and tripled to 6.0% for terms of 12 months or more.

As inflation trended down, real interest rates on dong deposits rose but remained negative. Liquidity shortages at some banks prompted them to offer deposit interest rates close to 20%, above a 14% cap imposed by the SBV. The average rate for borrowing in dong rose to 22% in July 2011, before easing to 19% by March 2012.

High borrowing costs, central bank administrative controls, and weak business sentiment pulled back growth in credit to 14.3% year on year by the end of 2011, from a rapid 32.4% in 2010 (Figure 3.31.3). Tighter liquidity contained growth in M2 money supply to 12.1%, slowing from 33.3% the previous year.

Most commercial banks met a year-end deadline to limit credit outstanding to "discouraged" activities including property, marketable securities, and consumer credit to 16% of total lending. The overall portion of credit to discouraged activities was estimated at 11.3% at end-2011.

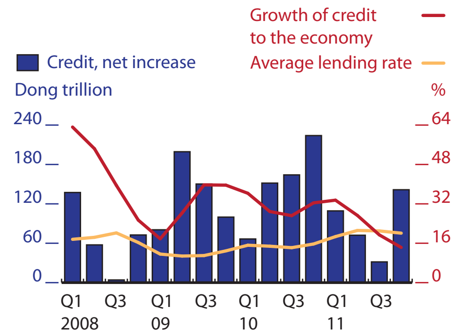
The government stabilized the dong exchange rate through monetary tightening, coupled with a large one-step devaluation in February 2011 and administrative measures such as caps on US dollar deposit interest rates and restrictions on the use of gold and foreign currency. Still, over the year, the dong depreciated by 10% against the US dollar (Figure 3.31.4).

Fiscal tightening involved cuts in expenditures, mainly capital works, and gains in revenue. The government raised operating expenditure on education, health, and social security, but total spending, both on-budget and off-budget, is estimated to have declined in real terms last year. High prices for domestically produced oil contributed to the increase in revenue, as did the impact of inflation and exchange-rate movements. As a result, the budget deficit narrowed to 4.4% of GDP, from 5.6% in 2010 (Figure 3.31.5). Using an international fiscal definition, the deficit was estimated at 4.0% of GDP.

With robust exports, the government met its objective of greatly shrinking the trade deficit in 2011. Merchandise exports (up by 34% on a balance-of-payments basis) and imports (up by 26%) each totaled about $97 billion. High oil prices propelled exports of crude oil by 46% (using customs data) and exports of agricultural products by 30%. Shipments of manufactured goods rose by 35%, shielded from the impact of the global downturn because they are mainly low-value added manufactures. Currency depreciation buffered exports from rising domestic costs.

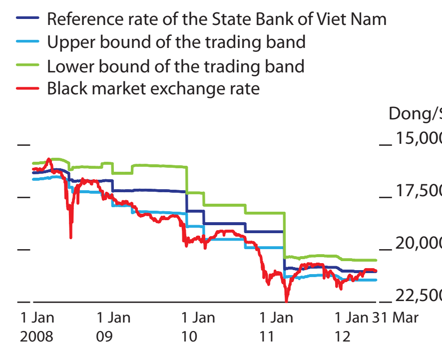
Imports decelerated owing to lower demand for raw materials and other production inputs for export industries, the cooling of private consumption, and currency depreciation. Also, the government restricted imports of some consumer goods.

3.31.3 Credit growth and lending rate



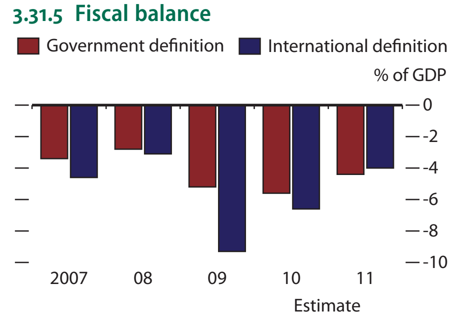
Sources: State Bank of Viet Nam; Ho Chi Minh Securities Corporation.

3.31.4 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

3.31.5 Fiscal balance



Note: International definition includes off-budget spending and onlending, but excludes principal debt repayments and revenue and expenditure carried forward. It estimates revenue and expenditure for 2010 and 2011 that is not yet recorded (fiscal accounts for these 2 years are still incomplete).

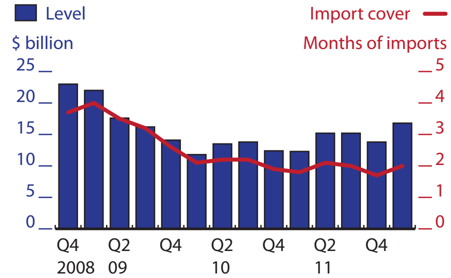
Sources: Ministry of Finance; ADB estimates.

The current account turned to a small surplus (0.2% of GDP), the first surplus in 10 years. That reflected the smaller trade deficit and a 10% increase in remittances (to about $8.7 billion). Portfolio investment inflows were below 2010 levels at an estimated $1.4 billion (the VN index of share prices dropped by 27% in 2011) and foreign direct investment was slightly lower at about $6.5 billion.

These capital inflows contributed to a rebuilding of international reserves by an estimated $1.4 billion to $13.8 billion in 2011. Favorable foreign exchange market conditions in the first quarter of 2012 enabled the SBV to further increase reserves, to an estimated $16.8 billion, equivalent to about 2 months of import cover (Figure 3.31.6).

Monetary tightening led to liquidity stress in some banks last year. Three small banks facing liquidity problems merged in December 2011 under the supervision of the SBV, which provided liquidity support to the merged entity and instructed a state-owned commercial bank to provide it with credit.

3.31.6 Gross international reserves



Notes: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Import data are on free-on-board basis.

Sources: State Bank of Viet Nam; ADB estimates.

Economic prospects

The government, attempting to expand the economy while bringing down high inflation, targets a modest acceleration in GDP growth in 2012 (to 6.0–6.5%) and much lower inflation (under 10%). Fiscal and monetary statements suggest some easing in policy settings. The budget indicates that on-budget public spending could rise by about 6% in real terms (compared with a decline in 2011) and the fiscal deficit target in 2012 is widened slightly from last year to 4.8% of GDP.

The SBV is targeting credit growth of 15–17% in 2012, slightly faster than 14.3% recorded in 2011, and the goal for growth in M2 money supply is 14–16%, up from last year's outcome of 12.1%. The authorities have directed banks to continue to limit lending for property, securities, and consumer credit to 16% of loan portfolios.

Credit growth ceilings this year are bank-specific, depending on a range of financial soundness indicators. Weaker banks have a lower ceiling for credit growth than others. Strong banks with higher credit growth ceilings hold an estimated 90% of total banking assets.

In March 2012, the SBV responded to the gradual easing of inflation by lowering the refinancing, discount, and repo rates by 100 basis points (Figure 3.31.7) and reducing the ceiling on dong deposit rates from 14.0% to 13.0%. The monetary authorities indicated that further easing depends on inflation trending down toward the target (and the forecasts below assume this will be the case).

The SBV introduced central bank bills of 1–6-month terms to improve liquidity management, and used these securities to sterilize bank reserves created by foreign exchange purchases.

Preliminary data indicate that GDP grew by 4.0% in the first quarter of 2012, decelerating from 6.1% in the fourth quarter of 2011. Industrial production increased by 4.1% year on year. Credit contracted by 2.5% during the first 2 months of this year. In further signs of sluggish economic activity, merchandise imports grew by 7% in the first quarter.

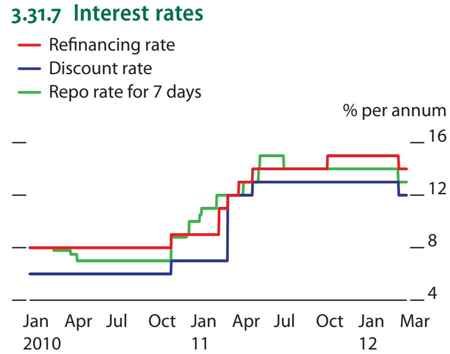
Private consumption in 2012 will get support from easing inflation. Investment will likely remain subdued, given uncertainties about

3.31.1 Selected economic indicators (%)

	2012	2013
GDP growth	5.7	6.2
Inflation	9.5	11.5
Current account balance (share of GDP)	-1.5	-2.2

Source: ADB estimates.

3.31.7 Interest rates



Source: State Bank of Viet Nam.

the health of the financial sector, and government capital spending is expected to be flat. Growth in exports will slow from 2011, owing to weaker world trade, although Viet Nam should benefit from the expected gradual pickup in the United States, its biggest export market.

On the balance of these factors, GDP is forecast to grow by 5.7% in 2012 (Figure 3.31.8). Growth is expected to pick up to 6.2% in 2013, owing to the improved global outlook for trade and investment and likelihood of easier monetary policy next year.

Inflation is forecast to trend down this year, reflecting the policy tightening and high base set for the consumer price index in 2011. Food price inflation is abating. Weather conditions for agriculture were generally favorable in the first quarter of 2012 and global food prices are projected to ease this year. However, the government raised administered fuel prices by 3–12% in March. Average inflation this year could ease to just under double digits, provided policy settings are kept sufficiently firm. (Core inflation, which excludes food and energy, will be more persistent, though.) Year average inflation in 2013 is seen quickening to 11.5%, in tandem with economic growth and on expectations of higher global food prices and hikes in domestic electricity and fuel costs.

The current account is forecast to record a deficit equivalent to 1.5% of GDP in 2012 and 2.2% in 2013, largely due to subdued exports.

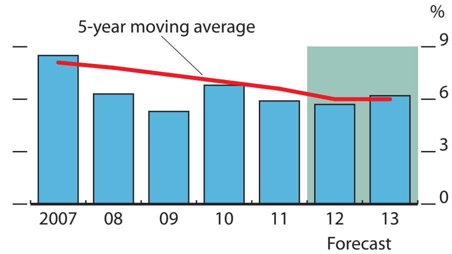
This outlook would be at risk if the government were to ease policies at a pace unsettling the foreign exchange market. Real savings of dong depositors have been eroded by negative interest rates over a prolonged period. The cumulative "errors and omissions" in the balance of payments, estimated at $18 billion in 2009-2011 (Figure 3.31.9), reflects large volumes of foreign currency and gold outside the banking system.

Lowering interest rates too quickly could put the dong under renewed pressure. This would undermine macroeconomic stabilization efforts, erode investor and consumer confidence, and undermine foreign reserves. Vulnerabilities in the banking system also pose a risk. Business confidence and the financial system would be shaken if problems at small banks were to spread.

While foreign reserves have been rebuilt, they are still low, making the economy vulnerable to external shocks. On the fiscal side, the costs of recapitalizing banks, restructuring state-owned enterprises (SOEs), and raising civil service wages to compensate for rapid inflation puts at risk public capital spending. The ratio of current to capital expenditure increased significantly last year. Additionally, an increasing proportion of government spending is being channeled off budget (Figure 3.31.10), raising public financial management risks.

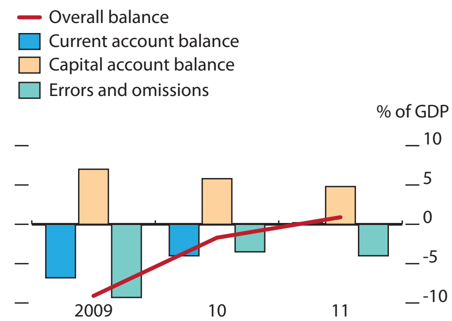
The authorities will need to accelerate reforms of SOEs if they are to raise the efficiency of this large sector of the economy, a prerequisite for lifting average GDP growth to 7–8%, the target of the Socioeconomic Development Strategy 2011-2020. Reform efforts so far have focused on small to medium-sized SOEs. The government has committed to draw up restructuring plans for 21 large state groups to make them more commercially oriented. It wants to reduce by about half the number of SOEs to 690 by 2015, and then to 200 by 2020, through full or part privatization.

3.31.8 GDP growth



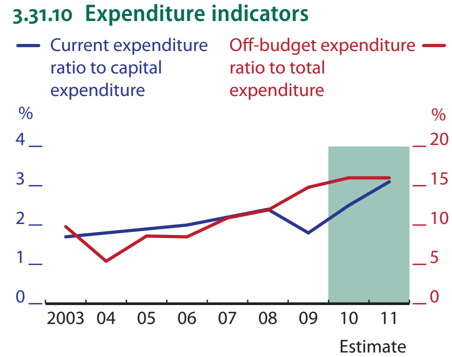
Source: Asian Development Outlook database.

3.31.9 Balance-of-payments indicators



Sources: State Bank of Viet Nam; ADB estimates.

3.31.10 Expenditure indicators



Note: At end-March 2012, the government had yet to finalize fiscal accounts for 2010.

Sources: Ministry of Finance and ADB estimates.

Concerned about SOEs expanding into areas unrelated to their core businesses, the government has banned them from making such investments. Increased transparency of the financial performance of state enterprises would provide a strong signal to the market that the government was committed to reforms.

Policy challenge—financial sector restructuring

Rapid growth in lending over several years, followed by the squeeze on credit in 2011 and exacerbated by downturns in property and equities markets, have added to stresses for banks. The ratio of nonperforming loans to total loans increased to an estimated 3.4% (Figure 3.31.11), although it would be much higher under international accounting standards. This rising ratio and the risk profile of some bank balance sheets, particularly those with exposure to unprofitable and overstretched SOEs, raises questions about capital adequacy, particularly for small banks. The dangers are compounded by shortcomings in risk management at banks and deficiencies in the regulatory and supervisory framework.

A 16% increase in US dollar borrowing in 2011 heightened foreign exchange risk for banks. This year, the SBV has increased surveillance of foreign currency lending. From May 2012, it will restrict foreign currency lending only to firms engaged in export and import activity; it will also reduce limits on banks' foreign exchange positions.

Uncertainty over the financial health of banks has unsettled investors and hampered interbank market operations. A Financial Sector Assessment Program, to be conducted by the International Monetary Fund and World Bank at the request of the Vietnamese authorities, suggests they intend to address weaknesses in the banking system. The assessment, expected in the first half of 2013, will give recommendations for financial sector restructuring.

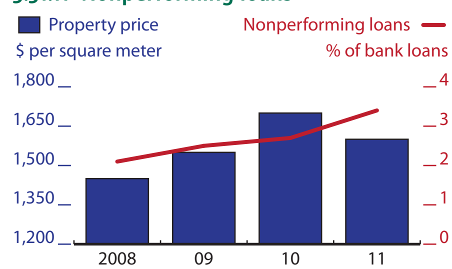
In March 2012, the government outlined a plan that includes injecting capital into banks and encouraging strong banks to acquire weaker ones. Officials said part-privatization of state-owned commercial banks will be accelerated and bank capital requirements raised. Funding and timing of the bank recapitalization have not been disclosed in detail. The government wants to see, over the next few years, one or two state-owned commercial banks well placed to compete against other banks in Southeast Asia.

Safeguarding the banking sector is the immediate priority. The longer-term requirement is to develop a diversified and efficient financial system that can mobilize funding to meet the 7–8% economic growth target.

The government has already this year approved a plan to revamp the securities market. It covers development of the government and corporate bond markets, a restructuring of the two stock exchanges as well as securities firms, and an improved payment and settlement system for securities. Under the plan, policies are to be formulated to encourage more domestic and foreign investors in securities.

These complex reforms, which will take years to complete, would benefit from coordination with the proposed restructuring of SOEs.

3.31.11 Nonperforming loans



Note: Property price is the average price of high and medium-priced condominiums.

Sources: State Bank of Viet Nam; CB Richard Ellis; ADB estimates.

The Pacific

Fiji
Papua New Guinea
Timor-Leste

Cook Islands
Kiribati
Marshall Islands
Federated States of Micronesia
Nauru
Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji

The country continues with weak economic growth, held back by policy uncertainty and structural constraints, which have contributed to low levels of private investment. Tourism is performing well, but other leading sectors, such as sugar and textiles, are struggling to compete internationally. Economic prospects are further clouded by weak global markets. Public expenditure is limited by high levels of debt and, longer term, structural reforms are essential for the economy to achieve its growth potential.

Economic performance

In 2011, the economy grew by 2.1% after 2 years of contraction. The improvement reflects recovery in agriculture, which had been affected by cyclone damage in 2010. It also reflects an increase in tourist arrivals of 6.8% (Figure 3.32.1). Offsetting these gains, gold output fell by 22% as capital works reduced output from the key Vatukoula mine. Electricity production was also down more than 4%, because consumption was constrained by higher electricity prices.

Exports (through higher earnings from reexports, sugar, gold, molasses, and timber) rose by 26.5% in 2011, while merchandise imports (largely machinery and transport equipment, food, and mineral fuels) climbed by 16.3%.

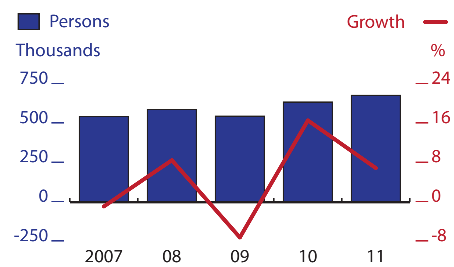
Inflation reached double digits in midyear but averaged 8.7% for the year, up from 7.8% in 2010 (Figure 3.32.2). This reflected higher fuel and food prices, an increase in value-added tax, and steeper electricity prices.

The budget deficit was equivalent to 3.5% of GDP in 2011, up from 2.1% of GDP in 2010. Tax revenue exceeded budget estimates with growth in collections from value-added, hotel turnover, and water resource taxes. Total revenue fell below budget estimates, however, on delays in selling government assets. Expenditure was slightly lower than expected because of underspending on the operating and capital budgets.

Government expenditure in 2011 was dominated by current spending, which accounted for 86% of budget outlays. The wage bill remained at around 40% of total public spending, or nearly half current outlays. In recent years the government has increased spending on infrastructure. Capital investment has risen from 9% of total public spending (3.5% of GDP) in 2007 to an average of 14% of total public spending (5.2% of GDP) in 2008–2011.

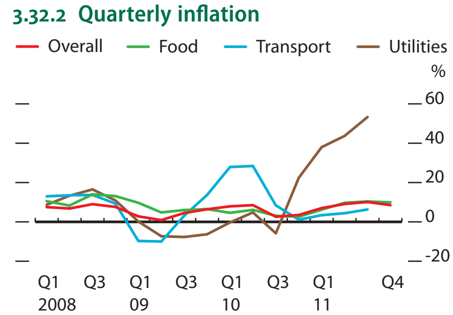
Monetary growth was 16.5% in 2011. This reflected a $250 million foreign bond issue by the government in March 2011 and resulting influx of foreign exchange, as well as higher foreign exchange earnings and weak import growth.

3.32.1 Visitor arrivals



Sources: Reserve Bank of Fiji; ADB estimates.

3.32.2 Quarterly inflation



Source: Reserve Bank of Fiji.

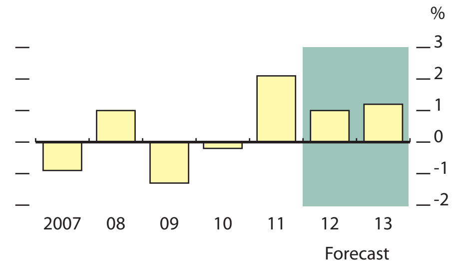
This chapter was written by Laisiasa Tora of the South Pacific Subregional Office, ADB, Suva.

Since 2008, Fiji's financial markets have had excess liquidity but, despite monetary-policy easing, domestic credit growth has continued to slow, rising by just 10% in the 4 years to end-2011. After holding steady for 6 months, the Reserve Bank of Fiji (RBF) cut its policy rate in October 2011 by 100 basis points, to 0.5%. Although lending to the private sector subsequently rose, the RBF is concerned that small and medium-sized enterprises are being excluded. It has, therefore, introduced a loan guarantee scheme, among other measures, to encourage such lending.

Fiji's index for the real effective exchange rate rose on an annual basis by 5.2% in 2011 due to comparatively high domestic prices. This indicates a loss in international competitiveness against major trading partners, as well as an erosion of the benefits from devaluation in 2009.

The current account deficit widened marginally to 11.2% of GDP in 2011, from 11.0% the previous year. The surplus in the capital and financial accounts declined following repayment of a $150 million global bond, issued in 2006, using part of its March 2011 bond issue. As of end-2011, official foreign exchange reserves reached $856 million, equivalent to around 5 months of imports.

3.32.3 GDP growth



Sources: Fiji Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2012 Budget Address*; ADB estimates.

Economic prospects

The Asian Development Bank projects GDP growth of 1.0% in 2012 and 1.2% in 2013 (Figure 3.32.3)—lower than government expectations—reflecting its assessment of likely weak global demand, slow growth in bank lending, low levels of private investment, and the effects of the floods in early 2012.

Construction and investments in mining could support modest growth. For example, investment to date for the Namosi copper mine has been about 2.2% of GDP, or $86.2 million. The impact of further investment on growth is likely to be muted, however, as equipment will be imported.

The government foresees a budget deficit of 1.9% of GDP for 2012, based largely on expectations of improvements in the economy (Figure 3.32.4). Revenue is forecast at $1.1 billion, 12.7% higher than in 2011. Corporate and personal income tax cuts are expected to boost spending and investment. Tax revenue will be supplemented by the conversion of the 5% hotel turnover tax to a service turnover tax applying to most tourism-related services. This is expected to generate $32.6 million in revenue in 2012. Other measures include increases in the airport departure tax, higher excise taxes, and new levies, including voice call charges and credit card fees.

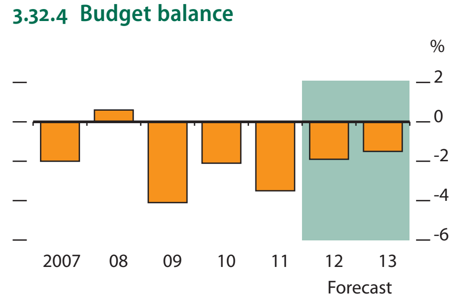
Government expenditure is estimated at $1.2 billion in 2012, up by 5.9% from 2011. Operating spending, which makes up 70% of the total (around $840 million) is projected to be 5% higher. Capital expenditure (around $320 million) is projected to rise by 7.1%. Key features of the 2012 spending program include a 3% salary increase for civil servants and an increase of $36.6 million (or 7.0%) in the infrastructure development budget allocation, to be financed largely by the export-import banks of the People's Republic of China and of Malaysia. The government projects a reduction in the debt-to-GDP ratio, from 51% in 2012 to around 49% by

3.32.1 Selected economic indicators (%)

	2012	2013
GDP growth	1.0	1.2
Inflation	5.1	3.0
Current account balance (share of GDP)	-9.6	-11.6

Source: ADB estimates.

3.32.4 Budget balance



Source: Fiji Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2012 Budget Address.*

2014, if its economic and revenue growth targets are met. However, this will still exceed the government's target of 40%.

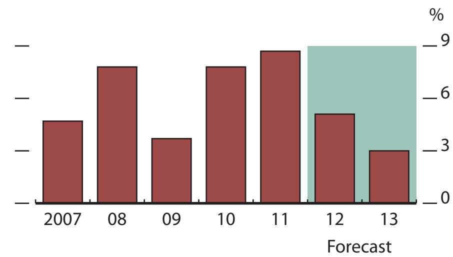
Crucially, if these targets are not achieved, the fiscal position could deteriorate. This would affect the provision of essential public services and increase public debt. There would be little scope for further fiscal expansion.

At end-March 2012, the RBF left its policy rate at 0.5% in light of continuing uncertainty in the eurozone and the need to support domestic investment activity. In February, it required commercial banks to set aside 4% and 2% of their deposits for loans for the agriculture and renewable energy sectors, respectively. It is important that this measure is closely monitored to prevent a rise in nonperforming loans.

Average annual inflation is projected to decline to 5.1% in 2012 (Figure 3.32.5). This forecast stems from the weak growth outlook, projected declines in international food prices, and dissipation of one-time price adjustments from last year.

The current account deficit is projected to narrow to 9.6% of GDP in 2012 (Figure 3.32.6), despite lower sugar production, primarily because of lower prices of imported commodities. Foreign reserves are expected to remain above the targeted 3–4 months of imports in 2012.

3.32.5 Inflation



Sources: Reserve Bank of Fiji; ADB estimates.

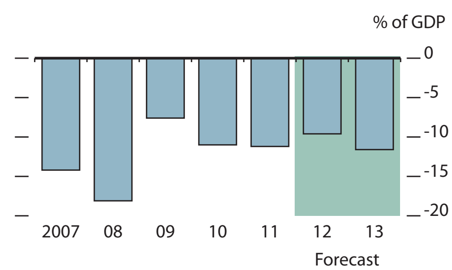
Policy challenge highlights

Fiji has experienced low economic growth, rising emigration, and high poverty over the past decade, mainly because of low domestic investment. Private investment is low, there has been little new domestic lending, and public investment has been constrained by poor implementation. Since 2005, gross domestic investment has averaged 13.1% of GDP a year, well below the government's target of 25%. The ratio of private investment to GDP declined from an average of 11.3% in 2000–2005 to 7.5% in 2006–2010; in 2011 it was around 2%.

The government recognizes that the economy operates below its growth potential because of an array of difficult macroeconomic, structural, and sector policy constraints. State-owned enterprise reform is progressing, and the government is seeking to divest its holdings in several enterprises. Yet the pace of reform is constrained by fiscal limits, a lack of technical capacity, limited stakeholder buy-in and consultation, and inconsistencies in the way reform principles are applied. The medium-term macroeconomic outlook is weak and foreshadows greater poverty challenges—unless structural reforms are carried out in a coherent and coordinated manner.

Business confidence is unlikely to be restored until progress is made on political reform. The drafting of a new constitution this year and the holding of national elections in 2014 will be crucial in this respect.

3.32.6 Current account balance



Source: Fiji Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2012 Budget Address.*

Papua New Guinea

High international commodity prices boosted economic growth in 2011. Restrained expenditure growth allowed the government to accumulate public trust fund savings. GDP growth will remain high in 2012 as construction of a large resource project reaches its peak. The following year, economic pressures will emerge as construction of that project winds down and government revenues from existing mining operations decline. A major challenge is to ensure that the poor benefit from the country's higher income.

Economic performance

The economy continued its strong performance in 2011, with GDP growth of 8.9% marking a decade of uninterrupted expansion. Industry made the largest contribution to growth owing to resource investments, including the construction of a $16 billion liquefied natural gas (LNG) project and high government spending that boosted demand in the sector (Figure 3.33.1). Construction was also supported by property developments as investors responded to very high rental demand in urban centers.

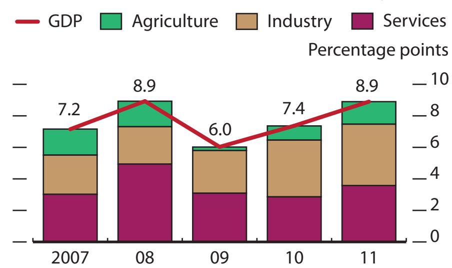
The contribution of industry to overall growth was partly offset by the mining and oil sector, which contracted by 8.7% as a result of declining output from maturing mining and oil operations. Agricultural output rose by 4.5% as producers responded to higher commodity and food prices.

Strong economic growth continued to create income-earning opportunities. The Central Bank Business Liaison Survey showed a 7.1% increase in formal employment in the first half of 2011.

The deficit on the current account of the balance of payments widened to 36.8% of GDP in 2011. Higher commodity prices raised the US dollar value of merchandise exports by 27.8%. Mineral exports climbed by 17%, as rising copper and gold sales more than offset an 11% decline in oil revenue. The value of agricultural exports, which make up roughly a quarter of export revenue, rose by about 51% in 2011, primarily as a result of 63% growth in palm oil exports, an 88% jump in coffee sales, and a 100% surge in marine products.

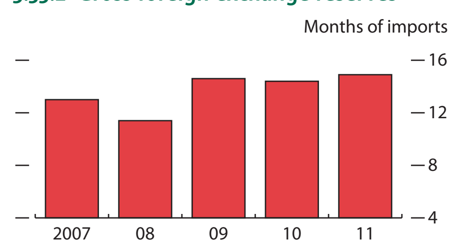
Increased exports were, however, outweighed by a rise in imports, particularly those related to construction of resource projects. Yet because resource-project imports are financed mainly through foreign direct investment, the large current account deficit does not jeopardize external stability. High foreign exchange reserves held by the central bank, which totaled 15 months of nonmineral import cover in 2011 (reaching 18 months in October), also support external stability (Figure 3.33.2).

3.33.1 Contributions to growth (supply)



Sources: Department of Treasury. *2012 National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.2 Gross foreign exchange reserves



Note: Imports exclude mining and oil commodities.

Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

This chapter was written by Aaron Batten of the Papua New Guinea Resident Mission, ADB, Port Moresby.

The 2011 budget recorded a small deficit of $40 million (equivalent to 0.3% of GDP) (Figure 3.33.3). Adjusting official numbers for net trust fund deposits, though, gives an effective budget surplus equal to 2% of GDP. This difference arises owing to the government's classification of trust fund deposits as spending, while international government accounting standards treat them as savings.

Strong growth and high commodity prices took domestic revenue collection 6.6% above projections (Figure 3.33.4). A midyear supplementary budget allocated an extra $359.6 million in expenditure to infrastructure, health centers, and prefunding for a new commitment to achieve universal primary and secondary education.

High levels of government expenditure, large resource investments, and rising international food prices spurred inflation in the first half of 2011, with the consumer price index increasing year on year by 9.6% at end-June 2011. Price increases slowed in the second half, mainly reflecting strong exchange rate appreciation.

Also supporting moderating price growth was monetary intervention: the central bank issued a net $0.6 billion in central bank bills, raised the policy interest rate (the kina facility rate) by 75 basis points to 7.75%, and lifted the capital-adequacy requirement for banks from 4.0% to 6.0%.

A significant policy development in 2011 was the announcement of a new sovereign wealth fund to manage all future mineral revenue. The fund aims to encourage stable and sustainable increases in government expenditure by establishing a maximum drawdown rule and channeling all mineral funds through the budget. The fund also aims to protect local export industries by investing unspent mineral revenue in offshore assets.

One challenge, however, is that the proposed new agencies that will use mineral revenue to finance infrastructure and state-owned enterprise investments have the potential to replicate existing government structures and complicate public financial management.

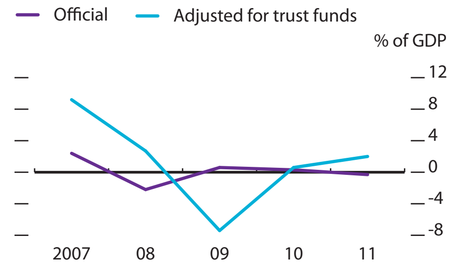
Economic prospects

Growth is seen moderating to 7.5% in 2012 and more sharply to 4.5% in 2013 (Figure 3.33.5). This year growth will be supported by higher prices for the country's key export commodities, heavy government spending, and rising domestic employment, at the same time as the LNG project's construction phase reaches its peak. Growth will also be supported by a 20% expansion of the mineral sector as production starts at the Ramu nickel and cobalt mine, although this will be partly offset by a 9.9% reduction in oil production.

The slowdown in 2013 will stem from the winding down of LNG project construction, which will hit demand in a range of sectors, including construction itself, transport, and aviation. This effect will spill over into the wholesale and retail sectors. Adding to this shock will be further declines in oil production, which is predicted to contract by 17% in 2013.

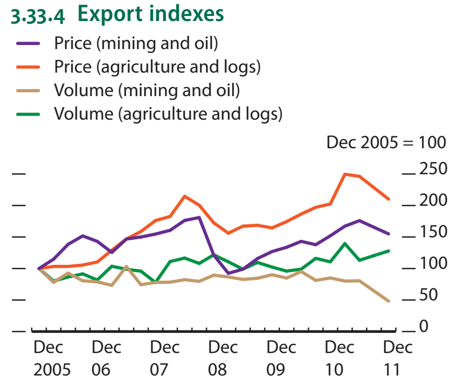
Inflation is expected to remain high in 2012 (Figure 3.33.6). Record public and private investment will leave many areas of the economy, including construction, shipping, and port facilities, operating at close to full capacity. Offsetting these pressures is the kina exchange rate,

3.33.3 Budget balance



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

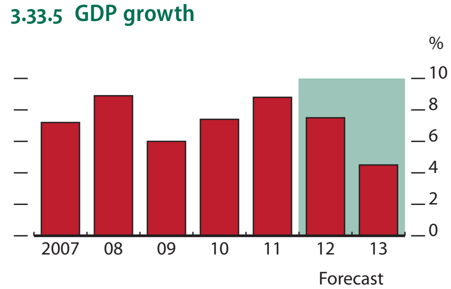
3.33.4 Export indexes



Note: Index rebased to December 2005 = 100.

Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

3.33.5 GDP growth



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

which is likely to remain high against those of major trading partners in 2012, after appreciating by 21% against the US dollar and 18% against the Australian dollar in 2011. On balance, price growth in 2012 is expected to ease slightly to 7.0% and to 6.0% in 2013 as the economy slows further and LNG-related construction activity declines.

In the external accounts, resource-project imports will maintain a large current account deficit, of around 33.2% of GDP in 2012 and 29.7% in 2013 (Figure 3.33.7). Foreign direct investment will continue to finance this gap. Foreign reserves are expected to remain adequate in terms of import cover over the forecast period.

The 2012 budget targets a balanced position, with an expected 9.5% increase in domestic revenue collection. As in previous years, the budget excludes net trust fund expenditure. Pressure to draw on these accumulated savings will be raised in the lead-up to national elections in mid-2012. Given existing capacity constraints, any large trust-fund drawdowns would add to inflationary pressures and crowd out private sector activity.

Fiscal stress will mount in 2013 as revenues from maturing mining and oil operations continue to decline. Combined with slowing growth, this is expected to begin a 2-year period of stagnant revenue collection, until LNG revenue begins in 2015.

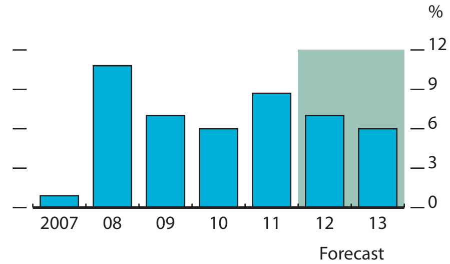
Low public debt—about 24% of GDP in 2011—will enable measured government borrowing to maintain expenditure without compromising macroeconomic stability, although public finances face some risks, and a decline in international commodity prices would be painful. Revenue projections in the 2012 budget are predicated on an optimistic outlook for commodities: cocoa, coffee, palm oil, rubber, and tea prices are expected to moderate only slightly but remain near record highs, while prices of copra, copra oil, and copper are all expected to rise. The price of gold in particular, which makes up almost half of export earnings, is forecast to be 20% higher in 2012 than in 2011.

If commodity prices decline significantly this year, the government will face pressures to meet expenditure commitments without undermining the fiscal discipline that has underpinned the last decade of macroeconomic stability.

Another risk to the economic outlook is the government's growing off-balance sheet contingent liabilities related to resource-project guarantees and unfunded superannuation liabilities, now totaling 32% of GDP. Of particular concern is the potential for unresolved landowner compensation issues to delay LNG project construction, which may result in the government being obliged to meet its project-completion guarantees.

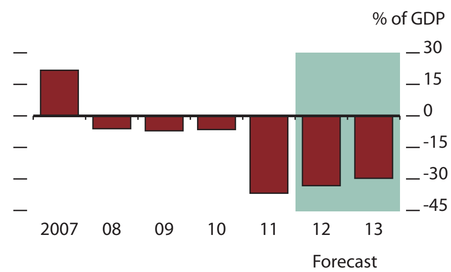
On the upside, medium-term projections do not incorporate some potential new mining investments, including extending the lifespan of the Ok Tedi mine and a second LNG project.

3.33.6 Inflation



Sources: Department of Treasury. *2012 National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.7 Current account balance



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.5	4.5
Inflation	7.0	6.0
Current account balance (share of GDP)	-33.2	-29.7

Source: ADB estimates.

Policy challenge—tackling inequalities

The last decade of economic growth has led to rising inequalities. Mineral exports and resource-project construction have underpinned a 30% increase in real per capita incomes from $1,398 in 2002 to $1,850 in 2011. But the link between economic growth and the welfare of the poor is weak—the country is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 153 out of 187 countries in the 2011 human development index compiled by the United Nations Development Programme.

A major challenge is the limited ability of the public sector to translate higher revenue into improved public services. A lack of socioeconomic data makes tracking performance difficult, but anecdotal evidence suggests that, despite a 120% increase in government expenditure since 2002, the quality of service delivery has remained stagnant and in some cases even declined, particularly in rural areas.

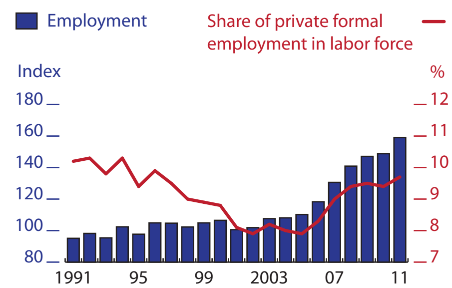
The effects of growth on employment creation are also restricted by the business environment. The country ranked 101 out of 183 countries on the World Bank's 2012 *Doing Business* survey, the lowest in the South Pacific and well behind regional partners in Southeast Asia. So, despite some growth in recent years, the formal private sector remains small, employing less than 10% of the economically active population (Figure 3.33.8) and concentrated in just a few industries such as mining and agriculture.

High inflation has also undermined the inclusiveness of growth. Although wage earners can negotiate higher wages when costs rise, the roughly 85% of the population reliant on cash crops for their semi-subsistence livelihoods have seen their purchasing power deteriorate rapidly in recent years. Further, structural constraints in land and housing markets have restricted the supply response to rising property demand, and contributed to rising rental prices. As a result, an increasing portion of urban residents are now forced to live in informal urban settlements, which have poor access to power and sanitation facilities and which pose significant personal security risks.

Inequality is also growing in villages, reflecting rising compensation payments to incorporated landowner groups made by mining companies for use of land. With low educational and financial literacy levels, members of these groups can rarely hold leaders to account for the equitable distribution of royalty payments.

The government will have a major opportunity to improve living standards when revenue starts to flow to the budget from LNG exports. Inclusive growth will, however, require substantial reforms to public financial management to ensure that higher expenditure improves service delivery. A rejuvenated public sector is also needed to create a more diversified private sector able to create jobs on a broad base, by rehabilitating infrastructure and by pursuing an aggressive structural reform agenda that addresses the pervasively high cost of doing business.

3.33.8 Employment



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; PNG National Census 1990; World Bank. World Development Indicators online database (accessed 15 March 2012); ADB estimates.

Timor-Leste

Economic growth remained high in 2011, supported by another large increase in government expenditure. Double-digit growth is forecast for 2012, before a moderation in fiscal expansion sees some easing in economic growth. Inflation climbed sharply, and is expected to remain internationally high in 2012 and 2013. The key economic challenge is to move from an economy driven by public sector activity to one in which the private sector plays a key role.

Economic performance

The economy's strong growth performance continued in 2011, with GDP, excluding the offshore petroleum sector and the United Nations (the measure of GDP used hereafter), expanding by 10.0%. The spending of petroleum revenue continued to drive the economy. Although the full 2011 budget allocation was not spent, government expenditure, including development partner–funded activities, reached $1.4 billion. This was an increase of 36.4% from 2010, and saw the ratio of government expenditure to GDP reach 185.5% in 2011.

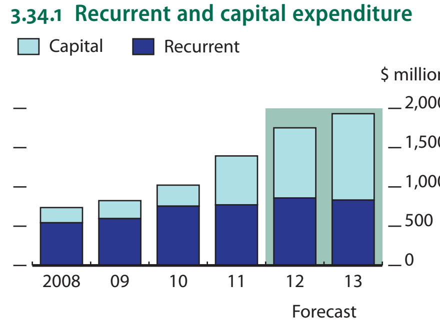
The government's capital spending more than doubled in 2011 (Figure 3.34.1), while recurrent expenditure rose by only 2.2%. Expenditure on wages and salaries rose by 22.6% in 2011 to $112 million, primarily because a large number of temporary civil service positions were converted to permanent positions during the year (Figure 3.34.2). This moved expenditure out of goods and services and this category was therefore below both the budgeted level and the outturn for 2010. Overall, 88.3% of the budget was spent in 2011, a similar ratio to the previous 2 years.

The national electrification program begun in 2008 accounted for most of the capital spending in 2011. Around half the total cost of $0.9 billion was spent during the year. The program will provide two new power stations and a new transmission system, and will greatly extend the distribution system. The first major milestone was met in late 2011, when the first power station entered operation.

A large budget surplus was again recorded. The steep rise in the world oil price boosted petroleum revenue to a new high of $3.5 billion over the year, dwarfing the $0.1 billion raised domestically. The overall budget surplus of $2.5 billion was more than three times GDP. Public savings of $2.5 billion boosted the balance in the Petroleum Fund to $9.3 billion, around 12 times GDP.

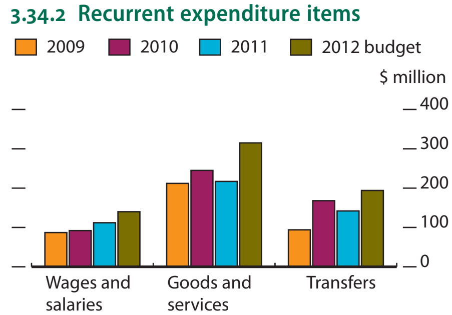
Average annual inflation was 13.1%. Inflation rose rapidly in the first quarter of 2011 as higher world oil and food prices fed through the economy. Other contributing factors to the first quarter rise were a reduction in rice subsidies, and disruption to the harvest cycle because of excessive rain in 2010. There was little additional inflation in the second

3.34.1 Recurrent and capital expenditure



Sources: ADB estimates based on Timor-Leste National Statistics Directorate. Government of Timor-Leste Transparency Portal. http://www.transparency.gov.tl/english.html; Government of Timor-Leste. *State Budget: Book 1 and Book 6*. Various years.

3.34.2 Recurrent expenditure items



Sources: ADB estimates based on Timor-Leste National Statistics Directorate. Government of Timor-Leste Transparency Portal. http://www.transparency.gov.tl/english.html; Government of Timor-Leste. *State Budget: Book 1 and Book 6*. Various years.

This chapter was written by Craig Sugden of the Special Office in Timor-Leste, ADB, Dili.

and third quarters, despite strong domestic demand. But in the final quarter, year-on-year inflation reached 15.4%.

Increased demand in the lead-up to end-of-year celebrations and the loss of capacity at the international port in Dili from October as new navy vessels occupied one of three berths were the key contributors to the fourth quarter jump in inflation (Figure 3.34.3). This jump was despite the deflationary effects of some easing in world food prices and an appreciation of the United States dollar (which is used by Timor-Leste as its official currency) against key currencies.

After 5 years of almost no change, lending levels rose by 18.5% in 2011 (Figure 3.34.4), helped by a shift in lending policy at one of the larger commercial banks toward more risk sharing. The July inauguration of the country's fourth commercial bank and the first locally owned bank, the Banco Nacional Comércio de Timor-Leste, also contributed to the rise in lending. Deposits with the banking system increased by 6.0% in 2011, while the broad money measure of money supply expanded by 9.3%.

The data show a large increase in imports during 2011, consistent with the high import content of heavy government expenditure. Merchandise imports were almost double the previous year's. Nonpetroleum merchandise exports, predominately coffee, declined by 18.5% and remained a small fraction of merchandise imports. The surplus on the income account attributable to petroleum revenue continued to outweigh the wide trade deficit in 2011, providing for a large current account surplus of more than three times GDP.

Economic prospects

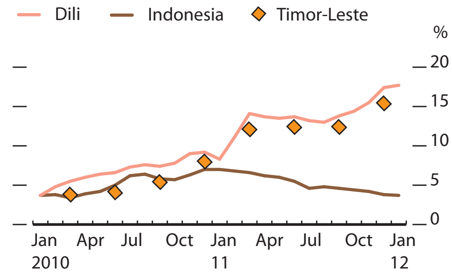
The continuing rise in government spending is projected to see the economy stay strong. But the rate of economic growth is expected to ease, from around 10.0% in 2012 to 8.0% in 2013, as the rate of fiscal expansion begins to moderate (Figure 3.34.5). Government expenditure is projected to expand by 25.7% in 2012, but by only 10.3% in 2013.

Inflation is seen remaining high in the first half of 2012. The temporary loss of capacity at Dili port, and extra demand arising from preparations for the Parliamentary elections due midyear, are expected to maintain upward pressure on prices. Inflationary pressures are expected to decline over the second half of 2012 as these effects pass, and as the departure of the United Nations mission (to be completed by 30 December) helps slow the expansion in aggregate demand. Inflation is projected to average 10.2% in 2012 before declining to 7.4% in 2013.

The budget for 2012 provides for a further large increase in government expenditure to $1.8 billion, of which $1.6 billion will be from the Petroleum Fund and domestic revenue, with the remainder from development partners. The ratio of expenditure to GDP is projected to remain close to 200% in 2012.

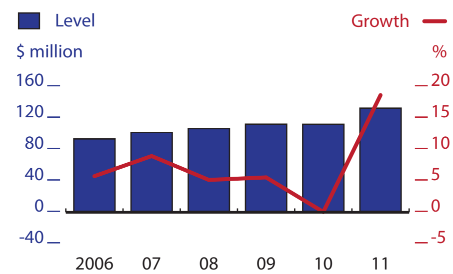
Big-ticket capital expenditure items funded from the multiyear Infrastructure Fund are again prominent in the budget. Capital spending is budgeted to rise to 100% of GDP. Outlays on the national electrification program are tapering off, but will remain high at $280 million. A large allocation is to be made for infrastructure designed to trigger industrial development on the south coast—the Tasi Mane program—and

3.34.3 Inflation



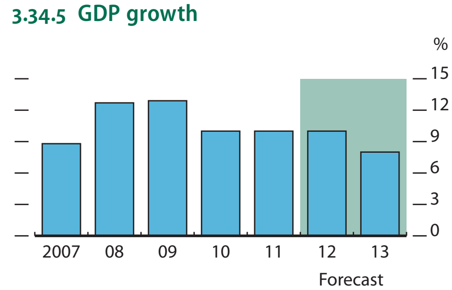
Source: Timor-Leste National Statistics Directorate.

3.34.4 Total loans and advances



Source: Central Bank of Timor-Leste.

3.34.5 GDP growth



Note: Nonpetroleum, non-UN GDP, annual growth.

Source: Government of Timor-Leste. 2011. *State Budget 2012: Budget Overview. Book 1.* November.

$170 million is allocated for road projects. Road investments will be partly funded by the government's first loans. A total of $150 million in loans from development partners is proposed to support a multiyear project to begin upgrading the country's major roads.

World oil prices are projected to remain around current levels in 2012 and 2013, underpinning high petroleum revenue (Figure 3.34.6) as well as large budget and current account surpluses. These surpluses are projected to remain close to 200% of GDP in 2012, before easing in 2013 (Figure 3.34.7).

Longer-term prospects for private sector development and the economy more broadly have been strengthened by the early 2012 government approval of a framework for public–private partnerships. The framework identifies the type of public infrastructure that may be considered for such partnerships, and how such projects will be evaluated, provisioned, and managed. It is now important to bring forward the best candidate projects to address looming infrastructure bottlenecks. Priorities are operating and maintaining the expanding electricity system, rehabilitating the only international airport, building a new international sea port, and upgrading the degraded water supply system in Dili.

A large step forward was also taken through Parliament's approval in early 2012 of a land law that provides a framework for land ownership and resolution of conflicting claims. Complementary laws that allow the state to acquire land for public purposes were also approved. These new laws extend a legal process established in 2011 for registering land claims and confirming those that are undisputed (so far, 92% of 47,000 registered claims have been undisputed). A Civil Code that came into force in March 2012 also includes a section governing day-to-day decisions such as the sale and lease of land. Such legal reforms are an essential underpinning of private sector development because they provide greater certainty over property rights.

Policy challenge highlights

A key issue facing Timor-Leste is whether the economy should be slowed in an effort to reduce inflation. While some farmers have benefited from the boost to their income provided by higher food prices, many of the urban poor are suffering from the increased cost of living. Other policy responses also warrant consideration. Notably, enhanced targeting of the government's sizable public social safety net, which received another large funding increase in the 2012 budget, could help alleviate pressures on the poor. It is also important to keep infrastructure investment high, as this is needed to alleviate supply bottlenecks and reduce the cost of local production.

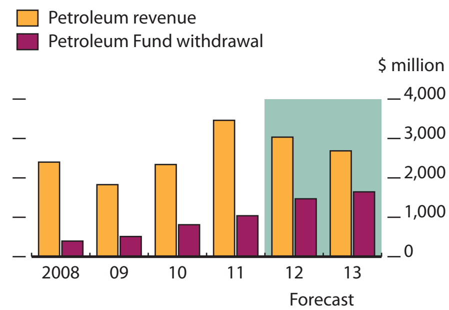
The major economic challenge remains moving from an economy in which growth has been primarily dependent on public sector activity to one in which the private sector plays a key role. The inaugural Business Activity Survey, covering 2010, has provided a reminder of the nascent state of the private sector. The survey confirmed the concentration of the formal business sector in Dili—more than 80% of employment and value-added was earned by Dili-based businesses—and its shallow structure—the retail and wholesale, construction, and accommodation and food services accounted for about 60% of total employment and value added.

3.34.1 Selected economic indicators (%)

	2012	2013
GDP growth	10.0	8.0
Inflation	10.2	7.4
Current account balance (share of GDP)	229.4	153.7

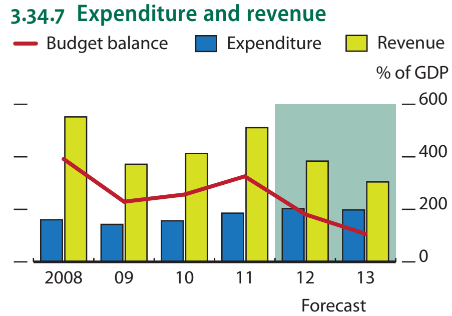
Source: ADB estimates.

3.34.6 Petroleum accounts



Sources: ADB estimates based on Timor-Leste National Statistics Directorate. Government of Timor-Leste Transparency Portal. http://www.transparency.gov.tl/english.html; Government of Timor-Leste. *State Budget: Book 1 and Book 6.* Various years.

3.34.7 Expenditure and revenue



Sources: ADB estimates based on Timor-Leste National Statistics Directorate. Government of Timor-Leste Transparency Portal. http://www.transparency.gov.tl/english.html; Government of Timor-Leste. *State Budget: Book 1 and Book 6.* Various years.

Small Pacific countries

Overall growth among the 11 small Pacific countries was faster in 2011 than in 2010. All of them except Tonga expanded. In three, the growth in gross domestic product (GDP) was 5.0% or more and the Solomon Islands—at 9.3%—was one of the fastest-growing economies in developing Asia.

The growth in tourism evident in 2010 continued in 2011, particularly in the Cook Islands, Palau, and Samoa, and the number of tourist arrivals hit records. Construction had an important influence on growth in many of the small economies, notably the Cook Islands, the Marshall Islands, Samoa, and Vanuatu, but in the Federated States of Micronesia a winding down of large public construction projects led to slower growth.

The outlook for these small economies is positive. Most of them are expected to have faster growth in 2012 than in 2011. The main exception is Solomon Islands where growth is likely to decelerate because of a decline in logging. All of them are expected to continue expanding in 2013, but all—apart from Vanuatu—at a slower pace than in 2012.

Stable oil and lower food prices will keep inflation generally lower in 2012 than in 2011, but several countries will have higher inflation on increased domestic demand and domestic constraints. In 2013, most of these economies face the prospect of slightly higher inflation, because food prices are expected to pick up.

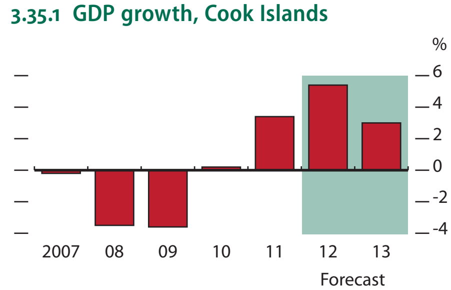
Improving government fiscal management and public sector efficiency, as well as maintaining basic public services by investing in vital infrastructure, are priority needs to support sustained growth in the small Pacific countries.

Cook Islands

After several years of negative or slow growth, the Cook Islands recovered in FY2011 (ended 30 June 2011) with GDP growth of 3.4% (Figure 3.35.1). This reflected expansion in tourism and fisheries, as well as increased construction associated with upgrading of Avatiu port. Tourism accounts for about two-thirds of GDP and an improved economic outlook in Australia and New Zealand (the source of four-fifths of arrivals) helped push visitor arrivals to over 108,000 in FY2011, a new fiscal year high. During July–December 2011, arrivals increased by 6.4% relative to the same 6 months in 2010 (Figure 3.35.2).

In FY2011, inflation slipped to 0.6% from 1.8% in FY2010, driven primarily by declines in housing and household costs, such as rent and utilities.

3.35.1 GDP growth, Cook Islands



Sources: Ministry of Finance. 2011. *2012/13 Budget Policy Statement* and *2011/12 Half Year Economic and Fiscal Update*. December; ADB estimates.

This chapter was written by Christopher Edmonds, Emma Veve, Rommel Rabanal, and Cara Tinio of the Pacific Department, ADB, Manila; Malie Lototele and Laisiasa Tora of the South Pacific Subregional Office, ADB, Suva; and Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney.

Government operating revenue was 1.9% higher in FY2011 than in FY2010, primarily because of the increased receipts from tourism. With operating expenditure edging up by 0.1%, the fiscal deficit narrowed slightly to 1.4% of GDP.

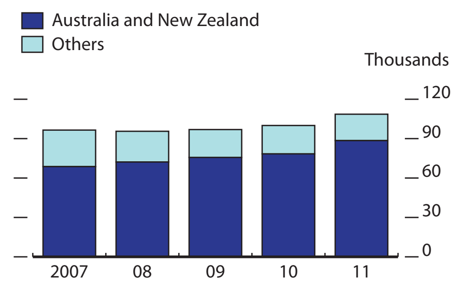
The trade deficit widened to US$286 million in FY2011. The value of merchandise imports increased by 7.7% but exports fell by 10.5%, largely owing to decreased pearl exports.

The economy is expected to grow at 5.4% in FY2012. This reflects increased visitor arrivals, particularly from Australia on the new Sydney–Rarotonga direct flights that began in July 2011. The start of large infrastructure works (roads, water, and energy) will help the expansion continue, with the economy projected to grow by 3.0% in FY2013.

In FY2012, government operating revenue is expected to increase by 3.2%. Tax revenue is forecast to rise by about 6.6% because of growth in tourism and the introduction of a withholding tax. Government operating expenses are expected to rise by 3.1% in FY2012. A budget deficit of 1.4% of GDP is forecast.

The government in 2011 carried out a functional review, which recommended that it should focus on its core business and its regulatory and enabling roles. The government will take a phased approach to implementing the recommendations for public sector reform, reflecting capacity constraints. Although the review was silent on the appropriate size of the public sector, it is an issue that the government will have to address if it is to manage spending.

3.35.2 Visitor arrivals, Cook Islands



Source: Cook Islands Statistics Office.

Kiribati

The economy grew by 3.0% in 2011 largely due to stronger retail activity. Inflation was 7.7% (compared with deflation of 2.8% in 2010) because of increased food and fuel prices (Figure 3.35.3).

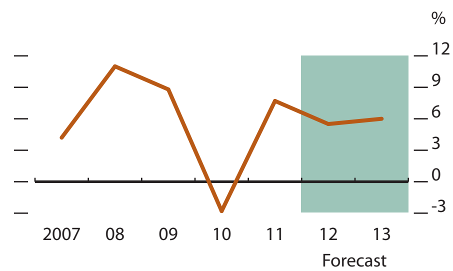
Government revenue collection in 2011 was about 20% lower than in the previous year and 9% below budget estimates. This fall stemmed from a decline in the value of income from fishing licenses and a poor fishing season. (Licenses are paid in United States (US) dollars, which depreciated against the Australian dollar, used by Kiribati as its currency.) Expenditure rose by about 10% because of increased spending on infrastructure projects.

The fiscal deficit thus widened from 8.1% of GDP in 2010 to 17.7% in 2011. The gap was partially funded by concessional borrowing, but also by a drawdown of capital from the Revenue Equalization Reserve Fund (RERF), a sovereign wealth fund, the earnings from which are intended to balance recurrent financing needs.

GDP is projected to climb by 3.5% in 2012 with the start of major development partner–funded infrastructure projects, such as road building, as well as airport and seaport reconstruction. In 2013 growth is expected to come off a little to 3.0% (Figure 3.35.4). Over the next 2 years, inflation is projected to drop to 5.5% and then increase to 6.0%, reflecting expected movements in international food prices.

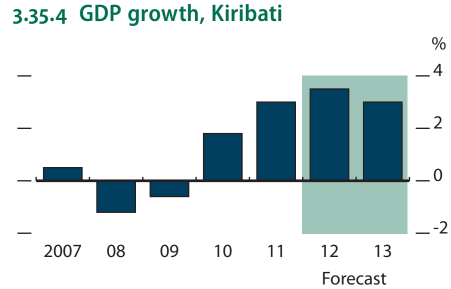
A new government took office in January 2012. Its first budget, which should be presented in April, is likely to see a widening of the fiscal deficit, reflecting a scheduled increase in infrastructure spending. The

3.35.3 Inflation, Kiribati



Sources: International Monetary Fund. 2011. *Article IV Consultation*. May. http://www.imf.org; ADB estimates.

3.35.4 GDP growth, Kiribati



Sources: International Monetary Fund. 2011. *Article IV Consultation*. May. http://www.imf.org; ADB estimates.

deficit will be partly funded by an RERF drawdown, raising concerns about the fund's long-term sustainability after drawdowns averaging around A$17 million in the last four years.

Growth of the RERF is the key to ensuring long-term fiscal sustainability. Reducing the annual demands on the fund to a level that can be met from its income will require extensive fiscal consolidation. Over the medium term, the government should aim to stabilize the value of the RERF, by keeping budget deficits to 5–6% of GDP. Stronger control of expenditure on personnel costs is one option it could investigate.

Marshall Islands

Economic growth slowed slightly to 5.0% in FY2011 (ended 30 September 2011). This solid performance was supported by fishing activity, continued high spending related to US military operations under the Kwajalein Land Use Agreement, and the upgrade of the international airport in Majuro.

Inflation shot up to 9.5% (from 1.6% in FY2010). Steep rises in the prices of commodities (which have a weighting of nearly 50% in the consumer price index), high transport costs arising from the country's remote location, and the pickup in domestic demand drove this increase.

The fiscal surplus fell from 4.6% of GDP in FY2010 to 1.4%. Although grants declined, domestic revenue—mainly from fishing license fees—rose. Public expenditure climbed by 6.1%, reflecting, primarily, increased purchases of goods and services.

The current account remained in deficit (12.6% of GDP). Although merchandise exports expanded by 26.5% to US$40.8 million, imports reached US$114.5 million.

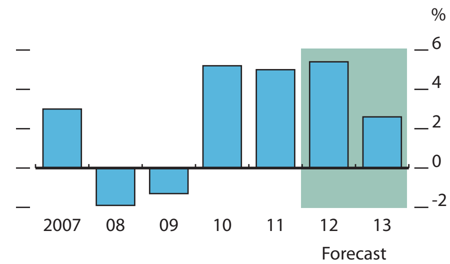
Economic growth is foreseen to reach 5.4% in FY2012, boosted by continued growth in fisheries and airport-related construction, before slowing to 2.6% in FY2013 (Figure 3.35.5). FY2013 is likely to see a fiscal surplus of slightly over 1% of GDP. A projected step-up in grants will finance about 70% of the budget and contribute to a 5.1% gain in total receipts. Total government expenditure will rise by 5.7%, partly due to greater subsidies to state-owned enterprises (SOEs).

Inflation is projected to slow to 2.5% in FY2012 before accelerating to 3.0% in FY2013, in line with expected trends in global food prices (Figure 3.35.6).

The current account deficit is forecast to widen to 30.3% of GDP in FY2012. Although merchandise exports will grow by 14.8%, imports are expected to jump by 29.8% owing to continued demand from the airport upgrade and expansion of fisheries.

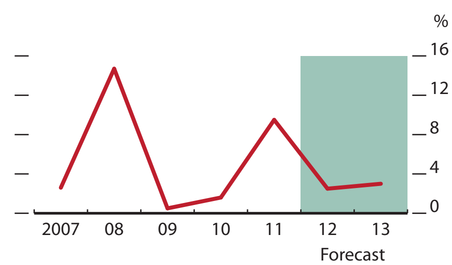
The country has to build up the Compact Trust Fund to prepare for fiscal self-sufficiency once US Compact grants expire in 2023, while paying down the high government debt. It also needs to generate sustainable economic growth. Fiscal and structural reforms are needed to stimulate private sector economic activity, generate domestic employment and income, and broaden the local tax base. Tax reforms are required to increase government revenue and offset planned reductions in grants. In addition, SOE reforms and cutbacks in public expenditure are needed to improve the fiscal balance.

3.35.5 GDP growth, Marshall Islands



Sources: Republic of Marshall Islands Fiscal Year 2010 Economic Review. http://www.pitiviti.org; International Monetary Fund. 2011. *Article IV Consultation—Staff Report.* November. http://www.imf.org

3.35.6 Inflation, Marshall Islands



Sources: Republic of Marshall Islands Fiscal Year 2010 Economic Review. http://www.pitiviti.org; ADB estimates.

Federated States of Micronesia

Public infrastructure construction continued to support economic growth in FY2011 (ended 30 September 2011). This was the third consecutive year of growth supported by airport improvement projects funded through US Federal Aviation Authority grants. However, as some projects reached their final stages, growth fell from 3.1% to 1.4% (Figure 3.35.7). Consumer spending appears to have recovered in FY2011, with the value of food imports from the US—the country's largest trading partner—increasing by about 8%.

Inflation rose to 7.9% in FY2011, due mainly to higher oil prices. The retail gasoline price was 30% higher in March 2011 than a year earlier.

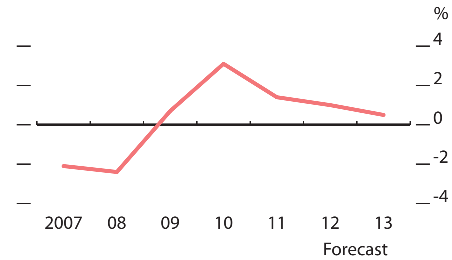
Progress in fiscal consolidation resulted in a small budget surplus, equivalent to about 0.4% of GDP in FY2011 (Figure 3.35.8). This is the third year of surplus following years of earlier deficits. Capital expenditure was cut by about 13% after the completion of some public works projects, and the reduction in government spending was about 2% for the year.

The modest pace of economic expansion is expected to moderate further to 1.0% in FY2012 as some infrastructure projects such as the Pohnpei airport runway extension are finished. In FY2013, GDP growth is forecast to tail off to 0.5% as more projects are completed. Weak private activity and annual declines in grants under the Compact of Free Association with the US also contribute to a subdued growth outlook.

Inflation of 3.5% is projected for FY2012 as prices of internationally traded commodities, other than oil, decline. In FY2013, inflation is expected to rise slightly to 4.0%, reflecting an assumed rise in global demand.

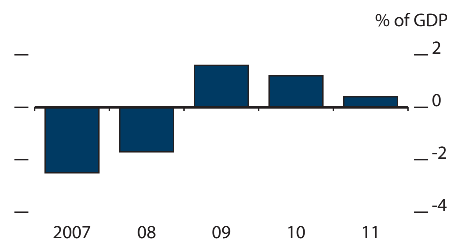
Small fiscal surpluses are projected for FY2012 and FY2013 but these fall short of target levels. In order to achieve savings in the FSM Compact Trust Fund to generate sufficient income to replace annual compact grants, which expire in FY2023, further fiscal consolidation is needed. This might involve a reduction in the public sector wage bill and revenue-raising measures (i.e., tax reforms and improvements in tax administration) to maintain fiscal surpluses over the long run.

3.35.7 GDP growth, Federated States of Micronesia



Sources: Pacific & Virgin Islands Training Initiatives. *Federated States of Micronesia Fiscal Year 2010 Economic Review.* http://www.pitiviti.org; ADB estimates.

3.35.8 Fiscal balance, Federated States of Micronesia



Sources: International Monetary Fund. *Federated States of Micronesia—2011 Staff Visit Preliminary Conclusions.* http://www.imf.org; ADB estimates.

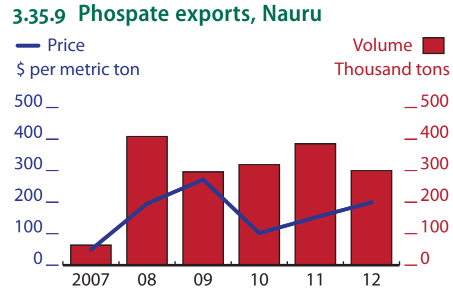
Nauru

The economy grew by 4.0% in FY2011 (ending 30 June 2011) largely because phosphate exports increased by more than 20% (Figure 3.35.9). The country has been experiencing deflation for the last few years and in FY2011 the consumer price index declined by 3.5%, in part because of appreciation of the Australian dollar (which Nauru uses as its official currency).

Government revenue in FY2012 is expected to be A$31.6 million and expenditure A$32.5 million, yielding a small deficit of A$0.9 million. Cash reserves brought forward from FY2011 will, however, result in a small surplus.

The Australian Agency for International Development estimated that in 2006 government debt obligations to external and internal debt holders were A$371.4 million, and A$264.8 million respectively, an enormous burden relative to GDP. By September 2010, overall debt had been reduced—external A$69 million and internal A$481 million. Nauru generally runs large current account deficits funded by development-partner inflows.

3.35.9 Phospate exports, Nauru



Note: Fiscal year ending June. FY2012 figures is for the first 7 months only.

Sources: Republic of Nauru Phospate Company; World Bank. *Pink Sheet.* http://go.worldbank.org/4ROCCIEQ50 (accessed 6 February 2011).

Recently improved phosphate-loading facilities are expected to lift phosphate exports to 450,000 tons in FY2012 from 350,000 tons in FY2011, taking economic growth to 4.8% in FY2012 and 4.2% in FY2013.

The level of national debt precludes sovereign borrowing, so Nauru will maintain near-balanced budgets in the forecast period. Recent reforms to the phosphate export enterprise may improve fiscal performance gradually. Inflation is expected to turn positive, as currency appreciation effects wash through, and average 1.5% and 2.0% in the next 2 fiscal years.

The limited growth prospects for very small Pacific countries, such as Nauru, were acknowledged in a recent review of Australia's official development assistance (ODA). A planned increase in ODA, to offset the lack of private sector activity, is likely to be delivered through program-based approaches. This will require improvements to the country's public financial management strategies in order to efficiently absorb and manage higher ODA levels and translate this into economic growth.

Palau

The economy grew by 5.8% in FY2011 (ended 30 September 2011), up from 0.3% the previous year. Growth reflected strong data for tourism, which accounts for about half GDP. Arrivals from Asia, particularly East Asia, rose steeply (Figure 3.35.10), aided by the addition of Delta Airlines flights between Palau and Japan. In FY2011, visitor arrivals increased by over 25% and exceeded 100,000 for the first time.

Rising food and transport costs raised inflation to 2.1% in FY2011, from 1.2% in FY2010. Inflation largely tracks price developments in the US—Palau's primary trading partner—in the absence of any major domestic inflationary factors.

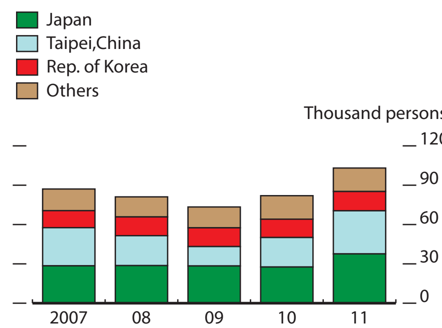
The government continued to reduce expenditure (by 3.1% during FY2011), with cuts focused on publicly provided goods and services. Public sector wages and salaries, which account for over a third of total government spending, rose by about 5% in FY2011. The fiscal deficit widened to 2.3% of GDP as lower grants from the US outweighed an increase in domestic revenue associated with the economic recovery.

Tourism will remain the key source of growth for the foreseeable future, and visitor arrivals will continue to depend on developments abroad—particularly in Japan; Republic of Korea; and Taipei,China. Palau's visitor arrivals are projected to go up by 7.5% and 6.0% in the next 2 fiscal years, supporting GDP growth of 3.0% and 2.0% (Figure 3.35.11).

Inflation is projected to fall to 2.0% in FY2012 and to edge up to 2.5% the following year, in line with expected international commodity price trends.

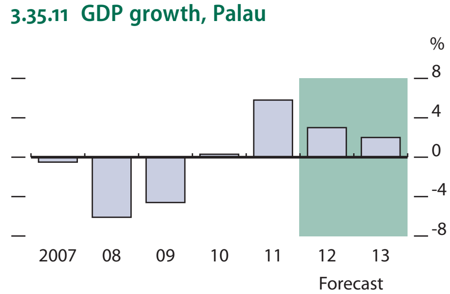
The government is expected to maintain its contractionary fiscal stance on concerns about its fiscal position. Comprehensive civil service reform is needed to reduce the public sector wage bill. New revenue-raising measures, including increased tax rates for high-income earners and a steeper hotel-room tax, are under consideration and are likely to be adopted this fiscal year. Further tax reforms, such as a value-added tax, may also be required.

3.35.10 Visitor arrivals, Palau



Source: Palau Visitors Authority. http://www.visit-palau.com (accessed 16 March 2012).

3.35.11 GDP growth, Palau



Sources: Pacific Financial Technical Assistance Centre; ADB estimates.

Palau's tourism-oriented economy relies heavily on basic public goods like transport infrastructure and reliable service delivery. These facilities are, though, approaching full capacity and need to be expanded. Sustaining tourism growth would also benefit from improvements in the business environment, such as simplifying licensing procedures and expanding access to skilled labor and credit.

Samoa

Growth picked up to 2.1% in FY2011 (ended 30 June 2011), from 0.2% the previous year (Figure 3.35.12), reflecting growth in construction as infrastructure projects were continued or initiated. Higher consumer spending also contributed, fueled by rising remittances (particularly from Australia and New Zealand). Construction-related industries like transport and communications posted modest growth, as did tourism.

Average annual inflation rose to 2.9% in FY2011, driven by higher prices for imported food (mainly rice, flour, and chicken) and fuel.

Government revenue and expenditure were generally in line with budget targets, except development spending. This category was underspent by 18.9%, given slow activity at several construction projects. The fiscal deficit was 6.5% of GDP, lower than the budget estimate of 9.6% and the FY2010 outturn of 7.4%. The narrower deficit was in line with the recommendation of the International Monetary Fund to move toward a medium-term target of no more than 3% of GDP by FY2013. Although Samoa remains at low risk of debt distress, public debt is rising and is close to 40% of GDP in present value terms. Accelerating the pace of fiscal consolidation would ensure adequate capacity to absorb shocks in the future and accommodate rising debt repayments.

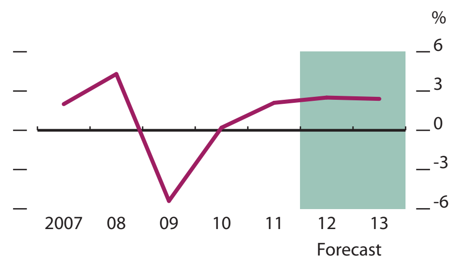
The Central Bank of Samoa continued easing monetary policy to stimulate economic activity and stabilize the economy. It reduced its policy rate, and through its credit line facility lowered lending rates to the Development Bank of Samoa and the Samoa Housing Corporation. Credit to the private sector recovered but grew by only 6.5% in FY2011, in line with weak economic activity and despite ample financial sector liquidity and low nonperforming loans.

The current account deficit remained at about 9.3% GDP in FY2011 (Figure 3.35.13) as some recovery in incomes from tourism and remittances offset a wider merchandise trade deficit (due to higher petroleum payments and increased imports associated with post-September 2009 tsunami reconstruction). Total imports rose by 11.4% (in US dollar terms), and exports of fresh fish, beer, and nonu juice fell by 5% due to weakening demand in major markets, including Japan and New Zealand.

The economy is expected to grow by 2.5% and 2.4% in the next 2 fiscal years, driven mainly by tourism and remittances. Tourism earnings in the first 6 months of FY2012 were 2% higher than the equivalent FY2011 period. Private remittances rose by 3% to US$86.7 million during the same period. This expansion, however, will not be enough to fully offset the withdrawal of fiscal stimulus.

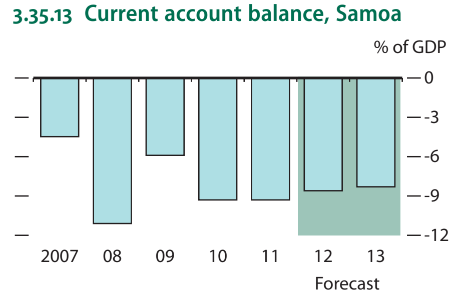
Medium-term prospects will depend on how the US, Australian, and New Zealand economies perform; these countries are Samoa's largest trading partners and main sources of remittances and tourist arrivals.

3.35.12 GDP growth, Samoa



Note: Fiscal year ending June.
Sources: Samoa Bureau of Statistics; ADB estimates.

3.35.13 Current account balance, Samoa



Sources: Central Bank of Samoa; Samoa Ministry of Finance. 2011. *Fiscal Strategy Statement 2011/12*. May.

Also, manufacturing output is likely to decline given the scaling down of production at the Yazaki auto-part plant due to a reduction in wire harness orders from Toyota Australia.

The FY2012 budget projects the fiscal deficit to remain at 6.5% of GDP.

Inflation is expected to continue rising to about 5.0% in FY2012—as strong domestic demand counteracts increased local agricultural production and falling international commodity prices—but then to fall back to 3.3% in FY2013.

The balance of payments is projected to record an overall surplus in FY2012 due to the anticipated heavy influx of donor funds (about US$100 million in external grants and loans). Exports of artesian water, fish, and nonu juice are likely to benefit, as the People's Republic of China phases in duty-free entry of a greater range of Samoan products in line with a July 2010 trade agreement.

Continued efforts to advance fiscal consolidation and to lower public debt are essential to create the fiscal flexibility necessary to enable the government to respond to external shocks.

Solomon Islands

The economy grew at 9.3% in 2011–the fastest of the Pacific island countries. As in previous years, the major contributor to growth was log production, where output was more than 1.9 million cubic meters, around one-third more than in 2010. This reflected continued high demand in Asia. The country also benefited from high international prices for other commodities such as palm oil, cocoa, copra, and fish, as well as renewed gold exports from the Gold Ridge mine in Guadalcanal, which resumed production after closing in June 2000 due to civil conflict.

After falling to 1.0% in 2010, inflation jumped to 7.4%, largely reflecting strong growth and higher global food and energy prices. In 2011, the central bank allowed the Solomon Islands dollar to appreciate vis-à-vis the US dollar by 8.7% in an explicit effort to contain inflation. It also resumed issuing its own short-term bills to reduce liquidity in the banking system. After contracting in 2010 and the first 9 months of 2011, credit growth increased to 7.2% in the last quarter of the year.

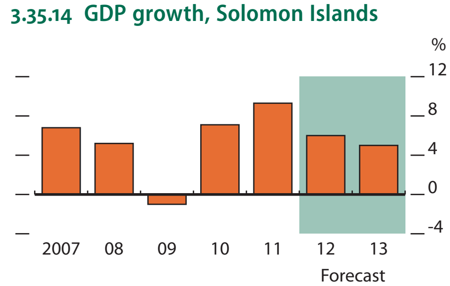
A budget surplus equivalent to 2.1% of GDP was recorded in 2011. Revenue increased by almost 25% from 2010. Strong production of logs and favorable prices in 2011 boosted customs duties, while strong economic activity and elevated fuel prices led to higher inland revenues (i.e., goods and sales taxes, personal and corporate income taxes).

Overall recurrent expenditure grew by 1.2% in 2011, with payrolls growing by 4.2% owing to cost-of-living adjustments to public service salaries. Development expenditure grew by 54% during the year. Public debt declined from 24.0% of GDP in 2010 to 21.6% in late 2011, related to debt repayments and an increase in nominal GDP.

The current account deficit narrowed to 11.2% of GDP, from 27.6% in 2010 on higher exports and reduced imports of capital equipment following the reopening of the Gold Ridge mine. The deficit has been funded through donor inflows and foreign investment. Foreign reserve cover improved to over 9 months of imports as of December 2011.

Growth is expected to moderate to 6.0% and 5.0% over the next

3.35.14 GDP growth, Solomon Islands



Sources: Solomon Islands National Statistics Office; ADB estimates.

2 years (Figure 3.35.14). Reduced logging output, due to overexploitation of the native forest, will be partly offset by increased value of gold output, as the Gold Ridge mine reaches full output, and by strengthening commodities such as palm oil, copra, and vanilla.

The 2012 budget is balanced. Expenditure is to increase by 47%, which will be covered by a 22.4% gain in revenue, a drawdown on the National Transport Fund for development projects, and by using grants from the Regional Assistance Mission to Solomon Islands (RAMSI). To help preserve the budgetary position if the strong revenue growth does not continue, much of the increase in spending is in one-time items such as the hosting of the Pacific Arts Festival, or items that can be scaled back, including a planned doubling of debt repayments in late 2012.

This rate of expenditure growth, however, is unsustainable and will need to be reduced in future budgets.

Inflation is expected to moderate over the next 2 years as growth and global commodity prices ease. Average inflation of 5.5% and 5.0% are forecast (Figure 3.35.15). The central bank will likely continue to let the exchange rate appreciate modestly if inflation does not moderate.

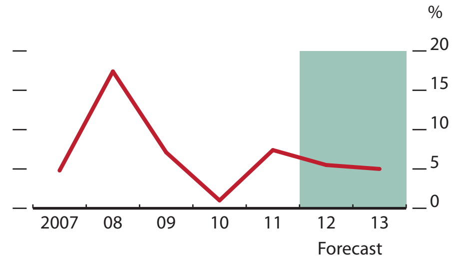
The current account deficit is forecast to widen to around 15.0% of GDP in 2012 and 2013 as a result of slower export growth. The gap will be funded through continued donor inflows and foreign investment. Foreign reserves should remain at around 7–8 months of imports.

The private sector faces numerous challenges to doing business. It must compete with SOEs, which receive preferential access to resources and operate in markets reserved for them, such as power and water supply. The SOEs hold nearly a quarter of the nation's fixed assets, absorb large amounts of scarce capital, and generally yield negative returns on their fixed assets and investments, thereby increasing costs for private enterprises.

A State Owned Enterprise Act, passed in 2007, and its accompanying regulations, issued in 2010, now provide a robust framework for SOE governance and monitoring. Implementation of this act—including improving the accuracy and timeliness of the financial information prepared by SOEs as well as requiring proper costing, funding, and documentation of all community service obligations—is essential to improving efficiency and accountability.

Major gaps exist in access to infrastructure across the country. A majority of the nation's rural population does not, for example, have access to paved roads, regular electricity supplies, or telecommunications.

3.35.15 Inflation, Solomon Islands

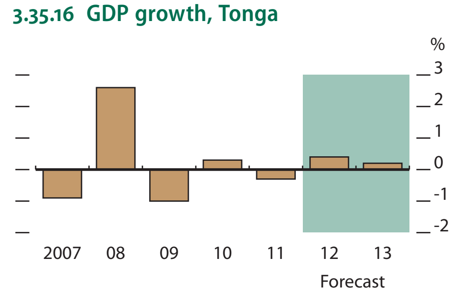


Sources: Central Bank of Solomon Islands; ADB estimates.

Tonga

The economy contracted by 0.3% in FY2011 (ended 30 June 2011) after growth of 0.3% the previous year (Figure 3.35.16). Remittances, coming largely from the US, continued to decline, and, coupled with banks' steps to repair their balance sheets, affected both business and household investment and consumption. Tourism, and particularly the cruise liner market segment, was the bright spot in the economy, with tourism receipts growing by 14.8% (in real terms) in FY2011 from the previous year.

3.35.16 GDP growth, Tonga



Sources: Ministry of Finance and National Planning; ADB estimates.

Inflation rose to about 6.1%, reflecting the surge in global fuel and food prices and higher excise taxes on tobacco and alcohol.

Revenue in FY2011 was 5.8% more than in FY2010, but despite this and receipt of budget support grants from development partners, the FY2011 fiscal deficit widened to 7.9% of GDP, financed mainly by loans from the EXIM Bank of China and drawdowns on domestic cash balances. The share of public debt to GDP rose to 56.1% (including the undisbursed portion of loans) by end-FY2011, exceeding the government's target ceiling of 40%.

To boost commercial bank lending, the central bank continued to ease monetary policy, although lending to businesses and households in 2011 continued declining, by 11.1% and 4.6%, respectively.

In the external account, fish and squash exports (which account for more than half of all exports) grew by only 1.9% in FY2011 (after more than doubling in FY2010) given problems in meeting quarantine requirements for New Zealand, and unfavorable weather. Imports, dominated by basic consumption goods, increased by 16.6%, largely due to higher oil prices as well as increased imports of wholesale and retail goods and construction materials.

Foreign reserves remained at comfortable levels, reaching 7.7 months of imports, reflecting receipts of development-partner funds, ample liquidity in the financial system, and weak business and household activity.

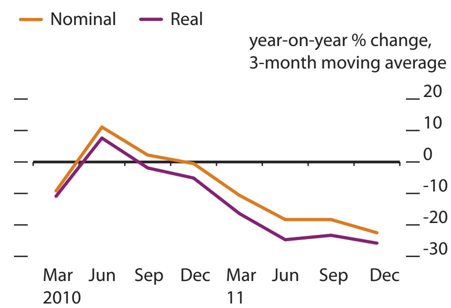
The economy is forecast to show virtually zero growth in the next 2 years. Domestic economic activity is expected to remain weak despite donor-funded public construction, in view of declining remittances and flat credit growth, which will affect household consumption and private sector investment.

A bleak outlook on remittances is also foreseen given the slow recovery in the US and continuing high unemployment in other source economies such as New Zealand. Government analysis suggests remittances are likely to be permanently lower than in the past (Figure 3.35.17). Exports, which are around 3% of GDP, could, however, lead a stronger expansion of the economy if supply-side constraints are addressed and compliance with export market quarantine standards improves.

The central bank is expected to continue its loose monetary policy stance, unless global commodity prices rise further. Inflation is likely to hover around 6.0% in FY2012.

Tonga is classified by the International Monetary Fund as at high risk of debt distress. The high public debt and its composition pose serious challenges. Debt repayments are expected to increase by 70% in FY2014, when repayments start on a loan from the EXIM Bank of China. It is critical that the government uses year-end cash surpluses, reprioritizes expenditure, and raises the tax effort to build cash reserves, which could provide a buffer against cross-currency foreign exchange risks and safeguard the government's expenditure programs.

3.35.17 Private remittances, Tonga



Source: National Reserve Bank of Tonga.

Tuvalu

After 2 years of contraction, the economy grew by 1.0% in 2011 (Figure 3.35.18), largely due to higher remittances. The consumer price index increased by 0.5% in 2011, which was lower than in most other Pacific economies, reflecting the appreciation of the Australian dollar (which Tuvalu uses as its currency) against the US dollar.

Total revenues and grants for 2011 were slightly below budget but about 20% higher than in 2010. The increase was mainly due to the grants. Government expenditure fell by more than 7% as subsidies were reduced and spending on capital projects declined. These developments led to a reduction in the fiscal deficit from over 30% of GDP in 2010 to about 8% in 2011. However, weakly controlled spending on the Tuvalu Medical Treatment Scheme remains a heavy drain on the budget with actual expenditure 70% above budget in 2011. Total government debt was estimated at 44.3% of GDP in 2010, and may be higher with the status of contingent liabilities from joint-venture fishing companies to be determined (Figure 3.35.19).

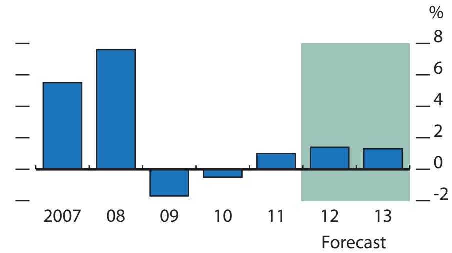
The market value of the Tuvalu Trust Fund stood at A$115.1 million as of 30 September 2011. As this was 9.7% below its prescribed maintained value, nothing was distributed from the fund to the Consolidated Investment Fund (CIF—the vehicle through which budget deficits are financed).

Growth is expected to edge up to 1.4% and 1.3% in the next 2 years, supported by development partner–financed upgrading of the Tuvalu airfield and airport. Increases in remittances are also expected.

Total revenue and grants are budgeted at A$24.1 million in 2012, 7% less than the 2011 outturn, due to a projected 3.3% reduction in receipts from fisheries licenses and lower grant funds. Government expenditure is estimated at A$29.2 million (13% below the 2011 projected outturn) as the government tries to control spending. At A$5.1 million, the budget deficit is forecast at 14.3% of GDP. The CIF held A$3.1 million in December 2011 and, given the expected deficit, is likely to be exhausted this year. Further distribution from trust fund earnings is not expected until 2014 at the earliest.

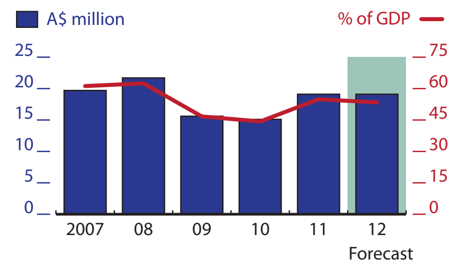
The fiscal situation remains precarious. With the likely exhaustion of the CIF in 2012, development partners will become the primary avenue for budget financing, underlining the importance of reforms and expenditure controls.

3.35.18 GDP growth, Tuvalu



Sources: International Monetary Fund. 2011. *Article IV Consultation*. August. http://www.imf.org; ADB estimates.

3.35.19 Total government debt, Tuvalu



Sources: International Monetary Fund. 2011. *Article IV Consultation*. August. http://www.imf.org; ADB estimates.

Vanuatu

Growth nearly doubled in 2011 to 4.3%, reflecting strong agricultural exports (notably copra and coconut oil), high international commodity prices, and growth in construction. Tourist arrivals fell, however, by 3.5% from the 2010 level, which had been inflated because flooding in Fiji diverted tourists to other destinations (Figure 3.35.20).

Despite high global energy and food prices, the consumer price index rose by just 0.8% in 2011. This was partly explained by a slowdown in growth of private credit.

The current account deficit was steady at 5.9% of GDP in 2011, and was more than covered by foreign investment and donor inflows. By

3.35.20 Visitor arrivals, Vanuatu

Source: Vanuatu National Statistics Office.

December 2011, foreign exchange reserves had risen to 6.3 months of import cover, from 5.8 months in March 2011.

Economic growth of 4.5–5.0% is forecast over the next 2 years (Figure 3.35.21). This will be driven by increasing construction, continuing strength in agricultural production, and recovering tourism (additional flights are planned from Australia and Fiji).

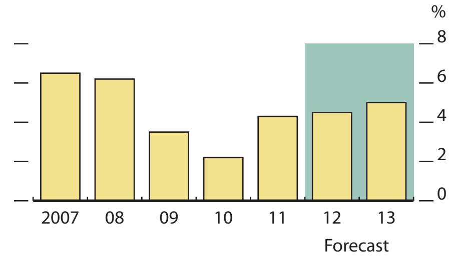
Small fiscal deficits of 1.5% and 2.7% of GDP are expected as the government increases borrowing to fund improvements to infrastructure. Public debt as a share of GDP is expected to remain around 20%, as higher debt is offset by growth in nominal GDP. If, however, contingent liabilities associated with past losses of some of the poorer performing SOEs were included, debt as a share of GDP would likely exceed the government's ceiling of 40%.

Inflation is expected to pick up as the economy grows, to around 3.0–4.0% in the next 2 years.

The current account deficit is forecast to widen a little to 6.3–6.5% of GDP over the next 2 years, as a result of stronger imports related to infrastructure projects. The gap will be funded through continued donor inflows and foreign investment. Foreign exchange reserves are expected to remain at levels needed to finance 5–6 months of imports.

Vanuatu became WTO's 154th member in November 2011. Joining required reductions in tariffs but the resulting loss in revenue will be partly offset by excise tax increases. Taxes as a share of GDP are already relatively low at around 19% of GDP. Thus, as the indirect tax base erodes, the government will need to consider bringing in measures to broaden the tax base, such as a progressive income tax.

3.35.21 GDP growth, Vanuatu



Sources: Vanuatu National Statistics Office; ADB estimates.